

# Accounting Update: What's New From GFOA?

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# Topics

- Audit Committees
- Auditor Association
- OPEB bonds
- Effect of recent auditing standards
- Common reporting deficiencies

# Audit Committees

GFOA Recommended Practice

# Background

- Original recommended practice (RP)
  - First issued in 1997
  - Minimal revisions in 2002
- Private-sector developments lead to completely revised RP in 2006

# Sources for revised RP

- Sarbanes-Oxley Act
- Securities and Exchange
  - Regulation 33-8220
- New York Stock Exchange and National Association of Securities Dealers
  - Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

# Conceptual background

- Three groups responsible for financial reporting
  - Governing body (“first among equals”)
  - Financial management
  - Independent auditor
- Audit committee
  - Practical tool for governing body oversight
  - Forum separate from management

# Scope of recommendation

- Every government should establish an audit committee or its equivalent

# Establishment

- The audit committee should be formally established
  - Charter
  - Enabling resolution
  - Other appropriate legal means

# Relationship to auditor

- The audit committee should be made directly responsible for
  - Appointment
  - Compensation
  - Retention
  - Oversight

# Lines of reporting

- The independent auditors should report directly to the audit committee

# Initial documentation

- Scope of the committee's responsibilities
- Structure
- Processes
- Membership requirements

# Periodic self-assessment

- The audit committee should itself periodically assess its structure and operations
  - No less than once every five years

# Basic knowledge needed to serve

- All members of the audit committee should possess or obtain a basic understanding of governmental financial reporting and auditing

# Financial expert

- The audit committee should have access to the services of a financial expert
  - Committee member
  - Outside party engaged by the committee for this purpose

# Description of financial expert

- The financial expert should possess an understanding of generally accepted accounting principles and financial statements
  - Through both education and experience
  - Specifically relevant to the government sector

# Experience requirements for financial expert

- Specific experience should include
  - The preparation or auditing of financial statements of comparable entities
  - The application of such principles in connection with the accounting for estimates, accruals, and reserves
  - Experience with internal accounting controls, and an understanding of audit committee functions

# Qualifications for members

- All members of the audit committee should be members of the governing body
  - But not a governing body member who exercises managerial responsibilities that fall within the scope of the audit

# Number of members

- Sufficient for meaningful discussion and deliberation
- Not so many as to impede efficient operation
  - Minimum membership of the committee no fewer than three

# Member orientation

- Members of the audit committee should be educated regarding
  - Role of the audit committee
  - Personal responsibility of members
    - Duty to exercise an appropriate degree of professional skepticism

# Responsibility of committee

- The audit committee should provide independent review and oversight of
  - Financial reporting processes
  - Internal controls
  - Independent auditors

# Internal audit function

- The audit committee should have access to
  - Reports
  - Annual work plan

# Reporting

- Written report on how the committee has discharged its duties and met its responsibilities.
  - Issued annually
  - Addressed to the full governing body
  - Accompanied by charter or similar documentation
  - Made available to the public

# Avoiding management override

- The audit committee should establish procedures for the receipt, retention, and treatment of complaints
  - Specifically provide for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

# Resources

- The audit committee should
  - Be adequately funded
  - Be authorized to engage the services of financial experts, legal counsel, and other appropriate specialist, as necessary to fulfill its responsibilities

# Stated basis for conclusions

- The audit committee should state that it has discussed the financial statements
  - With management,
  - With the independent auditors in private
  - Privately among committee members
- The audit committee should state its belief that the financial statements are fairly presented

# Auditor Association

GFOA Recommended Practice

# Background

- Issue: Auditor involvement with later use of audited financial statements
  - Offering statements
  - Web sites

# Auditing standards

- Presumption that auditor is not associated
  - Association may be created by
    - Actions
    - Clause in audit contract
- No auditor association with other contents of web site
  - Not “documents”

# Auditing standards (cont.)

- If an association is created
  - Auditor must “read” accompanying material
    - No material inconsistency in information or manner of presentation

# Governments should be free to use their own audit report

- *Having paid for the independent audit, a government owns the audited financial statements and should feel free to use them in any appropriate manner.*
  - Same set of financial statements
  - Not used in potentially misleading manner
  - No material subsequent event

# Avoid creating an “association”

- *The independent auditor should not be permitted to create an essentially artificial “association” with audited financial statements included in offering statements or posted on the government’s website simply by inserting a clause to that effect in the audit contract*

# Avoiding an association (cont.)

- Written clarifications
  - Consider including affirmative language in audit contract
  - No objection to auditor clarification in offering statements
  - No objection to auditor clarification in engagement letter
  - The audit contract should clarify freedom to post financial statements on website.

# Minimize costs and delays

- *When the independent auditor actually does happen to become associated with audited financial statements included in an offering statement, a state or local government should take steps to avoid unwarranted delays and unjustified costs.*
  - Maximum time
  - No additional fee

# Effect of recent auditing standards

Statements on Auditing Standards  
(SAS) Nos. 103-112

# SAS No. 103

- *Audit Documentation*
- Effect on auditors
  - Changes date of auditor's report
- Effect on government being audited
  - Delays could result in higher audit fees
- Recommended action
  - Facilitate timely completion of the audit

# SAS Nos. 104-111

- “Risk-assessment suite”
- Effect on auditors
  - Must gain understanding of the *environment*
  - Must document risk assessment
    - Effect on materiality
    - Conclusion regarding fair presentation
- Effect on government being audited
  - Audit fees may increase from 10 to 15 percent

# SAS No. 112

- *Reporting Deficiencies*
- Effect on auditors
  - Identifies specific situations as deficiencies
- Effect on government being audited
  - Will likely increased number of deficiencies
- Recommended action
  - Comprehensive control framework

# OPEB Bonds

GFOA Recommended Practice

# Background

- Nature of transaction
  - Plan-related debt v. benefit obligation debt
    - Plan-related debt uses borrowed proceeds to pay plan to assume actuarial risk from employer
      - Expense of period
    - Benefit obligation debt reinvests borrowed proceeds to take advantage of a plan earnings rate in excess of the employer's borrowing rate
      - Pension/OPEB asset

# Pension obligation bonds RP

- Risks generally also apply to OPEB bonds
  - Risk that leverage will not succeed
  - Lost borrowing flexibility
  - Potentially misleading improvement in funded ratio

# Additional risk

- Greater volatility
  - Utilization less predictable than mortality
  - Benefits typically not guaranteed
  - Potential effect of future healthcare initiatives
  - Changes in medical technology
  - Changes in societal expectations

# Additional risk (cont.)

- Benefit changes may occur as a result of new reporting requirements
  - Capping contributions
  - Reducing benefits
  - Move to defined contribution plans
- Potential overfunding
- “Safe” funding level yet to be determined

## Additional risk (cont.)

- Trust funds not yet generally in use
- Potential premature establishment of irrevocable trust fund

# Specific recommendations

- Allow sufficient time for a public-policy dialogue to occur between the governing body, employee groups, finance officials, and the public they serve regarding the appropriate funded ratio for OPEB.
  - Failure to do so could produce “solutions” that ultimately fail to reflect the desires and considered judgment of constituents.

## Specific recommendations (cont.)

- Consider OPEB bonds only upon consultation and advice from a knowledgeable financial advisor who is not also serving, or planning to serve, as an underwriter of the OPEB bonds
  - Potential issuers should compare the results of any proposed OPEB bond issuance to both
    - Advance funding on the basis of the ARC
    - Pay-as-you-go funding

## Specific recommendations (cont.)

- Refrain from issuing OPEB bonds until all issues concerning the proper establishment of a qualified trust fund, investment procedures, and investment guidelines have been resolved

## Specific recommendations (cont.)

- Consider, upon consultation with actuaries and other experts, limiting the planned funded ratio to an amount suggested by actuarial and other analysis

# Summary

- GFOA urges governments to exercise considerable caution when contemplating the possibility of issuing OPEB bonds

# Common reporting deficiencies

Certificate of Achievement for  
Excellence in Financial Reporting  
Program

# Letter of transmittal

- Incorporate relevant information on long-term financial planning
- Incorporate information on relevant financial policies
- Incorporate information on the budget not included elsewhere in the report
  - Legal level of control
  - Budgeted funds

## Letter of transmittal (cont.)

- Avoid “topical discussions” solely on the basis of prior “Blue Book” recommendations
- Eliminate description of three sections of a CAFR and similar “boiler plate”

# MD&A

- Ensure comprehensiveness
  - Include analysis of *all* major funds
  - Include budgetary analysis
    - Limit to general fund
    - Discuss variance between final amended budget and actual
- Analyze rather than quantify

## MD&A (cont.)

- Ensure that the numbers reported correspond to those reported in the financial statements
- Present comparative data at the proper level of detail (both by activity and in total)

# Government-wide net assets

- Refrain from reporting internal balances in the primary government's total column
- Separate the long-term portion of certain accrued liabilities
- Distinguish depreciating capital assets from non-depreciating capital assets

# Government-wide net assets (cont.)

- Ensure proper classification of various components of *net assets*
  - *Invested in capital assets, net of related debt*
    - Exclude unspent proceeds
    - Exclude advances from other funds
    - Exclude amounts in debt service “reserves”
    - Exclude debt used for non-construction “reserves”
  - *Restricted net assets*
    - Amount should *exceed* that reported in fund statements

# Government-wide activities

- Refrain from reporting transfers in the primary government's total column
- Gains/losses
  - Regular disposals – not part of functional cost
  - Impairments – part of functional cost
- Provide detail on *taxes* included in *general revenue*

# Governmental funds

- Include all major funds
  - The funds included may vary from year to year
- Balance sheet
  - Report only *due* portion of accrued liabilities
    - Application to vacation leave and claims and judgments
- Operating statement
  - Limit reporting of *other financing sources/uses*

# Governmental funds (cont.)

- Budgetary comparison
  - Present only for the general fund and major special revenue funds

# Proprietary funds

- Operating statement
  - Tie should be to *changes* in net assets
- Cash flows
  - Include disclosure for non-cash items

# Other items – basic statements

- Exclude all other types of financial presentations
  - Exclude statement of changes in agency fund assets and liabilities

# Notes

- Verify blending v. discrete presentation
- Deposits and investments
  - Drop custodial credit risk classifications
  - Distinguish “policies” from legal requirements and practice
- Disclose purpose of internal balances and transfers

# Combining and individual funds

- Budgetary comparisons
  - Include all appropriated annual/biennial budgets for governmental funds
  - Report at legal level of control