

An Introduction to Financial Accounting and the Performance of Audits

I. Introduction

The purpose of this document is to provide an introduction to government accounting, financial reporting and auditing, as well as the fiduciary duties of special district directors and management. The goal of the document is not to provide guidance to accounting and auditing professionals serving special districts; rather, the goal is to help laypersons, specifically directors and managers, gain a better understanding of special district finances, including accounting and audit requirements.

Special districts have a unique relationship to their customers – the customers “own” the utility system and entrust the district to operate and maintain the system efficiently, effectively and in full compliance with laws and regulations governing the provision of services. Local government is more accessible to people than any other level of representative government; this is particularly true for special districts delivering essential utility services.

A district must strive to maintain the trust given to it by its customers. Operating the district’s utility system in an open and transparent manner and demonstrating that the district is a proper steward of public resources, including public funds, is essential to maintaining public trust. In this context, the importance of a thorough and independent annual financial audit cannot be overstated. The presentation and dissemination of the annual audit report to district customers is one tool to communicate proper stewardship of public funds, and as such, it should be available on the district Web site and referenced in billing inserts and press releases.

Of course, before an audit report is rendered, a district must retain an audit firm that demonstrates the highest ethical and professional standards. A district should also periodically consider whether it is prudent to change its auditor or audit firm to ensure that the evaluation of a district’s financial statements will continue to be thorough and above reproach in all aspects of the audit process.

Special districts, as with any level of state and local government, have a duty to justify their activities and financial decisions in the context of budgetary restrictions. The proper performance of this duty will ensure that a district is fiscally accountable to its customers. The Government Accounting Standards Board (GASB) defines fiscal accountability as “the responsibility of governments to justify that their actions in the current period have complied with public decisions concerning the raising and spending of public moneys in the short term (usually one budgetary cycle or one year).” In other words, a district, from its governing board to its management to its

staff, should “say what they do and do what they say” and demonstrate this commitment to customers and other external audiences.

II. Internal Control Framework

District directors and management are entrusted as stewards of the financial resources provided by taxpayers and customers. Whether such resources are in the form of cash, equipment or water rights, they are entrusted to the care of districts and need to be properly safeguarded, managed and accounted. Decisions regarding the allocation of resources should be based on complete, accurate, reliable, relevant and timely information. The development of a strong system of internal financial controls can help a district provide assurances that its accounting system and financial data are reliable. A comprehensive internal control framework also will reduce the opportunity for errors or fraudulent expenditures.

According to the publication titled “Governmental Accounting, Auditing, and Financial Reporting” (Government Finance Officers Association, Gauthier, Stephen J., 2001), a financial control framework should:

- Provide a favorable control environment
- Provide for continuing assessment of risk
- Provide for the design, implementation, and maintenance of effective control-related policies and procedures
- Provide for the effective communication of information
- Provide for the ongoing monitoring of the effectiveness of control policies and procedures, as well as the resolution of potential problems identified by controls

Internal Controls Ensure Accuracy, Compliance with Law

Internal controls are the system of checks and balances an organization employs to prevent and detect errors in the processing of data to ensure accuracy and reliability, to promote smooth operation, to monitor and maintain compliance with laws, regulations and contractual arrangements, and to safeguard and manage district assets. Typically integrated into an organization’s daily activities, internal controls are within the organization’s overall control environment. An organization’s control environment is embedded in its organizational structure, culture, philosophies, policies and procedures as established by the governing board and management.

The American Institute of Certified Public Accountants (AICPA) defines internal controls as the organizational plans and procedures designed to (1) safeguard assets, (2) verify the accuracy and reliability of accounting data and other management information, (3) promote operational efficiency, and (4) ensure adherence to prescribed policies and procedures. This broad definition can be subdivided into two components: administrative controls and accounting controls.

Administrative controls are comprised of, but are not limited to, the process, procedures and records concerned with the decision-making process leading to management's authorization of transactions, compliance with regulations and establishment of policy. These are management functions directly associated with the responsibility for achieving the objectives of the organization.

Accounting controls are the organization's plans, processes, procedures and records concerned with the safeguarding of assets, processing efficiency, compliance with policy and procedures and accuracy and reliability of financial information. Consequently, they are designed to provide reasonable assurance that transactions are executed in accordance with the general or specific authorization of the governing board and management; transactions are recorded as necessary to maintain accountability of assets and to permit preparation of financial statements in accordance with generally accepted accounting principals or other applicable criteria; access to assets is permitted only in accordance with prescribed authorization; the recorded accountability for assets is compared with existing assets at reasonable intervals, and appropriate action is taken with respect to any differences; and a periodic review or monitoring of the accounting controls to ensure proper functioning.

District management must identify and ensure compliance with applicable federal, state, and local laws and regulations relating to the accounting and control of district finances. The objectives of an internal control system are to provide an adequate check and balance structure that functions as the backbone to the organizational information integrity. As such, an effective internal control system should:

- Evaluate and promote efficiency
- Minimize errors and fraud
- Discourage waste
- Encourage, monitor and measure compliance
- Provide accountability
- Safeguard resources
- Promote accuracy and reliability

Most administrative and accounting internal control procedures are incorporated within an organization's routine operating systems. Since every organization is unique with different visions, missions, structures, cultures, philosophies, policies and procedures, there will be some variations to the control environment, internal control structure and implementation procedures required to ensure an adequate functioning internal control system. However, there are certain basic principles that must be present in any organization to ensure the adequacy of internal controls:

- Development of an effective organizational structure;
- Establishment of appropriate administrative and accounting policies and procedures;
- Provisions for the protection of assets; and

- Review and monitoring of the controls.

Implementing Internal Controls

Management is responsible for internal controls; however, the functioning of those internal controls is the responsibility of everyone in the organization. Through the implementation of the basic principles and establishment of policies and procedures, the governing board and management will outline guidelines and instructions to be used throughout the organization for transaction processing and asset control.

The responsibility for proper functioning of the established internal controls lies within the operational processes performed throughout the organization, from the field division's custody of equipment, to the treasury's safeguarding of cash, to engineering's authorization of purchases or accounting's reconciliation of bank statements. These examples, and many more administrative and accounting internal controls, provide vital and interwoven control processes over information that affects stewardship and decision-making. The organizational structure, policies and provisions provide the foundation of general principles upon which the processes and procedures are built. These processes and procedures for internal controls are at a greater level of detail to effect understanding and instruction in performing the duties and tasks.

After the establishment of an effective organizational structure and adoption of appropriate policies and procedures, the most important element in an internal control system is the implementation or "putting into practice" of the control duties and tasks. District management is responsible for the design and implementation of programs and controls to prevent and detect fraud, for example. The effective implementation and monitoring of the internal controls means everyone understands and performs his duties and tasks properly so the network of internal controls enhances the organization's overall control environment. Sometimes organizational or personnel changes can create voids in the functioning of internal controls processes and procedures which should be considered and remedied. For example, elimination of a position that provided certain internal control procedures should require reassignment of those internal control duties and procedures.

To enhance informational integrity and the organization's control environment, the governing board should adopt the necessary principles and guidelines that establish a positive control environmental tone and philosophy. These policies should then be expanded by management into operational procedures to meet the organization's internal control system identified objectives and principles. Through operational procedures and an implementation plan the internal control process, based on the established policies, would promote integrity in the obtaining and management of information and assets.

The processes to help ensure the objectives are met and principles implemented include:

- High quality personnel
- Separation of duties
- Assignment responsibility
- Proper authorization
- Adequate supervision
- Verification, comparison and reconciliation
- Establishing routine procedures
- Job rotation
- Investigation of variances
- Physical control and security over property
- Control review and monitoring programs (internal audit function)

Of course, the size of a district's staff will dictate the level of sophistication regarding the design of an internal control structure. Written documentation of policies and procedures setting the internal control structure and system plan will help ensure understanding, operation and monitoring of adequate internal controls. As with any process, its effectiveness requires effort, time and resources to ensure adequate and proper functioning and monitoring.

An efficient and well-functioning internal control system will provide integrity to information and asset management, and support good stewardship and sound decision-making. A district must have a comprehensive internal control framework in place to enable an independent auditor to conduct an audit. An auditor must gain an understanding of a district's internal controls, in part to obtain the evidence needed to support an opinion on the fair presentation of the financial statements. Smaller districts, however, do not have a large enough staff to establish a sufficient segregation of duties to develop and implement meaningful internal controls. Therefore, it is more efficient from an audit standpoint to expand the number of substantive tests of financial transactions than to evaluate or rely on internal controls.

III. Basic Financial Statements

A district's financial statements are much more than a presentation of numbers, charts and graphs. They should be viewed as the foundational documents for demonstrating both fiscal and operational accountability to the district's management, governing board, and ultimately, to the district's customers. The financial statements are the responsibility of district management. The accounting profession has identified standards governing the formatting and contents of private and public sector financial reporting; GASB is the authoritative accounting and financial standard-setting body for state and local governments, although governments may elect to follow Financial Accounting Standards Board (FASB) pronouncements. GASB is the pri-

mary source of generally accepted accounting principles (GAAP) for state and local governments; GAAP represents the conventions, rules and procedures established to ensure the basic financial information is available to assess an entity's finances.

Special districts should implement governmental financial reporting models established by GASB. The objective of GASB pronouncements is to enhance the understandability and usefulness of the general-purpose external financial reports of state and local governments for the citizenry, legislative and oversight bodies, and investors and creditors.

Understanding Financial Statements

The key components of financial statements include:

- Management Discussion and Analysis (MD&A)
- Basic Financial Statements
- Required Supplementary Information (RSI) (if required)

A district's financial statements may include both government-wide financial statements and fund financial statements; e.g., water system, wastewater system, and electric system. Briefly, the purpose of MD&A is to provide a narrative introduction and overview that can be used to interpret the basic financial statements. It includes financial statement descriptions, comparisons between fiscal years, capital asset activity, changes to long-term debt and management's financial outlook. The basic financial statements include the statement of net assets; the statement of revenues, expenses and changes in net assets; the statement of cash flows and the notes to the financial statements. Since most districts record infrastructure assets and related depreciation, required supplementary information is not necessarily a required financial statement component.

There are a number of questions the district governing board and management should ask during the process of producing basic financial statements:

- Is the district better off today than it was one year ago?
- Are there any estimates in the financial statements? If so, what are they and what assumptions are used (e.g., interest rates, discount factors, usage rates)?
- Are there any pension and/or post retirement benefits being funded by the district? Is there any unfunded pension or post-retirement liability?
- Is there any debt or potential debt of the district not presented in the financial statements?
- Are there any deviations from GAAP?
- Are there any differences between the published annual audited financial statements and the internal financial statements used by staff and directors to manage the district? If so what are they?
- How do the statements compare to annual budgets and projections?
- Do the investments tie to portfolio report?

- What is the review process to insure the financial statements are appropriate and accurate?
- Does the district have written fiscal policy and procedure manuals?
- Are the employees, board members and volunteers who handle cash and investments bonded?
- Is there adequate insurance coverage to safeguard the district's assets?

The financial statements should fairly present the financial operations of the district to the governing board and district customers. The statements should thoroughly present the district's assets, liabilities and net assets; revenues, expenses and changes in net assets; and the uses and sources of cash flows. The statements also may be used to assist the district in assessing its ability to meet short- and long-term obligations, unexpected emergencies and annual revenues and funding requirements. The basic financial statements represent the minimum information that is included in a district's financial report in order to comply with GAAP and enable an independent auditor to issue an audit opinion.

Assets, Liabilities and Net Assets

The basic financial statements include the statement of net assets, which is referred to as a "balance sheet" for corporations. The difference between assets and liabilities is considered net assets. A district's net assets are similar to "retained earnings" in a corporation. Net assets are subdivided into two categories: 1. Net assets invested in capital assets and 2. Net assets expendable financial resources. The statement of net assets should be present assets and liabilities based on their relative liquidity.

Definition of Net Assets

A District's net assets are similar to "retained earnings" in a corporation. For a special district, retained earnings are called net assets, i.e. assets less liabilities. Net assets are subdivided into two categories:

- 1. Net assets invested in capital assets** - Net assets invested in capital assets are considered non-expendable, i.e. financial resources are not available for use. These would include such assets as buildings, dams, water treatment plants, pipeline, power plants, etc.
- 2. Net assets expendable financial resources** - Net assets expendable financial resources are total net assets, less net assets invested in capital assets (net of debt), They are further subdivided in two categories:
 - a) Restricted** – Commonly referred to as "Reserved Net Assets" and restricted as a party outside the District imposes their restriction. These would include the unspent connection charge revenues per California Government Code Section 66013 and reserves required to be kept under bond indentures, etc.

b) **Unrestricted** – Unrestricted would be available for “Designation” for specific purposes as established by the Board.

Net Assets Invested in Capital Assets

Net assets invested in capital assets are reported as capital assets, less accumulated depreciation and outstanding principal of related (capital asset) debt. Because of the capital-intensive nature of water agencies, this amount is typically a significant portion of net assets. Because these funds have already been utilized for the investment in capital assets [debit capital assets, credit cash], the amount of net assets invested in capital assets is not available to be expended.

Net Assets Expendable Financial Resources - Restricted (Reserved)

From time to time, parties outside of the District (such as debt instruments or law/regulations of other governments) impose restrictions on net assets. For example, unspent proceeds related to debt are reported as restricted net assets. Amounts subject to third party restrictions are considered “Reserved.”

District reserves, established by third party restrictions, will be monitored and reviewed for compliance with specific agreement(s).

Net Assets Expendable Financial Resources - Unrestricted

Unrestricted net assets are the portions of net assets that remain after restricted and invested in capital assets (net of related debt) are subtracted. The unrestricted net assets are available for the District’s governing board designation or appropriation. Normally, assets subject to self-imposed restrictions (i.e. Board designation) are not reported as part of restricted net assets because the governing board can remove the restriction in the same manner it was imposed. Hence, these amounts are considered “Designated.”

Net Asset Reserve and Designation Policy

Special districts should consider establishing, dedicating and maintaining reserves and designations annually to meet known and estimated future obligations as deemed prudent and/or required by agreement. The Net Assets Reserve and Designation Policy should be designed to ensure the reasonableness and adequacy of District reserves and designations. The policy would establish distinct purposes, funding and use for designated amounts. It would sets target funding levels, both minimums and maximums, for the accumulation of designated balances, as well as identify events or conditions that might prompt the use of the designated funds.

The establishment of a written policy relating to the accumulation and expenditure of net assets will provide assurance to district management and the district governing body that financial resources are used in an effective and efficient manner and that the district has matched its future infrastructure and service needs with sufficient financial resources to accomplish the mission of the district. The presence of such a policy, and adherence to its requirements, will provide greater assurance to district

ratepayers and taxpayers that the accumulation and expenditure of fund balance is based on sound financial practices.

IV. The Comprehensive Annual Financial Report

As stated previously, GAAP define the minimum standard for acceptable basic financial reporting for local governments such as special districts. The minimum standard mandates a complete set of basic financial statements, including accompanying note disclosures, as well as the presentation of certain required supplementary information (RSI), if required. GFOA encourages local governments to include this minimum presentation within a more expansive presentation known as a comprehensive annual financial report (CAFR). All special districts should consider this expanded presentation, but it is recognized that smaller districts may not have the staff resources and finances to support such an undertaking.

A CAFR includes three basic sections: an introductory section, a financial section and a statistical section. The introductory section provides general information about the district and its organizational structure, the governing board and management, and information that may be useful in assessing the district's overall financial condition. The financial section includes the basic financial statements and RSI, if required, as well as the independent auditor's report. The statistical section provides trend data on key financial indicators for the district.

Finally, the Government Finance Officers Association (GFOA) has formally recognized the CAFR as an appropriate document for meeting the disclosure requirements of Securities and Exchange Commission requirements for those districts that issue municipal debt. GFOA has provided specific guidance for districts that use a CAFR for this purpose.

V. Generally Accepted Auditing Standards

The standards for financial audits in the public and private sectors are provided by generally accepted auditing standards (GAAS). The Auditing Standards Board of the AICPA establishes these standards. An independent auditor plans, conducts, and reports the results of an audit in accordance with GAAS. According to AICPA, auditing standards provide "a measure of audit quality and the objectives to be achieved in an audit. Auditing procedures differ from auditing standards. Auditing procedures are acts that the auditor performs during the course of an audit to comply with auditing standards (AICPA Professional Standards, AU §150.01). There are three categories of standards: (1) General standards, (2) Standards of fieldwork, and (3) Standards of reporting.

General standards require that an audit be performed by a person or persons possessing adequate technical training and proficiency as an auditor. The standards require

an auditor to be independent in mental attitude and to exercise due professional care in the performance of the audit as well as in the preparation of the audit report.

Standards of fieldwork require that an auditor prepare a plan to conduct the audit and ensure that persons performing the audit are professionally competent; any assistants working on the audit must be properly supervised. The auditor must have a sufficient understanding of the district's internal financial control structure in order to plan the audit and to determine the nature, timing, and extent of tests to be performed. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries and confirmation to afford a reasonable basis for an opinion of the financial statements under audit.

Standards of reporting outline the content of the written auditor's report, which must state whether the financial statements are presented in accordance with GAAP. Standards of reporting require the audit report to identify any circumstances in which GAAP have not been consistently observed.

An additional set of standards may guide audits when the special district receives or expends certain Federal funds. These audits are conducted in accordance with the Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations. The primary objectives of this type of audit—known as a “single audit”—are to establish uniform audit requirements for entities expending specified amounts of federal awards and to reduce the number of individual program audits. The goal is to increase the efficiency and effectiveness of the audits of federal funds. Single audit procedures are generally organized into an audit of the district's basic financial statements and include separate compliance audit requirements of the federal awards programs as well as testing compliance requirements.

VI. Legal Requirement For A Financial Statement Audit

Section 26909 of the California Government Code requires a county auditor to either make, or contract with a certified public accountant or public accountant to make, an annual audit of the accounts and records of every special district within the county for which an audit by a certified public accountant or public accountant is not otherwise provided. The California State Controller prescribes the minimum requirements of a special district audit (“Minimum Audit Requirements and Reporting Guidelines for California Special Districts”).

When a certified public accountant or public accountant under contract by the special district performs an audit of the district's accounts and records, the minimum requirements of the audit must conform with both minimum audit requirements prescribed by the State Controller and generally accepted government auditing standards (GAGAS), if applicable. The district's completed audit report must be filed with the State Controller and with the county auditor of the county in which the

district is located. The report must be filed within 12 months of the end of the fiscal year or years under examination. Any costs incurred by the county auditor, including contracts with, or employment of, certified public accountants or public accountants, in making an audit of a special district must be paid by the district. County costs are considered a charge against any unencumbered funds of the district available for this purpose. For districts lying within two or more counties, the auditor of the county in which the district's treasury--generally, district headquarters--is located is responsible for ensuring an audit is completed.

A special district may, by unanimous request of the governing board of the special district, with unanimous approval of the county board of supervisors, replace the annual audit with a biennial audit covering a 2-year period; or, if the district's annual budget does not exceed an amount specified by the board of supervisors, an audit covering a five-year period. Special districts are exempt from the requirement of an annual audit if the financial statements are audited by the State Controller to satisfy federal audit requirements. A county board of supervisors may substitute a financial review in accordance with definitions promulgated by the United States General Accounting Office for the audit of a special district, provided that all of the following conditions are met: (1) The board of supervisors is the governing board of the district, (2) The special district's revenues and expenditures are transacted through the county's financial systems, and (3) The special district's annual revenues do not exceed one hundred thousand dollars (\$100,000).

VII. Selection of an Independent Auditor

The selection of an independent auditor should be the responsibility of the district's governing board, unless some higher level of government statutorily appoints the independent auditor. The governing board may delegate this task to a smaller working group (Finance or Audit Committee) or individual (Finance Director), but the formal decision to retain an auditor should be made by the governing board based on a recommendation from a board committee or management. Because the auditor works for the district's governing board and not the employees of the district, the governing board or its audit committee should be an integral part of the selection process.

The quality of an auditor can vary from one practitioner (or audit firm) to another. Some audit firms have significant expertise in performing high quality audits of public sector entities, while others lack the specialized experience and expertise needed to appropriately complete such engagements. Therefore, it is critical that a special district carefully select an auditor. There is a clear correlation between the quality of a public sector audit procurement process and the quality of the audit received. The audit procurement process should be open and competitive to encourage greater participation by high-quality audit firms.

In the public sector there are three categories of audits:

Financial Statement Audits – These are audits designed to provide the users (i.e., governing body, public, financial institutions, etc.) of financial reports with assurance concerning the reliability of the reports. The goal of the annual financial statement audit is to assure users of a district’s financial statements that those statements are fairly presented. The fairness of the presentation of a set of financial statements is determined using a set of criteria known as GAAP.

Attestation Audits – These audits are designed to provide assurance on matters other than financial reports.

Performance (or Operational) Audits – These audits are designed to determine whether government programs or activities are meeting stated goals and objectives, and to determine if governments are performing duties in the most economic and efficient manner possible.

A district should prepare a comprehensive request for proposals (RFP) for auditing services. A sound RFP should result in proposals that include all of the information needed to evaluate the technical qualifications and relevant experience of an audit firm to perform the audit. The RFP also should provide interested audit firms with a detailed description of the district, its specific audit needs, and the district’s audit procurement process. The principal factors in selecting an auditor should be the auditor’s technical qualifications and relevant experience. While fees are an important consideration, they should not be allowed to dominate the auditor selection process.

The GFOA offers a model RFP for the procurement of audit services. District management should prepare and distribute the RFP to firms that includes the following components:

- Description of the scope of the audit and the reports required.
- Description of any other services requested.
- Definition of the district’s financial reporting entity, e.g., a district financing authority, as defined in GASB Codification Section 2100.
- Discussion of the qualifications of the audit firm.
- Discussion of the period to be audited and the term of the engagement.
- Identification of the timing of the audit and the reporting deadlines.
- Identification of the criteria to be used in evaluating responses and selecting an auditor.
- Other items specific to the district’s needs.

An audit firm must be qualified to perform a special district audit. The RFP must first solicit information as to whether the audit firm and all assigned key personnel are properly licensed (certified public accountant). Next, the RFP should seek information as to the size of firm, size of governmental audit staff, location of office,

and water, wastewater and electric system industry experience, as appropriate. The RFP should solicit information about the particular individuals that the audit firm intends to assign to the district audit, including individual's education, governmental continuing education, professional experience and industry experience. Finally, with respect to the qualifications and experience of the audit firm, the RFP should inquire as to the audit firm's compliance with a peer review program. The district should obtain a peer review report and copy of the accompanying letter of comment, if any, as part of the RFP process.

AICPA requires an audit firm to be independent in the performance of auditing services. Impairment of the auditor's independence could arise from the following issues:

- Providing accounting assistance to the district in which the auditor performs management functions could impair independence. Certain management functions currently being provided to the district that may impact the auditor's independence include bookkeeping, payroll accounting, benefit plan administration, investment advisory or management, employee search, financial consulting, business risk consulting, or information system design, installation or integration.
- Unpaid Fees - The auditor's independence will be impaired if fees for professional services rendered more than one year prior to the date of the current year's report remain unpaid when the report is issued.
- Client Employee - when the district employs an individual in the immediate family of an auditor, independence violations can occur.
- Financial Interests - When an auditor has a direct or indirect material financial interest in the district or the services provided by the district the auditor cannot be considered to be independent.

Following a review and analysis of audit proposals, the board committee and management should schedule interviews of a selected number of audit firms, if considered necessary. The board committee should participate in the review and analysis of the audit proposals and the board committee should participate in the interview of the qualified firms to assist the district in selecting the auditor that meets its needs.

VIII. Establishing The Terms Of The Audit Engagement

Once an audit firm is selected, the district should enter into a written agreement with the firm that outlines the rights and responsibilities of both parties. The auditor typically furnishes an engagement letter, which would be the written agreement. A district may request additional services that it desires to add to the scope of the audit engagement. The purpose of a written agreement between the district and the audit firm is to establish an understanding with the auditor regarding the services to

be performed. The board committee should review the document, noting each of the components of the agreement covered in the auditor's proposal. A member of the governing board should sign the letter of engagement.

Documentation of the understanding, at a minimum, should include the following:

- A statement that the objective of the audit is the expression of an opinion on the district's financial statements.
- Identification of district management's responsibilities and the auditor's responsibilities in conducting the audit.
- A determination of the audit standards to be followed and the reports required.
- A determination as to the need for a Single Audit in accordance with Office of Management and Budget (OMB) Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations.

An audit is designed to obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. An audit is not designed to detect immaterial errors or fraud. The auditor may decline to express an opinion or to issue a report if the audit firm is unable to complete the audit or to form an opinion. An audit is not designed to provide assurance about internal control or to identify reportable conditions.

IX. The Financial Statement Audit Process

An audit is defined as the systematic examination of the assertions or actions of a third party to evaluate conformance to some norm or benchmark. The purpose of an independent financial audit is to provide assurance apart from district management that district financial statements (reports) are reliable--that is, that the financial statements fairly present, in material respects, the financial position, the results of operations, and cash flows of the district. Such assurance is important to district directors, management and the customers, taxpayers and community or communities they serve.

Auditors use a variety of methods to obtain the evidence they need to determine whether a government's financial statements are fairly presented. Auditors inspect relevant documentation; observe employee performance; inquire concerning policies, procedures, transactions, and events of a district; confirm balances and transactions with outside parties; and perform analytical procedures to determine the reasonableness of transactions and balances.

According to the publication titled "An Elected Official's Guide to Auditing" by Stephen J. Gauthier (GFOA, 2002), the goal of the auditor is to obtain reasonable assurance, not absolute certainty that the financial statements are fairly presented. Auditors do not attempt to ensure that all of the data contained in the financial statements are 100 percent accurate, rather the auditor is testing that the financial statements are

free from any material misstatements. Auditors do not attempt to examine individually every transaction or event affecting a district's financial statements. Instead, auditors perform their work on a "test basis", which is often statistically based to provide a certain level of confidence.

District management is responsible for the design and implementation of processes and programs to prevent and detect fraud. The district should inform the auditor of all known or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, and (3) others where the fraud could have a material effect on the financial statements. District staff should also inform the auditor of any allegations of fraud or suspected fraud affecting the organization described in communications from employees, former employees, grantors, contributors, regulators, or others.

An auditor might become aware of significant deficiencies in the district's internal controls in the course of performing the district's audit. GAAS refers to such deficiencies as reportable conditions. Management is ultimately responsible for its financial statements, regardless of the degree of auditor involvement in their preparation. GAAS requires the auditor to obtain written assurance from district management (management representation letter) that the financial statements are in fact complete and free of material weaknesses.

X. The Audit Report

The audit firm's responsibility in completing the audit report is to express an opinion on the district's financial statements based on the audit. The audit report contains an opinion as to whether the financial statements present fairly, in all material respects, the district's financial position, results of operations, and cash flows in accordance with GAAP. This opinion is based on the auditor's judgment as to whether:

- The accounting principles selected and applied have general acceptance.
- The accounting principles are appropriate in the circumstances.
- The financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation.
- The information presented in the financial statements is classified and summarized in a reasonable manner; i.e., the information presented is neither too detailed nor too condensed.
- The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits; i.e., limits that are reasonable and practicable to attain in financial statements.

There are several types of "standard" Auditors' Reports. An unqualified opinion or "clean opinion" is the opinion the district desires as that is one in which the indepen-

dent auditor can state, without reservations, that the financial statements are fairly presented in all material respects in conformity with generally accepted accounting principles.

The two other primary types of opinions are qualified and adverse opinions. A qualified opinion is used when the auditor has reservations about the fair presentation of the financial statements in conformity with generally accepted accounting principles. An adverse opinion is used when the auditor states that the financial statements are not fairly presented in conformity with generally accepted accounting principles.

Additionally, the auditor should separately identify any problems encountered during the audit, such as significant deficiencies in internal control (typically communicated in a management letter), or violations of laws or regulations, and errors or fraud. District management is responsible for adjusting the financial statements to correct material misstatements and providing the auditor with a representation that the effects of any uncorrected misstatements are immaterial to the financial statements.

Auditing standards have been established to guide the communication of the results of an audit. The audit firm should communicate the following:

- Auditor Responsibility - The level of responsibility the auditor assumes for an audit performed in accordance with generally accepted auditing standards and the nature of the assurance the audit provides.
- Accounting Policies - The initial selection of, and changes in, significant policies or their application methods used to account for significant unusual transactions, and the effect of significant accounting policies in controversial or emerging areas.
- Estimates Used- The process management uses to formulate particular sensitive accounting estimates and the basis for the auditor's conclusions about the reasonableness of those estimates.
- Adjustments - The significant adjustments arising from the audit, both those that have been reflected in the financial statements and those that have not. In addition, the auditors must inform the board committee about uncorrected misstatements that management has concluded are not material to the financial statements. The presentation of audit adjustments to the board committee should be similar to the summary of uncorrected misstatements included in the management representation letter.
- Other Information - The auditor's responsibility for unaudited information in documents containing audited financial statements, the procedures performed, and the conclusions reached.
- Disagreements - All instances, including those that have been satisfactorily resolved, in which the audit firm and district management disagreed about matters that, individually or in the aggregate, could be significant to the district's financial statements or the auditor's report.

- **Prior to Retention Issues** - Any major issues that management discussed with the auditor in connection with the retention of the auditor, including the application of accounting principles and auditing standards.
- **Difficulties** - Any serious difficulties the auditor encountered in dealing with management such as unreasonable delays in providing needed information, unreasonable timetable set by management, or unavailability of district personnel.
- **Reportable Conditions** - Any matters coming to the auditor's attention that, in his or her judgment, should be communicated to the board committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the district's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
- **Fraud and Illegal Acts** - The auditor is required to make certain the audit committee is adequately informed of any illegal acts, unless clearly inconsequential, that come to the auditor's attention. If the auditor determines there is evidence fraud may exist, the auditor is required to report it to the appropriate level of management. If the fraud or potential fraud involved senior management or causes the financial statements to be materially misstated, it should be reported directly to the board committee. Auditors are also required to reach an understanding with the board committee about the nature and extent of communication expected about immaterial fraud not involving senior management. In the absence of such an agreement, the auditor should report all instances of fraud to both the appropriate level of management and to the board committee.

The district management and the audit committee, if applicable, should hold an “exit” conference with members of the audit engagement team after the auditor's report has been written. District management and the audit committee should include a report on issues discussed in the exit conference as part of the presentation of the audit report to the full governing board.

XI. Presentation of the Audit Report

A district should approach its annual audit process as an opportunity to identify both strengths and areas for improvement within a district's financial operations. In that spirit, a district should be prepared to openly unveil the audit findings at a public governing board meeting where directors are educated on the audit report, its various components and how to read and use the information in the audit report.

The presentation of the financial statement with the attached auditors' report should be carefully crafted with all potential audiences in mind. These audiences include not only the district governing board, but district customers, city and county elected officials, state legislators, members of the local business community, advisory committee members, the county grand jury, and the local news media. Each audience will

be interested in different aspects of the audit and will have a different level of understanding of the information to be presented.

Once the auditor has presented results of the audit to the district board, the district should take additional steps to make that information available to its various audiences. This can be done in a variety of ways including, customer newsletters, on the district Web site, in a bill stuffer, through advisory and committee presentations, and through general speaker's bureau presentations. The district should also be prepared to respond to customer and media inquiries concerning the audit, both the positive and not so positive results. The district should consider the development and implementation of a proactive strategy to inform its customers about areas identified as needing improvement, as well as positive results.

There are a number of key messages that should be included in any presentation of audit findings:

- The district engages in an annual audit by an independent, outside auditor to ensure that an impartial review of its financial practices is conducted.
- The district believes it is important to openly share the results of that audit with the public.
- An annual audit provides the district governing board with the opportunity to provide policy guidance to district management in any areas deemed necessary.
- The audit provides a “checks and balances” opportunity between an elected board and district management.

XII. Rotation of Auditors

Auditors are required to gain and document an understanding of a government's framework of internal controls as part of the audit planning process. This process is time consuming in the first year of an audit, because the auditors are becoming acquainted with and documenting the internal control structure for the first time. A multi-year audit contract has the advantage of providing a better audit in future years as the learning curve regarding the district's internal control process has been met. Multi-year audit contracts can help to create valuable continuity in the audit process and provide better audits. The General Accounting Office (Federal) recommends multi-year agreements preferably of a five-year duration. A district must retain the right to terminate such multi-year agreements should the auditor's performance prove unsatisfactory.

Mandatory auditor rotation (at the end of the current multi-year agreement) can be effective only if a district has access to a sufficient number of interested and qualified audit firms to ensure adequate competition. A rule requiring mandatory auditor rota-

tion could have the practical effect of forcing a district to select a less qualified audit firm. It could also decrease the number of qualified audit firms wishing to participate in the audit procurement process.

For the above reasons, agencies are not advised to institute a mandatory auditor rotation policy. At the end of each audit-contract term, or, if the District awards annual audit contracts, at least every five years, agencies are encouraged to engage in a full-scale, aggressive procurement process that encourages competition from all qualified firms, including the current auditor. There is no legal mandate that auditors must be rotated; GFOA opposes mandatory rotation of the independent auditor.

XIII. Conclusion

Independent financial audits are one of many financial tools that should be part of a district's complete approach to managing its finances. Audits should be viewed as an essential annual exercise involving the governing board, management, and district staff, with the goal of improving the financial management of the district, as well as ensuring financial accountability to district customers, taxpayers and other important external audiences. Governing board members can gain a more thorough understanding of the district's financial health by reviewing notes to financial statements as well as any estimates, assumptions, post retirement benefits and potential debts not listed as a liability.

The district's governing board should be knowledgeable of and comfortable with both the financial position and the financial condition of the district. The former is concerned with the district's existing resources and claims to those resources, while the latter involves both existing and future resources and claims to those resources. General purpose external financial reporting focuses almost exclusively on financial position. Special districts, particularly those delivering water, wastewater and electricity services, must have a long-term focus in order to meet increasing demands due to population growth, evolving economic trends, changes in resource usage and management, as well as climactic changes. Understanding a district's financial condition, then, will assist management and the governing board in planning for and responding to the challenges of the future.

The more financial information shared, held and understood by the governing board of a district, and the district's external audiences, the less likely a district will encounter financial surprises, including the fraudulent expenditure of district resources.

Local Government Audit Internet Resource Guide

These Web sites will provide the local government finance professional with a large amount of information regarding local government finances including guidelines, standards, publications, software and subscription services.

American Institute of Certified Public Accountants (AICPA)

www.aicpa.org

Association of Government Accountants (AGAC)

www.agacgfm.org

Chief Financial Officers Council (CFOC)

www.cfoc.gov

Federal Accounting Standards Advisory Board (FASAB)

www.fasab.gov

Financial Accounting Standards Board (FASB)

www.fasb.org

Government Accounting Standards Board (GASB)

www.gasb.org

Governmental Accounting Standards Advisory Council (GASAC)

www.gasb.org/gasac/

Government Finance Officers Association (GFOA)

www.gfoa.org/

National Association of Local Auditors (NALGA)

www.nalga.org

National Association of State Auditors, Comptrollers and Treasurers (NASACT)

www.nasact.org

U.S. Department of the Treasury

www.ustreas.gov

U.S. Governmental Accounting Office (GAO)

www.gao.gov

Acknowledgements

ACWA President Jerry Gladbach appointed a statewide task force in June 2004 to develop audit and financial guidelines to assist member agencies in establishing their own specific policies. ACWA thanks the task force for its tremendous contribution.

Audit Task Force Members

Larry Byers, Fallbrook Public Utilities District (Chair)

Steve Robbins, Coachella Valley Water District (Vice Chair)

Ross Borba, Westlands Water District

Barbara Dore, Castaic Lake Water Agency

Steve Northcote, CPA, Leaf & Cole, San Diego

Joe Parker, Placer County Water Agency

Carol Rische, Humboldt Bay Municipal Water District

John Schatz, Santa Margarita Water District

Andy Sells, ACWA/Joint Powers Insurance Authority

Mike Solomon, United Water Conservation District

Other Credits

Gary Arant, Valley Center Municipal Water District

Steve Hall, ACWA Executive Director

Jennifer Persike, ACWA Director of Strategic Coordination / Public Affairs

Robert Reeb, former ACWA State Legislative Director

ACWA Communications / Outreach Department

Graphic Design: Tina Lynn Design

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