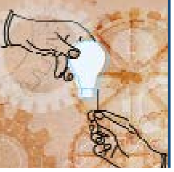

Audits of Group Financial Statements

Implications for Governments

By Stephen W. Blann

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In August 2011, the Auditing Standards Board of the American Institute of Certified Public Accountants released *Statements on Auditing Standards: Clarification and Recodification*, also known as the Clarity Project. These new auditing standards are effective for financial audits of periods ending on or after December 15, 2012. While the AICPA's stated objective for this project was to simply reorganize auditing standards generally accepted in the United States (the GAAS) to more closely align with their international counterparts, certain substantive changes were also made. One of the more significant of these changes is found in AU-C Section 600, *Audits of Group Financial Statements (Including the Work of Component Auditors)*.

Much of the impetus behind the new group audit standards was in response to situations such as those faced by multinational corporations with widely spread out divisions being separately audited in various countries. In those cases, a single auditor has to opine on the consolidated financial statements of the entire entity, and there is a clear need for detailed guidance on how to work with audit evidence gathered from disparate locations. However, the standards may also apply to the audits of state and local governments, where the landscape is quite different.

WHAT ARE "GROUP FINANCIAL STATEMENTS"?

GAAS define *group financial statements* as "financial statements that include the financial information of more than one component." A *component* is defined as "an entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements."[1]

Immediately, we can see that the group audit standards have introduced some new terminology that is very similar to terms with special meanings to governmental entities. For example, the auditing term *component* should not be confused with the governmental accounting term *component unit*. Further, the auditing term *business activity*, which is used in the definition of a component, should not be confused with the governmental accounting term *business-type activity*.

So what is a component? According to the AICPA's Audit Guide *State and Local Governments*:

> In applying the definition of a component in a governmental audit, it is helpful to consider the intent of AU-C section 600, which is to manage the aggregation risk inherent in the prepa-

ration of group financial statements. Accordingly, the auditor should obtain an understanding of the governmental entity, how its activities are managed, the governance structures, and how financial information is recorded in the accounting system and aggregated into the financial statements. The use of fund accounting by itself does not result in a component. Fund accounting is a mechanism to demonstrate accountability with the restrictions on resource inflows.[2]

In plain language, a component is an operation that is managed, governed, and accounted for under a single system. A component may include only a part of a legally separate entity, an entire legal entity, or a collection of separate legal entities. What matters in this context is not the legal or fund structure, but the organizational structure.

For example, consider the following two cities:

City A has a general fund, a water fund, and a legally separate downtown development authority that is reported as a discretely presented component unit. However, the entire entity is accounted for by common management in the same general ledger. City A could be considered a single *component* for the purposes of the group audit standards.

City B has the same funds and component unit as City A, but has separate financial management for the water fund and uses a separate general ledger to account for those operations. City B would have multiple *components* for the purposes of the group audit standards.

If the financial statements include more than one component, then they are considered *group financial statements*, and the group audit standards apply.

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CONSIDERING OPINION UNITS

Further complicating this issue for governments is the fact that auditors are required to form opinions on multiple *opinion units* rather than on the basic financial statements taken as a whole. Typically, those opinion units include the governmental activities, business-type activities, aggregate discretely presented component units, each major fund, and the other aggregate remaining fund information. Since each opinion unit is individually audited based on its respective performance materiality, each opinion unit can also be considered its own group. Accordingly, the group audit standards apply only if a single opinion unit contains more than one component.

It is worth noting that the AICPA has specifically excluded the financial statements of the governmental activities and business-type activities from the group audit considerations, as those opinion units are formed by combining the financial statements of the underlying major funds and aggregate remaining fund information, all of which are separate opinion units f or which the auditor expresses separate opinions.[3]

INVOLVING OTHER AUDITORS

Thus far, we have focused on defining components from an organizational and managerial perspective. There is one more factor to consider: having an operation separately audited; this factor would automatically constitute a separate component. If any portion of a government's financial reporting entity is audited by other auditors, that operation would be considered a component and would trigger the group auditing standards. Consider the example of City A above. If, despite having common financial management, the water fund was separately audited from the rest of City A, the financial statements would be considered group financial statements.

AUDITOR RESPONSIBILITIES

Whenever the group audit standards apply, auditors are subject to additional responsibilities that may add to the time and cost necessary to complete the audit. In brief, the auditor responsible for issuing an opinion on the overall reporting entity (the group auditor) must:

- Understand the group, its components, and their environments.
- Communicate with the component auditor and understand the work he or she performed.

- Consider how the component audits will be incorporated into the group audit.

Typically, the group auditor of governmental financial statements will elect to reference the report of the other auditors in his/her opinion on the group financial statements. This reference takes the form of a statement similar to the following: "We have audited the financial statements of the city. We did not audit the financial statements of the water fund. Those financial statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for the water fund, is based solely on the report of the other auditors."

Prior to the group audit standards, the principal auditor (now called the *group auditor*) had little responsibility other than to obtain the report of other auditors and reference it. Under the new standards, the group auditor must also evaluate the independence and professional competence of the component auditor and whether the group auditor will be able to rely on the component auditor's work. This may require the group auditor to review the work papers of the component auditor. In extreme cases, the group auditor may conclude that it cannot rely on the work of a component auditor and will need to perform his or her own procedures in order to render an opinion.

There is an obvious potential for difficulty here, as the auditors of the group and its various components may be competitors, selected through a bidding process. Further, group management may not have the jurisdictional authority over component management to resolve issues, should they arise. Unfortunately, the standards don't provide a clear remedy for this situation.

SUBSEQUENT EVENTS

Another new requirement of the group audit standards is that the group auditor must consider events that may have occurred subsequent to the issuance of the separate audits of any components through the date of the group auditor's opinion on the group financial statements. This may be especially significant for governments, where a separately audited component may have a different fiscal year, or otherwise issue its financial statements substantially earlier than the group financial statements.

While the responsibility for opining on the group financial statements rests with the group auditor, the component auditor is typically in a much better position to perform the evaluation of subsequent events at a component that may need to be reported in the group financial statements. Accordingly, it would be wise to communicate expectations for the timing of the issuance of the group financial statements to all of the components and to have both agree on a plan for completing the necessary audit procedures in advance.

CONCLUSIONS

As with any change in professional standards, it will likely take the auditing profession a little time to adjust to the new guidance and to develop some uniformity in practice. Governments should be mindful of situations that could arise regarding the applicability of the group audit standards, and develop a plan for dealing with the potential difficulties associated with them.

The first step is to communicate with your auditor to determine whether the group audit standards will apply to your government. If there are any separately audited components, request that group management and the group auditor be given the opportunity to review drafts of those financial statements before the audit is completed. Additionally, make arrangements in advance for the timing/method of updating subsequent event disclosures through the date of the group financial statements.

While there will always be potential for some difficulties when preparing group financial statements, with a little planning and communication, the implementation of these new standards should be relatively painless.

Notes

1. AU-C Section 600, paragraph 11.
2. Audit Guide, *State and Local Governments*, paragraph 4.98.
3. Audit Guide *State and Local Governments*, paragraph 4.101.

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