

## CHAPTER 15 – EFFECTIVE PRACTICES AND MANAGEMENT OPINIONS

### Introduction

“Effective Practices” is a business strategy that attempts to take advantage of successful policies, procedures or activities that have been implemented throughout a particular industry. Originally, it was “best practices” as used in the medical field. The process of “effective practices” strategy is to copy the application of similar operations and to modify the application to meet the particular needs of an organization. By understanding the principles and procedures of education accounting and finance, the school district will be better prepared to implement the best education accounting and finance practices throughout the education organization.

The purpose of this chapter is to outline various education accounting and finance principles and procedures to promote the implementation of accounting and finance effective practices throughout the education organizations within the state. These best practices are not necessarily the best policies and procedures to be implemented in every situation, but can be used as a model in developing specific procedures to be used in an organization. By constantly applying best practices, it is possible for an organization to achieve the organization goals in an efficient and cost effective manner.

### Section I - The Independent Audit Opinion

#### Introduction

Independent auditing of financial statements is one of the best-known services that certified public accountants provide; however, it is also one of the least understood activities. Most government organizations are required to issue financial statements. According to publications of the Association of School Business Officials and the American Institute of Certified Public Accountants, CPAs are engaged in the process of adding credibility to management’s financial representations by giving assurances that the financial statements conform to generally accepted accounting principles. CPAs have acquired the expertise and experience to give professional opinions on the overall fairness of the organization’s financial statements and are guided by the accounting profession’s basic tenets of integrity, objectivity and independence. Before interested parties can evaluate an auditor’s report and determine how much they can rely on the report, they should first gain an understanding of what an audit is and what an audit is not.

#### What An Audit Opinion Is Not

The financial information upon which the audit is based is NOT prepared by the auditor, but by management. The auditor does NOT express a judgment on the competence of management, advise on the desirability of funding the organization, nor assure that the employees are honest and competent. The CPA uses testing techniques and professional judgment, within the parameters of established standards, to reach an informed opinion on the overall fairness of the financial statements in accordance with generally accepted accounting principles. Although the purpose of an audit is NOT to uncover fraud, the auditor is required to design the audit to provide reasonable assurance that material errors or irregularities that exist in the financial statements are detected.

#### What An Audit Opinion Is

The primary objective of an audit is to provide reasonable assurance that the financial statements prepared by management are fairly presented in conformity with generally accepted accounting principles and do not contain material misstatements. Material misstatements include: (1) Unintentional misstatements or omissions in financial statements, and (2) intentional misstatements or omissions.

(Misstatements are considered material if they are significant enough to make a difference in the decisions of a reasonable financial statement user.)

It is virtually impossible for a CPA to examine all transactions recorded in financial statements. The auditor bases their opinion on selective testing using sampling techniques. Audits provide an economical and reasonable level of assurance that the financial statements are free from material misstatements, rather than a guarantee of absolute accuracy. Before forming an opinion, the auditor must consider the organization's internal control structure, which is divided into (1) the control environment, (2) the accounting system, and (3) the control procedures. The auditor uses this knowledge to identify the risk of misstatement in the financial statements and then designs procedures to reduce the risk. The auditor is also required to use analytical procedures, which are evaluations of financial information, in the planning and final review stages of all audits. In addition, the auditor is obligated to consider whether the overall audit results raise substantial doubt about the organization's ability to stay in operation. If there is doubt that the organization can continue as a "going concern," an explanatory paragraph must be included in the audit report.

## The Auditor's Standard Opinion

When an audit is completed, the auditor issues a report that states the CPA's responsibility, the nature of the work performed, and the conclusions reached. The auditor's standard report consists of three paragraphs: an introductory paragraph, a scope paragraph, and an opinion paragraph. The introductory paragraph differentiates management's responsibilities for the financial statements from the auditor's duty to express an opinion on them. The scope paragraph explicitly states that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material errors or irregularities. It also provides a brief description of what is involved in an audit and states that the auditor formed an opinion on the financial statements taken as a whole. The third or opinion paragraph presents the auditors conclusions.

The assurance, in the form of the CPA's opinion, is obtained by testing the data underlying financial position, results of operation, and cash flows. To do this, the CPA is guided by statements on auditing standards issued by the Auditing Standards Board of the American Institute of CPA's (AICPA). Also, subjective professional judgment is involved. The auditor then forms one of the following types of opinion:

- Unqualified – No significant limitations affecting audit performance and no material deficiencies exist in the financial statements.
- Qualified – The scope of the auditor's work is significantly restricted or there is a material departure from the generally accepted accounting principles.
- Disclaimer – Restrictions in the auditor's scope are so pervasive that the auditor cannot form an opinion on the fairness of the presentation.
- Adverse – Departures from generally accepted accounting principles are so significant that the financial statements do not fairly present the organization's financial position.

The basic point to remember is that an opinion is just that – it is an opinion, not a guarantee, that a professional has given on management's financial statements. Any user of the financial statements must carefully review such financial statements and all related footnotes, in addition to the auditor's report.

## Section II - Selecting an Independent Auditor

### Introduction

Regardless of the type or size of school district, an effective audit can improve management operations and yield dollar savings. It can also help avoid wasting the school district resources on a sub-standard audit. Outlined in the Federal Grants Management Handbook of the Grants Management Advisory

Services, the “National Intergovernmental Audit Forum” has identified the following “basic elements of an effective audit procurement process:”

1. **Planning for the Audit** – Determining what needs to be done and when. Planning to obtain a quality audit is usually rewarded by a timely and less expensive audit. Audit planning matters, include:
  - a. Each year, the auditor will provide a list of documents that are needed from the school district to complete the audit. To determine the specific audit requirements of the school district, reference the current auditor’s information request prior to last year’s audit. This information request can be used to establish the scope of the audit work plan for the district.
  - b. Every year, auditors are required to be evaluated by an independent public accounting firm. Determine who did the proposed auditors latest peer review and obtain a copy of the peer review report. Verify the professional experience of the proposed auditor by reviewing the peer review report and by requesting references from current school districts being audited by the auditor.
  - c. The Minnesota Department of Education provides a comparative list of school district audit expenditures. Use the list to establish a set of audit criteria to enable the school district to evaluate the proposed auditor, including technical qualifications, school district experience, price, timing, contingency requirements, and supplemental work costs.
  - d. Audit contracts can usually be more cost-effective if negotiated over a multi-year timeframe. Most often, contracts should cover a three- to five-year period to take advantage of the cost benefits of the multi-year audit and to realize the carry-over knowledge of the auditor. Determine an auditor rotation plan to maintain competitive pricing and to infuse new ideas into the process.
  - e. Based upon staff experience, many school districts will require accounting assistance to complete the documents required for the audit. Estimate the total cost of the audit by establishing a work schedule for the audit based upon the capability of the staff to compile required information and to prepare required work papers.
2. **Request for Proposal (RFP)** – Writing a clear and direct RFP. There are many ways to solicit bids for an audit, but the most effective way is to request a written proposal called an RFP (Request For Proposal). Although there should be a broad spectrum of potential audit firms to select from, the final screening process should be restricted to only 2 or 3 firms to request an RFP. With only a few audit firms to select from, the school district will have less work and the audit firms will respect the school district’s professionalism. Rural school districts may have a difficult time finding local auditing firms to include in the audit candidates. However, non-local audit firms often have more experience in dealing with Minnesota education issues and are usually willing to travel to more rural areas.

Proposals should be compared based upon technical qualifications and price, separately. Depending upon the RFP legal requirements, proposals that lack important comparative information should be updated to complete the comparison. In a technical service contract, a timely proposal submission is only an issue when the evaluation process is threatened, not when comparative information is required. Reduced audit price can often be related to the lack of technical qualifications that may not be beneficial to the school district. Generally, price should be a deciding factor when the technical qualifications are equal.

Preparation of the RFP must be in compliance with state rules and regulations. This is not hard as long as the school district tries to be fair to all auditor candidates. Even though the preparation of the RFP may have been thorough, the school district should still hold a “bidders conference” where audit candidates can discuss the audit request on an equal basis. The “bidders conference” is important as a defense against an unsuccessful bidder. Although the size and complexity of the audit may vary, the RFP should contain the following:

- a. Name and address of the school district;
- b. Scope of the services to be provided (timing, reports, presentations, etc.);
- c. Period of the audit (single or multiple years);

- d. Contact person in the school district;
- e. Format of the proposal to be prepared;
- f. Date and time proposal is due;
- g. Criteria used to evaluate the proposal;
- h. Method and timing of the payment.

The RFP should be designed to enable the auditor to demonstrate his or her ability to complete the audit to the benefit of the school district. Any other administrative information that would be helpful in preparing the audit proposal (i.e. “bidders conference” information, late proposals requirements or recommended audit fee range) should be included in the RFP at the discretion of the school district. Examples of information that should be requested from the proposed auditor include:

- a. Qualifications of the auditor that will be performing the field work including governmental audit;
- b. Approach to be taken to solve specific problems within the school district related to the audit;
- c. Examples of reports and schedules that are used to evaluate the sections of the statements;
- d. Experience in preparing financial reports and submissions required by the State of Minnesota;
- e. Cost structure and experience in preparing supplemental information for the audit;
- f. Results of peer review actions during the last three years;
- g. Notifications of change in staff for key audit positions for the school district;
- h. Experience with budget preparation requirements for the school district.

3. **Selecting a Qualified Auditor** – Evaluating the auditor’s ability to perform the audit. A critical element of selecting an auditor is the technical knowledge of the RFP evaluators. To limit errors in judgment and accusations of bias, establish an audit evaluation committee. Many of the same technical qualifications emphasized in the audit would be beneficial for the audit selection committee, namely, experience in auditing and/or accounting. In smaller school districts, some of these experience requirements may have to be reduced. Although price is an important factor in selecting an audit firm, a high quality audit at a fair price is more likely when both price and technical capability are used to select an auditor. The RFP evaluation process can be divided into two categories:

- a. **Minimum Requirements** – At a minimum, the bidders must have the technical qualifications to be considered for the audit selection. This includes minimum state licensing and governmental experience requirements, as well as a technical understanding of the education requirements of the audit. If the bidder is not able to document these minimum requirements, the proposal should be rejected, **EVEN IF THIS MEANS THAT NONE OF THE BIDDERS QUALIFY FOR THE AUDIT AND THE RFP PROCESS MUST BE STARTED OVER AGAIN.**
- b. **Technical Approach** – Most importantly, the audit proposal must communicate a sound technical approach to the audit that will meet the expectations of the school district. To verify the proposed audit approach, the technical issues must be reviewed and the audit references must be contacted and interviewed, including the following questions:
  - Does the proposal contain a sound technical plan and a realistic estimate of time?
  - Does the proposal show the bidder intends to comply with the audit requirements?
  - Does the technical plan show a practical approach to meeting deadlines?
  - Is the work plan reasonable with respect to procedures, controls and materiality?
  - Does the proposal indicate a willingness to avoid duplication of effort?

4. **Writing the Agreement** – Documenting the expectations of the auditor. The lack of a written agreement between the school district and the selected audit firm can result in a substandard audit. To avoid potential contract disagreements and misunderstandings, a written agreement should be prepared, agreed upon and signed by both parties before the audit fieldwork begins. To make sure that the contract contains the full scope of the audit requirements, the agreement should be prepared by the school district attorney and the RFP should be included in the contract by reference. At a minimum, the agreement should specify:

- a. Audit scope, objective and purpose;
- b. Deadlines for the work to be performed;
- c. Audit and supplemental work cost;
- d. Report format and timing of completion;
- e. Professional Auditing Standards to be followed.

In addition, the agreement should clearly document (1) the auditor responsibilities, (2) the nature of the work to be performed, (3) the procedures to follow if changes are required, (4) the format of the reports to be filed and (5) the ownership of work-paper information. In the absence of an RFP, many small audits are contracted by the engagement letter prepared by the audit firm. If the engagement letter is used as the written contract, the elements of the agreement that protects the school district should be included in the agreement and the agreement should be signed by both parties.

5. **Monitoring the Audit** – Reviewing the progress of the audit. Monitoring the progress of the audit is the most effective way to ensure that the school district receives both the scope and quality of the audit services specified in the written agreement. Monitoring can be accomplished by scheduling periodic progress meetings with the auditor to discuss the issues needed to be resolved before the audit is complete. During the audit, progress reports should be used to keep management informed of areas of deficiency and opportunities to control the cost of the audit. At the same time, the staff should work closely with the auditors on a day-to-day basis to review potential “audit findings” and to make audit corrections.

Finally, at the end of the audit, most auditors will provide an audit “exit conference” in which the findings and issues regarding the audit are discussed with the school district before being released to the general public. This conference is beneficial to the school district by enabling them to provide a rebuttal to the auditor’s conclusions or to prepare for potential public criticism. Remember, the auditor’s opinion is not necessarily accurate or without error. When appropriate, the school district should not be afraid to disagree with the findings of the auditor. Management has the opportunity and the responsibility to disagree with the conclusions of the audit if they think that the findings are not warranted. The auditor is concerned about complying with accounting rules and regulations, but they are also concerned about keeping the client. The school district might not get the auditors to change the audit findings but they might soften their recommendations to the benefit of the school district in the future.

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