



## A Cost-Effective Alternative to Full Scope Audits for Small Municipalities

By: Michael A. Crawford, CPA

I am often asked by small Oklahoma municipalities - "How much should an audit cost, and are there any alternatives to obtaining a full scope financial statement audit?" While the first question is hard to answer and is dependent on a number of variables, the second is easy to answer because of a change in state law enacted in 2005. In this article, I will try to answer both questions and provide a refresher on the provisions of House Bill 1670 (HB 1670) passed and signed into law in 2005.

### State Law on Municipal Audits

First and foremost, a municipality should research its own charter, if applicable, its municipal code, bond indentures, trust indentures, and other contracts to determine if any of these documents contain audit requirements that should be followed. If there are no such requirements, then Oklahoma state law prescribes the audit requirements.

Prior to 2005, pursuant to 11 O.S. Section 17-105, every municipality with an income of \$25,000 or more to its general fund during a fiscal year was required to undergo a full scope financial statement audit. In addition, pursuant to 11 O.S. Section 60-180.1, every public trust created for the benefit and furtherance of a public function with the municipality as the beneficiary, was also required to obtain an audit of its financial statements. There were no exceptions or other alternatives available.

However, in 2005, in an attempt to provide a cost-effective alternative to a full scope financial statement audit for small municipalities, I approached the Oklahoma State Auditor and Inspector's Office (SA&I) and the Oklahoma Municipal League (OML) to propose a change to state law. Through our coordinated efforts, we were successful in amending state law through the passing and signing of HB 1670 to provide eligible municipalities and certain public trusts a potential alternative to meeting statutory municipal audit requirements without having to undergo a full scope financial statement audit.

HB 1670 provided that a municipality with annual income to its general fund of \$25,000 or more but having a population less than 2,500 and no other applicable financial statement audit requirements in law, regulation, or contracts, could opt to have an "agreed-upon procedures (AUP) engagement in lieu of a full scope financial statement audit. The amended law retained the previous exemption for very small municipalities in that cities or towns with less than \$25,000 of revenue in their general fund would not be statutorily required to have either a financial statement audit or an AUP engagement.

In addition, the amended state law also provided that the trustees of a municipal trust which has more than \$50,000 in revenues or assets, and for whom an annual financial statement audit is not required by another law, regulation, or contract, may also opt for an AUP engagement in lieu of a financial statement audit. Furthermore, (1) public trusts which have less than \$50,000 in revenue and less than \$50,000 in assets, and for whom an annual financial statement audit is not required by another law, regulation, or contract and (2) public trusts which did not have financial activity exceeding \$50,000 since its last audit may apply to the State Auditor and Inspector for a waiver of the requirements of both a financial statement audit and an AUP engagement.

Table 1 on the next page provides a summary of the audit and AUP engagement requirements applicable and alternatives available to Oklahoma cities and towns. Remember, however, that a municipality's own charter, code, bond indenture, trust indenture, or other contracts may supersede these statutory requirements and require audits in certain cases.

The AUP engagement alternative to a full scope financial statement audit introduced above is discussed in more detail later in this article.

**Table 1 – Statutory Audit Requirements or Alternatives for Municipalities**

Type of Entity	Statutory Reference	Audit Requirements or Alternatives
Municipalities with less than \$25,000 in general fund income regardless of population, and a financial statement audit is not required by another law, regulation or contract	11 O.S. Section 17-105A	No statutory requirement for either a financial statement audit or an AUP engagement
Municipalities with \$25,000 or more in general fund income and a population of less than 2,500, and a financial statement audit is not required by another law, regulation or contract	11 O.S. Section 17-105B	Statutorily may have either a financial statement audit or an AUP engagement
Municipalities with \$25,000 or more in general fund income and a population of 2,500 or more	11 O.S. Section 17-105A	Statutorily must have a financial statement audit
Municipal public trusts which have less than \$50,000 in revenues and less than \$50,000 in assets, and a financial statement audit is not required by another law, regulation or contract	60 O.S. Section 180.1C	Statutorily may request a waiver of audit requirements from the SA&I to remove themselves from the requirement of both a financial statement audit and an AUP engagement
Municipal public trusts which have less than \$50,000 in financial activity since its last audit, and a financial statement audit is not required by another law, regulation or contract	60 O.S. Section 180.1C	Statutorily may request a waiver of audit requirements from the SA&I to remove themselves from the requirement of both a financial statement audit and an AUP engagement
Municipal public trusts which have more than \$50,000 in revenues or assets, and a financial statement audit is not required by another law, regulation or contract	68 O.S. Section 180.1B	Statutorily may have either a financial statement audit or an AUP engagement
Municipal public trusts for which a financial statement audit is required by another law, regulation or contract, regardless of the amount of revenues or assets or financial activity	68 O.S. Section 180.1A&B	Statutorily must have a financial statement audit

**The Cost of Full Scope Audits**

Needless to say, the cost of a full scope financial statement audit in today's environment can be significant. Following the high-profile scandals and big business failures such as Enron and others in the past decade, the professional audit standards an auditor must follow have undergone major changes. A financial statement audit performed in accordance with the current professional standards is more rigorous and demanding in terms of required audit work and audit documentation than in prior times. In addition, because of the unique and complex nature of governmental financial statements, governmental financial statement audits can be relatively difficult and time consuming and may even require expansion to include comprehensive compliance audits over federal awards in certain circumstances. As a result, audit fees have been on the rise.

Unfortunately, there are too many variables that can affect the cost of a financial statement audit to provide anyone with a reasonable estimate of what an audit should typically cost. Annual financial statement audit fees for municipalities could range anywhere from \$5,000 to \$500,000 depending on such things as:

- The size of the municipality, number of funds, types and volume of activities, number of public trusts, amount of long-term debt, pension and OPEB plans, etc.
- The quality, accuracy and completeness of the accounting system and records used to prepare the financial statements

- The quality and experience of the municipality's accounting staff and the amount of assistance they can provide during the audit
- The quality and experience of the individuals or firm preparing the annual financial statements
- The quality and experience of the firm auditing the financial statements and the rates and fees they are willing to accept on the audit engagement
- The type of financial statements to be prepared and audited (complete CAFR or just basic financial statements)
- The overall strength or weakness of the municipality's internal controls over financial reporting (directly affects the type and amount of audit procedures needed)
- The basis of accounting applied in the annual statements (GAAP or cash/modified cash basis)
- Whether or not the entity crosses the threshold to require a Single Audit (federal award compliance audit added to the financial statement audit)
- The number and type of award or grant programs included in the compliance audit scope

For example, there could be two municipalities with the same 2,000 population and the annual financial statement audit fees for one could legitimately be \$5,000 while the other could legitimately be \$50,000, because of the variables noted above.

I wish estimating audit fees were as easy as buying office supplies or a piece of equipment; however, the reality is that financial statements audits and their required amount of work will always vary significantly based on the factors noted above. In fact, the true scope of required audit work may not even be known by the auditor until well into the audit engagement, prompting needed revisions to originally estimated or proposed audit fees.

It was with these ever-increasing and often unpredictable audit costs in mind, that I approached the SA&I, OML and ultimately the State Legislature to propose an audit alternative for small cities and towns.

#### **The Possible Alternative to the Full-Scope Audit**

On June 9, 2005, Governor Brad Henry signed HB 1670 providing for the alternative to full-scope financial statement audits for certain small municipal governments. The bill included an emergency clause that made the bill's provisions effective July 1, 2005, and the SA&I began accepting such AUP engagements from eligible municipalities for fiscal years ending June 30, 2005 and thereafter.

HB 1670 defines an "eligible municipality" as a municipality with a population as of the most recent Federal Decennial Census of less than two thousand five hundred (2,500), and for whom an annual financial statement audit is not required by another law, regulation or contract.

For example, while a municipality may have a population under 2,500, they may still be required to comply with the federal Single Audit Act and Office of Management and Budget Circular A-133 based on the amount of federal awards expended in a specific year. The Act and Circular require a financial statement audit for the entity and compliance audit over major federal awards when the entity expends \$500,000 or more of federal awards in the fiscal year. As a result, even though a municipality may have a population under 2,500, it would not be eligible for the agreed-upon procedures engagement in the year the Single Audit Act and OMB Circular A-133 requirements must be met.

It should be noted that for eligible municipalities, the AUP engagement is an alternative "available" to the entity in lieu of a financial statement audit. However, nothing in the law precludes the governing body of an eligible municipality from engaging an auditor to perform a financial statement audit.

In addition, while a municipality may be eligible for an AUP engagement, one or more of its public trusts may be required (for example by a loan agreement, bond indenture, etc.) to undergo a financial statement audit. In such a case, the municipality could opt for an AUP engagement, while the public trust obtains a financial statement audit.

### **The Agreed-Upon Procedures Engagement**

If a municipality is eligible for and elects to undergo an AUP engagement in lieu of a financial statement audit, state law specifically identifies the minimum procedures that are to be performed by the auditor/accountant in this type of engagement. Statutory requirements include the following as minimum procedures to be performed, to the extent applicable:

1. Prepare a schedule of changes in fund balances for each fund and determine compliance with the statutory prohibition of creating fund balance deficits;
2. Prepare a budget and actual financial schedule for the general fund and any other significant funds listing separately each federal fund and determine compliance with the legal level of appropriations by comparing expenditures and encumbrances to authorized appropriations;
3. Agree material bank account balances to bank statements, and trace significant reconciling items to subsequent clearance;
4. Compare uninsured deposits to fair value of pledged collateral;
5. Compare use of material-restricted revenues and resources to their restrictions;
6. Determine compliance with requirements for separate funds; and
7. Determine compliance with reserve account and debt service coverage requirements of bond indentures.

The municipality also has the ability to engage the auditor/accountant to perform any additional procedures it may so desire beyond these statutory minimum procedures.

### **Hiring the Auditor and Filing the Report**

It should be noted that statutory time limits exist for hiring an auditor to perform the financial statement audit or the AUP engagement. State law provides that the audit or agreed-upon-procedures engagement shall be ordered within 30 days of the close of each fiscal year. This means that a municipality with a June 30 fiscal year should have an auditor/accountant engaged to perform either the audit or AUP engagement no later than July 30 of that year. While this represents the statutory deadline, practically the auditor/accountant should be engaged well prior to the close of the fiscal year in order to expedite the completion of the work following year end.

Current law also provides that a copy of the audit or AUP engagement report be filed, along with a \$100 filing fee, with the State Auditor and Inspector's Office within 6 months after the close of the fiscal year. Failure to file by this time results in a temporary hold of the municipality's share of the state gas tax allocation by the Oklahoma Tax Commission until such time the report is received by the SA&I, at which time the withheld gas tax is released to the municipality. If the report is not filed with the SA&I within two years after the end of the fiscal year, such gas tax allocated to the municipality is permanently forfeited to the appropriate County's highway fund.

### **AUP Engagement versus Full Scope Financial Statement Audit**

It is important to understand the differences between a full scope financial statement audit and an AUP engagement when an eligible municipality is making a decision as to which alternative is better for them.

A full scope financial statement audit is designed to provide an auditor's opinion (a high level of assurance) over the fair presentation of the entity's annual financial statements. It gives a positive conclusion and provides reasonable assurance to report readers as to whether the financial statements are fairly presented in all material respects. The financial statement audit standards are rigorous and demanding and require a great deal of audit work and documentation. As a result, the audit costs can be quite significant in comparison to fees for an AUP engagement.

On the other hand an AUP engagement is a less rigorous and less demanding assurance engagement that provides limited assurance to report readers by only reporting the specific procedures the auditor/accountant was engaged to perform and the results of those procedures. In other words, a complete set of financial statements is not required to be prepared and audited in an AUP engagement, and the auditor/accountant provides no opinion as to fair presentation of financial statements. Instead, the annual financial statements and accompanying auditor's opinion are replaced with a report on the specific procedures performed by the auditor/accountant, the findings that resulted from performing those procedures, and certain supporting financial schedules.

Obviously, an AUP engagement is much less expensive than a financial statement audit. However, it also provides less assurance than a full scope financial statement audit. Although not the same high level of assurance as provided in a full scope financial statement audit, the AUP engagement does still provide the municipality and its taxpayers with some assurances as to accountability and compliance with regards to the items included in the scope of the AUP engagement.

Interestingly, a similar law was passed by the 2011 State Legislature that became effective July 1, 2011, and provides for similar full scope financial statement audit alternatives, including AUP engagements, for Oklahoma county governments.

Clearly, if a municipality under 2,500 population or a public trust has issued publicly traded bonds or other long-term debt where report users, such as investors and creditors, are interested in the on-going financial condition and performance of the municipality, a financial statement audit may be required or, if not required, would still be in the best interest of the municipality and public. However, for many eligible Oklahoma cities and towns under 2,500 population, the AUP engagement may adequately serve the accountability needs of the municipality and its taxpayers, represent a cost effective alternative to the full scope financial statement audit, and allow more of the municipality's limited resources to be used in other areas of serving the public.

For more information about this AUP engagement alternative and an example AUP engagement report, see the Useful Tools section of our firm's web site at [www.crawfordcpas.com](http://www.crawfordcpas.com).

#### **About the Author**

Mike Crawford is Chairman Emeritus of Crawford & Associates, P.C. an Oklahoma City based CPA firm dedicated since its establishment in 1984 to exclusively serving the practice area of state and local government through accounting and consulting services. Mike is a past president of the Oklahoma Society of CPAs, an inductee into the Oklahoma Accounting Hall of Fame, recipient of the OSCPAs Public Service Award, and is past Vice-Chairman of the national Governmental Accounting Standards Advisory Council. Over the past thirty years, he has authored a number of professional guides, practice aids, and articles on topics of governmental accounting, auditing, and professional ethics. Although Mike is retired from active practice, he continues to stay busy as an author, consultant, and public speaker.

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