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The Independent Audit Report for a Municipal Government

Micheal D. Hendrickson

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THE INDEPENDENT AUDIT REPORT FOR

A MUNICIPAL GOVERNMENT

by

Michael D. Hendrickson

M. S. in Business Administration, University
of North Dakota, 1967

An Independent Study

Submitted to the Faculty

of the

University of North Dakota

in partial fulfillment of the requirements

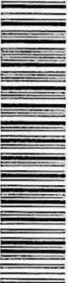
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This Independent Study Report submitted by Michael D. Hendrickson in partial fulfillment of the requirements for the degree of Master of Science in the University of North Dakota is hereby approved by the committee under whom the work has been done.

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William Johnson
Dean of the Graduate School

ABSTRACT

The main reports discussed are the importance of the independent auditor's opinion in municipal government and the existing conflicts in governmental accounting. The auditor's opinion is important because of the large audience to whom the report is presented. The special nature of the report as compared with commercial reports is also discussed.

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I. INTRODUCTION

ABSTRACT

Financial statements have two purposes. They reveal the financial position of the entity and they provide a basis for the independent auditor's opinion. The main aspects discussed are the importance of the independent auditor's opinion in municipal government and the existing conflicts in governmental accounting. The auditor's opinion is important because of the large audience to whom the report is presented, the unusual nature of the report as compared with commercial enterprises, and the lack of a profit being reflected in municipal statements. The conflict is illustrated by comparing procedures of the National Committee on Governmental Accounting with those of the American Institute of Certified Public Accountants.

The auditor, who is auditing for the municipality, must be familiar with the law in order to determine whether or not there has been compliance. If he does not know the law he cannot provide a check on a very important part of governmental accounting. In the short life of municipal accounting, laws have become increasingly more important.

The makeup of the independent audit report will depend upon the type of engagement. In general, it should contain a letter of transmittal in which the auditor discusses the scope and limitations of the audit, presents a summary of audit findings, and states

¹Victor A. Ellman, "Content of Financial Report as an Aid in Maintaining Municipal Credit," Municipal Finance, Vol. XXIII (August, 1955), p. 20.

recommendations for changes. The letter contains an opinion which is similar to that found in commercial audit reports.²

The report will contain the financial statements and a statistical section of the many funds. The statistical section is important,

I. INTRODUCTION

Financial statements have two purposes. They reveal the financial condition as of a specific date and they report on the stewardship of management. The municipal audit report becomes very important since there is no profit reported in municipal accounting. In commercial accounting, the financial statements reveal a profit. With certain limits, this profit combined with competition sets acceptable standards.¹

In municipal accounting, another factor of importance is compliance with legal provisions. In this respect, governmental accounting is unique from commercial accounting. The independent auditor, who is auditing for the municipality, must be familiar with the law in order to determine whether or not there has been compliance. If he does not know the law he cannot provide a check on a very important part of governmental accounting. In the short life of municipal accounting, laws have become increasingly more important.

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recommendations for changes. The letter contains an opinion which is similar to that found in commercial audit reports.²

The report will contain the financial statements and a statistical section of the many funds. The statistical section is important, especially to prospective investors in bonds. Statistical statements show non-financial data and financial trends such as tax rates, revenues, and expenditures. Financial statements, on the other hand, show such things as compliance with legal provisions and proper accounting for all funds. The number and types of statements will depend completely upon the size of the municipality, the number of transactions which have occurred, and the importance of analyzing changes which have taken place during the year. The statements will either be principle statements of the different funds or subsidiary statements which support different amounts in the principle statements. The principle statements are usually prepared from the accounts in the general ledger while the subsidiary statements are prepared from the various fund accounts.³

Most independent audit reports for municipalities are of the long-form type. The long-form is necessary because municipal financial statements are more difficult to read and understand than are the conventional commercial statements. In addition, municipal audit reports are more comprehensive because of the turnover of governmental officials. This makes it advisable to furnish explanatory material to aid in interpreting the statements. It should also be noted that

²Irving Tenner, Municipal and Governmental Accounting (3rd ed; Englewood Cliffs: Prentice-Hall, Ind., 1955) p.312

³Ibid., 313.

the report is long because of the many funds involved. Each of these funds requires a set of statements because each is a basic accounting entity.⁴

⁴Lawrence E. Rocca. "The Independent Auditor and the Municipality," Municipal Finance, Vol. XXXIV (November, 1961), p. 69.

from that used in commercial accounting. There are many examples of this variance in terminology. The term fund in commercial accounting concerns money while in municipal accounting a fund is a basic independent accounting entity. It has its own assets and liabilities, and is involved in the whole financial picture. The American Institute of Certified Public Accountants has eliminated the word surplus for use in commercial accounting. In municipal accounting the word surplus is carefully used and always qualified with a properly descriptive adjective.⁵ Words like encumbrance and appropriation are not used in commercial statements, but are used in municipal statements. In municipal statements, an appropriation is the assignment of a portion of a fund for a definite purpose. The purpose must conform to the restrictions of the fund. In other words, an appropriation is merely an authorization to make expenditures and to incur obligations for a specific purpose. Encumbrances are obligations in the form of purchase orders, contracts, or salary commitments. These encumbrances are chargeable to an appropriation for which a part of the appropriation is reserved.⁶ Revenue reflects profit in commercial statements.

⁵Lloyd Morry, "Toward a Common Language," Municipal Finance, Vol. XXIII (February, 1951), pp. 105-106.

⁶*Ibid.*, 105-107.

In municipal statements, revenue is in addition to cash or other current assets which are expendable and which do not increase any liabilities or reserves. Other payments are disbursements and expenditures.

II. DIFFERENCES IN TERMINOLOGY

AND AUDIENCES

The terminology used in governmental accounting often varies from that used in commercial accounting. There are many examples of this variance in terminology. The term fund in commercial accounting concerns money while in municipal accounting a fund is a basic independent accounting entity. It has its own assets and liabilities, and is involved in the whole financial picture. The American Institute of Certified Public Accountants has eliminated the word surplus for use in commercial accounting. In municipal accounting the word surplus is carefully used and always qualified with a properly descriptive adjective.⁵ Words like encumbrance and appropriation are not used in commercial statements, but are used in municipal statements. In municipal statements, an appropriation is the assignment of a portion of a fund for a definite purpose. The purpose must conform to the restrictions of the fund. In other words, an appropriation is merely an authorization to make expenditures and to incur obligations for a specific purpose. Encumbrances are obligations in the form of purchase orders, contracts, or salary commitments. These encumbrances are chargeable to an appropriation for which a part of the appropriation is reserved.⁶ Revenue reflects profit in commercial statements.

⁵Lloyd Morey, "Toward a Common Language," Municipal Finance, Vol. XXIII (February, 1951), pp. 105-106.

⁶Ibid., 105-107.

In municipal statements, revenue is an addition to cash or other current assets which are expendable and which do not increase any liabilities or reserves. Other terminology in municipal statements are disbursements and expenditures. Disbursements are payments in cash, while expenditures reduce the surplus of the various funds.⁷ In commercial accounting the terms disbursements and expenditures do not appear in statements, although they are a part of the vocabulary. The terminology is important because the municipal auditor must know the differences in order to prepare an audit report, or even to engage in a municipal audit.

A notable difference between audit reporting for a municipality and for a commercial enterprise is the audience for whom the report is prepared. In a commercial enterprise, the report is designed for the president, the board of directors, and the stockholders of the company. In municipal auditing the auditor has to consider a different type of audience. The municipal audit report must be digested by legislative and other governmental officials. The auditor must make his statements and illustrations simple and understandable because of the turnover of these governmental officials. Many governmental officials have little or no experience in governmental accounting, which makes it necessary to have a long form and self-explanatory type audit report. Another segment of the audience that must be considered is the general public. Since their tax dollars are being used, many of them are interested in the scrupulous or unscrupulous management of funds. Here again the auditor must make the report as simple and easy to follow as possible.

⁷Ibid., 108.

Readers of an audit report of a commercial enterprise are probably most interested in the profit and loss statement. The profit and loss statement is a good indication of the success or failure of the commercial enterprise. Readers of a municipal audit report are interested in knowing about nonobservance of the budget and improper management of tax money. Governmental officials and taxpayers have no profit and loss statement to aid them in evaluating municipal management.⁸ This would indicate that the opinion of the independent auditor of a municipality is more important than the opinion of the independent auditor of a commercial enterprise.

The independent auditor must recognize the important differences in commercial and municipal audit reporting. Two of the important contrasts which have been presented are the different audiences to whom the reports are offered and the different terminologies used in the reports. The audiences are interested in different things. The municipal audience generally wants to know if the tax money was managed properly and the commercial audience wants to know how much profit was produced. The terminology used in municipal audit reports is unfamiliar to commercial audit reports. The wording requires the independent auditor to annotate his reports to enable his audience to understand him. This is necessary because the municipal audience does not possess an adequate knowledge of municipal accounting.

⁸David M. Beights, "Municipal Auditing Standards, "The Accounting Review, Vol. XXX (July, 1955), p. 426.

V. C. Hamilton, "Relationship of the Independent Auditor to the Municipality," Municipal Finance, Vol. XXVIII (August, 1955), p. 22.

for elected officials and the general public. The auditor should make sure that his report reflects the collection and expenditure of public funds. The report should also reflect the operations of the municipality for the prior years. Because

III. IMPROVING THE INDEPENDENT AUDIT REPORT

Many provisions have been written into law which effect detailed accounting operations and hamper the application of sound accounting principles. Some of these laws have made it difficult for the audit reports and the municipal accounts to reflect true conditions. If legal and sound accounting principles conflict, legal provisions must take precedence. If accounts do not reflect the true condition, it is the independent auditor's responsibility to comment in the report. In this way, he will bring the conflict to the attention of municipal and possibly legislative officials. The independent auditor must remember that it is not his duty to merely comply with statutes, but rather to determine if the accounts and records are being kept accurately and honestly.⁹ Unless the independent auditor wants to qualify his opinion, the only action he can take is to recommend improvements to the legislative body or other governmental officials. Perhaps the American Institute of Certified Public Accountants should make a ruling as to whether conflict between legal provisions and sound accounting principles constitutes grounds for qualification of the opinion. In addition would require the independent auditor to

One area in which the independent auditor is in a key position to initiate improvements is in instituting a campaign of education

⁹W. G. Hamilton, "Relationship of the Independent Auditor to the Municipality," Municipal Finance, Vol. XXVIII (August, 1955), p. 22.

for elected officials and the general public. The auditor should make sure that his report reflects the collection and expenditure of public funds. The report should show a comparison with prior years. Because it is a public document and the taxpayer has a right to all essential information regarding the operation of the municipality, each section of the report should contain an easily readable narrative.¹⁰ The auditor must remember that it is the taxpayers dollars which are being spent. Too often, the independent auditor lacks consideration of his audiences and gears the report toward the accounting branch of the municipality. The independent auditor of a municipality works for the general public in the same respect that an independent auditor of a private enterprise works for the stockholders of the company.

Since one of the primary functions of the municipal audit report is to explain operations to the public, many accountants believe that an additional statement should be added to the opinion section of the report. The following is an example of how it would read with the additional statement:

In our opinion, the accompanying balance sheet and related statements of operations and surplus present fairly the position of the City of X at a given date, and the results of operations for the fiscal year, in conformity with generally accepted municipal accounting principles applied on a basis consistent with that of the preceding year. Generally acceptable standards of financial management and control for municipalities have been maintained consistently throughout the year under review.¹¹

The above addition would require the independent auditor to qualify his opinion because of mismanagement as he would for

¹⁰Ibid., 23.

¹¹Beights, The Accounting Review, XXX, 427.

inconsistency or unfair reflection of the financial position. The requirement would produce a more educational audit report to the public. The taxpayer would then have an unbiased and professional opinion on the management of tax dollars.

A concerted effort to amend laws and to educate the municipal audience would improve reports. However, legislation and education are not the only weak areas in audit reporting, because in some cases deficiencies are caused by the independent auditor.

One area where the independent auditor has been criticized is in fund accounting. Fund accounting is ignored in some reports and instead, a consolidated or co-mingled balance sheet is presented.¹² This type of presentation tends to obscure the true picture of the accounts. The auditor must remember that a fund is an independent entity and each fund has its own restrictions which are not revealed in a consolidated balance sheet.

The area of bond reporting in independent auditing needs improvement. Auditors are failing to make disclosures where contractual obligations and tax bond indentures are being violated.¹³ Bondholders and prospective bond buyers are interested in whether or not bonds are in default. Since the status of bonds is a good indication of the credit rating of the municipality, prospective investors may not invest in a municipality whose bonds are in default. Certainly, it must be admitted that the present bondholders have a right to know

¹²Roy L. Pope, "Letters," The Journal of Accountancy, Vol. CVII (April, 1959), p. 24.

¹³Ibid.

whether or not bonds are in default. Other obligations which often exist in a contract are covenants. Covenants are contractual obligations which pertain to raising rates when necessary to produce required revenue. Covenants also outline conditions under which additional bonds may be issued. Bondholders and prospective buyers are entitled to know whether or not these obligations are being adhered to by the municipality.¹⁴

The independent auditor has a moral obligation to educate elected officials. He can accomplish this through the use of self-explanatory and detailed financial statements in the audit report. Municipal governments could aid officials and the public by requiring that the independent auditor's opinion include a statement on proper financial management. The independent auditor also has an obligation to educate himself, especially in such areas as fund accounting and bond reporting which are unfamiliar to normal audit reports such as those found in commercial accounting. A good understanding of fund accounting is necessary in order to prepare proper reports which will reflect fairly the financial position of the municipality. Bond reporting is important because the status of bonds is a direct reflection on the credit rating of the municipality.

¹⁴Osa F. Alexander, "Financial Reporting to Municipal Bondholders," Municipal Finance, Vol. XXIX (August, 1956), pp. 55-59.

¹⁵Hamilton, Municipal Finance, XXVIII, 21.

IV. CRITICISMS OF THE NATIONAL COMMITTEE

ON GOVERNMENTAL ACCOUNTING

The National Committee on Governmental Accounting sets standards which effect auditors of municipal accounts. Many municipalities strive to meet the standards which are set in order to earn a Certificate of Conformance. A municipality that has a Certificate of Conformance has, in essence, a model financial and accounting system.

Some of the standards are disputed by Certified Public Accountants for different reasons. One such standard says that legal provisions should take precedence over accounting principles. This would presumably mean that legal provisions must be complied with, even though the resultant financial statements may not fairly present the financial position or results of operations. In the court case of Board of County Commissioners of Allen verses Baker and Miller, the Kansas Supreme Court ruled that the purpose of the independent audit is not merely to comply with statutes. The Court ruled that the main purpose was to determine whether the accounts and records were being kept honestly and accurately.¹⁵ It should be noted that it is the independent auditor's duty to see that the municipality complies with statutes, although this is not his main duty as previously mentioned.

The National Committee on Governmental Accounting has made a categorical implication that encumbrances should be taken into

¹⁵Hamilton, Municipal Finance, XXVIII, 23.

account without consideration for small municipalities.¹⁶ It is not practical for a small municipality to set up encumbrances since they have so few commitments. It is only practical for them to wait until the appropriations are actually used before they make an entry. In order to comply with the National Committee on Governmental Accounting, the small municipality would have to set up a separate account for encumbrances and a separate account for reserve for appropriations. This involves unneeded bookwork which serves no useful purpose when there are only a few commitments. The purpose of an encumbrance account is to show that part of the appropriations are being reserved for a commitment. Encumbrances are necessary only in the case of larger municipalities, who would otherwise not know their financial position throughout the year because of the numerous commitments that they enter into during the year.

The National Committee on Governmental Accounting has insisted that fixed assets be shown in the statements.¹⁷ With the exception of utilities, this seems to serve no practical purpose because the municipality is not trying to produce a profit. Since the municipality is not trying to make a profit and since they write off assets as they wear out, no depreciation is recorded. Instead, a record is kept of assets and as they wear out new assets are purchased, keeping within the limits of the budget.

Another implication made by the National Committee on Governmental Accounting is that combinations of balance sheets and operating

¹⁶Rocca, Municipal Finance, XXXIV, 70.

¹⁷Ibid.

statements of various funds are relatively unimportant.¹⁸ Although each fund is separate and the financial position of each must be shown, it is only logical to assume that combinations of financial statements would be helpful in giving a complete picture of the financial position of the municipality. If the independent auditor is not allowed to make combinations of statements, he will be able to show only the financial position of each fund. Although each fund is a separate entity, all funds are part of the municipality. The National Committee on Governmental Accounting has undoubtedly made the implication in order to prevent independent auditors from making only combination statements. Admittedly, the implication made by the Committee would discourage combination statements which tend to obscure the true picture of the funds. However, the National Committee on Governmental Accounting should outline procedures to be followed for both large and small municipalities.

¹⁸ Ibid. legislature is uneducated and thus unaware of the problems of municipal accounting.

Certain conflicts exist in governmental accounting. One conflicting area is with the independent auditor. He is auditing for cities which in many cases are striving to comply with procedures established by the National Committee on Governmental Accounting. In most cases, this same auditor is subject to procedures set down by the American Institute of Certified Public Accountants. He is left in a dilemma as to whom to satisfy in his audit report. Coordination and rulings are needed by the National Committee on Governmental Accounting and

the American Institute of Certified Public Accountants to resolve this area of conflict. Conflict also exists between laws and sound accounting principles. The CONCLUSION auditor could bring the conflict to the attention of governmental officials through a sustained

The independent auditor's opinion is significant in governmental accounting for several reasons.

- A. The independent auditor has no profit to present to his readers by which they could evaluate the report.
- B. The report is unusual since the accounting techniques are not the same as in commercial accounting.
- C. The report is presented to an audience which is not educated in municipal accounting.
 1. The public is the largest and least educated segment of the audience.
 2. Newly elected municipal officials are another segment who know very little about municipal accounting techniques.
 3. The legislature is uneducated and thus unaware of the problems of municipal accounting.

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