Annual Audits

The objective of an audit is to obtain independent assurance that a community's year-end financial statements are reliable, accurate, and complete. An audit also helps to ensure that financial checks and balances are in place to protect public assets. Consequently, it can be a powerful tool by which a community can build taxpayer confidence in government operations.

The Division of Local Services (DLS) encourages communities to have an independent audit performed by a certified public accountant each and every year. Cities and towns that receive in excess of $500,000 annually in federal funds (even if received indirectly through a state agency) are required to complete an annual audit that complies with the federal Single Audit Act of 1984. In each instance, financial statements must be prepared according to Generally Accepted Accounting Principals (GAAP).

An audit of a municipality's financial statements provides information that is especially valuable when credit rating agencies review and report on a city or town's fiscal condition as it prepares to enter the bond market. A municipality's inability to produce accurate financial reports could have a negative impact on its bond rating and a rating agency's opinion about its financial outlook. A credit rate reduction could result in hundreds of thousands, and possibly millions of dollars, in additional interest payments for taxpayers over the life of a borrowing. As important, a rate increase can create savings. The independent audit can also be a valuable management tool for assessing the fiscal performance of a community.

Although communities, which are not subject to the single audit act or do very little borrowing, are free to operate without regular audits of their financial statements, it is not a prudent course. Funding an audit at least every two or three years is still recommended. Otherwise, the costs can be high.

If a community is experiencing financial problems, the underlying causes will not be revealed if audits are infrequent. As a result, important decisions could be based on an inaccurate understanding of city or town finances. Checks and balances could be weakened and public assets could be at risk. Another downside of infrequent audits can be real dollar costs. When audits are conducted every three years, the auditor cannot rely on the accuracy of the prior year's, unaudited ending balances. Consequently, additional time (at a cost premium) is necessary to verify the accuracy of beginning balances.

Often the most important steps a municipality can take, occur long before the audit is complete. The quality of an audit is directly related to the knowledge, experience and professionalism of the selected auditor. Therefore, when selecting an outside auditor or audit firm, DLS recommends that the appointing authority be independent of those who will be the subject of the audit. Many municipalities create audit committees to fulfill this, and other, functions.

In general, members of the financial offices and a manager/administrator should be excluded from the audit committee and the hiring process in order to avoid the potential, or the appearance of conflict, since reviews effectively report on their performance. On the other hand, members of the town finance committee or city council are potential candidates. Residents with appropriate work experience or professional backgrounds can also make a valuable contribution to an audit committee.

As part of the process to procure services, an audit committee should determine in advance the requirements and objectives of the audit, as well as select the individual auditor or audit firm. The committee should attend an exit interview at the completion of the audit. More important, the committee should monitor the progress of municipal action to correct deficiencies cited in the audit report.

State law (M.G.L. Chapter 44 Section 42) requires communities to submit completed audits to the DOR Director of Accounts. State law also exempts contracting for audit services from the State Procurement Laws (M.G.L. c. 30B). It should be noted, as well, that an audit report is a public record.

An audit generally has three components including an opinion, followed by financial statements, and a separately provided management letter. Under professional codes of conduct, auditors are not permitted to prepare a municipality's financial statements. The role of the auditor is to review and comment on the accuracy and reliability of a municipality's year-end financial statements.

Toward this end, auditors will review the operating procedures, confirm that financial controls are in place and comment on the management practices as they relate to checks and balances. If he or she discovers deficiencies in systems, procedures and practices, they will be cited as "reportable conditions." A more significant problem or deficiency will be reported as a "material weakness." Technically, a material weakness is defined as a reportable condition of such magnitude that it could potentially result in material misstatements of the city or town's financial condition.

In the opinion, the auditor explains what tests, or measures, the independent auditor applied and what was found. An unqualified or "clean" opinion reflects an auditor's belief that the financial statements are fairly presented and in compliance with GAAP standards. A qualified opinion is issued when the auditor has reservations. Most damaging is an adverse opinion which is the auditor's statement that the financial statements do not comply with GAAP, or are otherwise inaccurate or unreliable.

Any observed or detected weakness is typically commented on in the management letter. If the management letter reveals improper or inadequate financial procedures, the problems should be corrected as soon as possible. A management letter should include a response from the municipality to each comment. It would clarify an issue or outline corrective action to be taken. Municipal responses are most appropriately developed by the city or town's financial management team.

Ultimately, effective use of the audit report recommendations can assist the community in improving its financial controls and practices. The result will be protection of community assets, potential upgrades in a community's bond rating, and increased public confidence in the government.