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## **Schools Beware: Increased Audit Reporting Risks Ahead!**

**by Amy J. Borman and Patrick J. Downey**

### **Background**

The Auditor of the State of Ohio is required by state law to audit Ohio's public schools, including community schools. Schools that receive more than \$500,000 in federal grants in a single year are subject to federal single audits. The Auditor also conducts federal single audits. One of the Auditor's purposes in conducting an audit is to determine whether an entity has internal control procedures that ensure it properly expends the public funds it receives. The Auditor publishes its audit reports on its website.

### **New Auditing Standards**

Last year the AICPA changed some key definitions used in the Government Auditing Standards, the rules the Auditor follows in its audits. The new definitions apply to audit periods ending after December 15, 2006. In January of this year, the Office of Management and Budget adopted similar definitions in Circular A-133, causing the new definitions to apply to single audits. The new definitions increase the risk the Auditor of the State of Ohio will report that a school has internal control problems.

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## Old and New Definitions

The Auditor, under both the old and new Government Accounting Standards, reports only material weaknesses in internal controls in its public report. When a school's internal control problems are not a material weakness, the Auditor either will report the problem in a private management letter or not report it. Under the old standards, a material weakness was:

“A reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.”

Under the old standards reportable conditions were:

“Significant deficiencies in the design or operation of internal control that could adversely affect the entity's ability to record, process, summarize and report financial data consistent with the assertions of management in the financial statements.”

The new Government Auditing Standards now define material weakness as:

“A significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected.”

The following are considered strong indicators of material weakness in internal controls.

- Ineffective oversight of financial reporting and internal controls by the entity's governing board
- Ineffective control environment
- Ineffective regulatory compliance function
- Ineffective internal audit function or risk assessment

The term “reportable condition” has been replaced with the term “significant deficiency,” which is:

“A deficiency in internal control, or combination of deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statement that is more than inconsequential will not be prevented or detected.”

The following are considered examples of significant deficiencies in internal controls.

- Lack of antifraud programs and controls
- Lack of controls over non-routine and non-systematic transactions
- Ineffective controls over the period-end financial reporting process
- Ineffective controls over selection and application of accounting principle in conformity with generally accepted accounting principles

## What This Means to You

Under the new definitions, the Auditor will demand that your school's internal controls meet a higher standard than was previously expected. As a result, the Auditor could determine that your internal control procedures have material weaknesses although the Auditor did not find a material weakness in your last audit.

## What Should You Do?

Some material weaknesses can be easily corrected. For example, internal controls must be both documented and followed. Consequently, the Auditor will cite a school for a material weakness if its procedures are not in writing despite the fact that it follows effective internal control procedures. The correction in such a case is for the school to document its procedures.

To reduce the risk that it will be cited for a material weakness in its next audit, your school should review its existing procedures to determine if it has adequate internal control procedures in place and its procedures are properly documented and followed. Eastman & Smith Ltd. would be happy to assist with your review.

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