Annual External Audits
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DLS
DIVISION OF LOCAL SERVICES
MA DEPARTMENT OF REVENUE

The objective of a year-end, external audit is obtaining an independent assurance as to whether a community's year-end financial statements are presented in accordance with provisions established by the Governmental Accounting Standards Board. By integrating a review of the internal controls associated with financial reporting, the audit also helps to ensure that financial checks and balances are in place to protect public assets. Consequently, regular external audits can provide a powerful tool by which a community can build taxpayer confidence in government operations.

The Technical Assistance Bureau (TAB) encourages communities to have independent audits performed by certified public accountants every year. Cities and towns that receive at least $750,000 annually in federal funds (even indirectly through a state agency) are required to complete annual audits that comply with the federal Single Audit Act of 1984.

Financial statement audits provide information that is especially valuable when a credit rating agency reviews and reports on a municipality's fiscal condition as it prepares to enter the bond market. A city's or town's inability to produce accurate financial reports could negatively impact a rating agency's opinion on its financial outlook and therefore affect its bond rating. 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, depending on the size and structure of the debt. 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 that are not subject to the Single Audit Act or that do very little borrowing are free to operate without regular audits of their financial statements, it is not a prudent course. Funding audits at least every two or three years is still strongly recommended. If a community is experiencing financial problems, the underlying causes will not be revealed by infrequent audits. 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 left at risk.

Often the most important steps a municipality can take occur long before the audit is conducted. An audit's quality is directly related to the auditor's knowledge, experience, and professionalism. Therefore, when selecting an outside auditor or audit firm, TAB recommends the appointing authority be independent of those who will be the subjects 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 auditor hiring process to avoid the potential for, or 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 valuable contributions to an audit committee.

As part of the process to procure services, an audit committee should determine in advance the audit's requirements and objectives and select the individual auditor or audit firm. State law also exempts contracting for audit services from the state procurement laws (M.G.L. c. 30B). The committee should attend an exit interview at the audit's completion and monitor the progress of municipal action to correct any deficiencies cited in the audit report.

It happens that municipalities will rely on one auditor or audit firm for multiple years. In fact, the Government Finance Officers Association (GFOA) recommends that communities engage the same auditor by entering into multiyear agreements, or a series of one-year contracts, for a term of at least five years. A multiyear agreement allows for greater continuity and enables a new auditor to spread initial start-up costs over multiple years, potentially reducing costs in the initial years. However, after this term, the GFOA recommends a full, competitive selection process and a rotation of auditors after each multiyear agreement, provided there is adequate competition among qualified auditors. Contracting with a new audit firm not only brings a fresh perspective, but it also reflects good practice. In general, communities are encouraged to re-advertise for auditing services every five to eight years. The GFOA acknowledges that there may be circumstances or locations where there is a lack of competition among fully qualified auditors. In such cases, participation of the current auditors is acceptable, assuming their past performance has been satisfactory and conformed to industry standards.

State law requires communities to submit completed audits to the Division of Local Services, Director of Accounts (M.G.L. c. 44, §42). It should also be noted that an audit report is a public record.

An audit generally has three components: an opinion, the financial statements, and a separately provided management letter. The auditor's role is to review and comment on the accuracy and reliability of a municipality's year-end financial statements, and under professional codes of conduct, auditors are not permitted to prepare the financial statements. The auditor should review the operating procedures, confirm whether financial controls are in place, and comment on management practices relating to checks and balances. If deficiencies are discovered in procedures or practices, the auditor will cite them as 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 a magnitude that could potentially result in material misstatements of the municipality's financial condition.

In the opinion, the auditor explains the tests or measures that were applied and what was found. An unqualified or "clean" opinion reflects the auditor's belief that the financial statements are fairly presented and comply with GAAP standards. The auditor issues a qualified opinion when he or she 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.

In the management letter, the auditor comments on any observed or detected weaknesses. The pertinent members of the city's or town's financial management team should provide written responses to every comment. Here, financial officials can clarify issues but should also outline a corrective action plan for each citation. The community should resolve all identified problems as soon as possible.

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