STATE OF UTAH
LEGAL COMPLIANCE AUDIT GUIDE
July 1, 2013

OFFICE OF THE
UTAH STATE AUDITOR

REVISION HISTORY

If you are using a version of the *Legal Compliance Audit Guide* dated prior to July 12, 2013, please consider the following changes which have been made since the original issuance of the July 1, 2013 version of the *Guide*:

CHAPTER	SECTION	PAGE	CHANGE(S) MADE	DATE CHANGED
Introduction	Reporting	I-5	I/C Deficiencies Row – Changed to indicate that auditor's should use professional judgment to determine reporting	July 9, 2013
1	I. Utah Retirement Systems Compliance	1-11	"Applicable to" column changed to "ALL"	July 9, 2013
3 App 3-3 App 3-4	A. MSP Procedures (introductory verbiage) MSP Schedule MSP State & Fed Revenue Reconciliation	3-2 3-3-2 & 3-3-3 3-4-1	References to "Board Leeway" and "Voted Leeway" changed to "Board Local Levy" and "Voted Local Levy"	July 12, 2013
App 3-3	MSP Schedule	3-3-2 & 3-3-3	"Board Local Levy" and "Educator Salary Adjustments" lines moved from "Restricted Programs" to "General Programs"	July 12, 2013
Introduction	Application section	I-1	Corrected link to the *Guide for Agreed-upon Procedures Engagements*	July 25, 2013

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INTRODUCTION

This introductory section addresses the application of compliance audit requirements for local governments and those nonprofit organizations required to file their audited financial statements with the Office of the Utah State Auditor (OSA). It also discusses performing risk assessment procedures and tests of controls, materiality, and reporting on state legal compliance.

Chapters 1 and 2 of this *State of Utah Legal Compliance Audit Guide (Guide)* provide general compliance requirements with which local governmental entities must comply. Chapter 3 contains specific compliance requirements for grants received from the Utah State Office of Education, as well as applicable agreed-upon procedures related to those grants. Chapter 4 contains compliance testwork guidance for state funds received by local governments and nonprofit organizations. Chapter 5 provides report illustrations.

In addition to the compliance requirements listed in this *Guide,* the auditor is expected to test compliance with other laws, regulations, contracts, and grant agreements that could be material to the financial statements. *U.S. Auditing Standards—AICPA Clarified* (AU-C) section 250 requires that as part of the audit of the financial statements, auditors test state laws and regulations that could directly and materially affect the determination of financial statement amounts. *Government Auditing Standards* (GAS) 4.19 extends that requirement to include contracts and grant agreements. A law or regulation would be considered to have a direct and material effect if noncompliance has the potential to materially misstate the financial statements. **These types of compliance requirements should be tested as part of the audit of the financial statements and may not be included in this *Guide.*** This may include, but not be limited to, compliance with the State Money Management Act, compliance with debt or bond requirements, or debt limitations. This *Guide* is not intended to identify compliance requirements that could be material to the financial statements. Therefore, the auditors should use appropriate audit procedures, such as inquiry with management, review of minutes, and other procedures as considered necessary. to identify the compliance requirements that should be tested as part of a financial audit.

APPLICATION

This *Guide* applies to audits of:

- Local government entities:
  - Counties
  - Municipalities
  - Local Education Agencies (LEAs):
    - School districts
    - Charter schools (including charter schools organized as nonprofits)
  - Local and special service districts
  - Other local government entities
- Nonprofit organizations that receive at least 50% of their funds from federal, state, or local government entities (excluding charter schools structured as nonprofits)

This *Guide* does not apply to:

- State departments or agencies
- Local government entities that are allowed and choose to receive an agreed-upon procedures engagement as outlined in the OSA's *Guide for Agreed-upon Procedures Engagements for [Local Governments, Nonprofits, or Charter Schools] with Revenues or Expenditures Greater than $100,000 and Less Than $500,000* (see OSA's website at http://auditor.utah.gov/local-government/for-cpas-and-practitioners.

Utah Code Annotated (UCA) 51-2a-202 requires audits of local government entities to be performed in accordance with both GAS and state auditing requirements. Further, UCA 51-2a-301 requires the OSA to

establish guidelines, qualifications, criteria, and audit procurement procedures for all entities that file financial reports.

Compliance audits and attestation engagements usually are performed in conjunction with a financial statement audit. Accordingly, **the guidance in AU-C section 935, *Compliance Audits*, is applicable when an auditor performs a compliance audit** in accordance with 1) generally accepted auditing standards, 2) the standards for financial audits under GAS, and 3) this *Guide*. When an auditor is engaged to perform agreed-upon procedures to assist users in evaluating an entity's compliance with specified requirements (as required by Chapter 3, Appendix 3-1 and Appendix 3-2, in this *Guide*), AICPA *Statements on Standards for Attestation Engagements*, Section AT 601, *Compliance Attestation*, applies.

GAS and this *Guide* contain certain standards and requirements that are supplementary to auditing standards generally accepted in the United States of America (U.S. GAAS), and to the guidance on how to apply those standards and requirements.

AUDIT REQUIREMENTS

Local Government Entities

UCA 51-2a-201 requires all local government entities with total annual revenues or expenditures (expenses) greater than or equal to $500,000 to have their financial statements audited by an independent certified public accountant licensed to practice in Utah. Additionally, the Utah State Office of Education requires operating charter schools with annual revenues and expenditures less than $500,000 to have an audit. **All local government entities that receive an audit are required to follow the compliance testwork identified in this *Guide.***

Nonprofit Organizations

UCA 51-2a-201 and UCA 51-2a-102(6)(f) require the filing of financial reports with the OSA by all nonprofit organizations that received at least 50% of their funds from the federal, state, or local governments, as a condition for receiving such aid. **Nonprofit organizations required to file a financial report with the OSA are required to follow the compliance testwork identified in this *Guide,* unless those nonprofit organizations did not receive any State funds. Nonprofit organizations are not, however, required to report on the general state requirements contained in Chapters 1 and 2 of this *Guide*.** However, **charter schools structured as nonprofit organizations** are considered public schools and, therefore, Chapters 1 and 2 apply, similar to school districts.

Nonprofit organizations that receive less than 50% of their funds from federal, state, or local government entities are not subject to any of the requirements of this *Guide*. Testwork and reporting are not required by this *Guide* even if major State grants have been received by these entities. (However, the State grant may be subject to audit requirements if agreed to in the contract with the entity awarding the funds.)

MATERIALITY

Materiality for compliance differs from financial statement materiality. Materiality for compliance is affected by 1) the nature of the compliance requirement, 2) the nature and frequency of noncompliance identified, and 3) qualitative considerations, such as the needs and expectations of oversight and granting agencies and other users of the auditor's report.

AU-C 935 defines **material noncompliance** as "a failure to follow compliance requirements . . . that result in noncompliance that is quantitatively or qualitatively material . . . to the affected government program." A **material weakness in internal control over compliance** is defined as "a deficiency . . . in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis."

In addition to the discussion above from AU-C 935, the *AICPA Audit and Accounting Guide for State and Local Governments*, paragraph 4.21, discusses other qualitative factors that the auditor may consider in evaluating material noncompliance:

- The potential effect of the noncompliance on the government's ability to raise resources (for example, through taxes, grants, contributions, or debt or loan financings) in the future.
- The potential effect of the noncompliance on the continuation of existing relationships with vendors, employees, and elected appointed officials.
- Whether the noncompliance involves an activity that often is scrutinized by elected or appointed officials, citizens, the press, creditors, or rating agencies.
- Whether the noncompliance is an isolated event or instead has occurred with some frequency.
- Whether the noncompliance results from management's continued unwillingness to correct internal control weakness.
- The likelihood that similar noncompliance will continue in the future.

PERFORMING RISK ASSESSMENT PROCEDURES AND INTERNAL CONTROLS

For each general compliance area and each compliance requirement for major state programs selected for testing, the auditor should perform risk assessment procedures to obtain an understanding of the applicable compliance requirements and the entity's internal control over compliance with the applicable compliance requirements. **Procedures to test the *effectiveness* of internal control over compliance are not required.** However, performing risk assessment procedures to obtain an understanding of the entity's internal control over compliance **includes an evaluation of the design of controls and whether the controls have been implemented.**

When evaluating whether controls over compliance have been properly designed and implemented the auditor should consider the risk of material noncompliance (what could go wrong) when determining whether controls are sufficient. The auditor should also remember that there are five components of internal control that should be considered and not focus solely on traditional control activities such as review, approval, reconciliation, etc.

For example, in Chapter 1 Section A. Cash Management of this *Guide,* the auditor is required to document control procedures over the completeness and accuracy of the deposit and investment report submitted to the State of Utah Money Management Council. The Money Management Council uses this report to evaluate compliance with rules established by the Council. These rules are designed to safeguard public funds by ensuring that funds are deposited into secure financial institutions and that investments do not exceed an acceptable level of risk. The first step is to assess risk and evaluate what could go wrong. Risk considerations could include:

- Does the person preparing the report have an incentive to misstate the report?
- Has the auditor found errors on the report in the past?
- What is the potential impact on the entity if additional deposits are included or if other deposits are excluded from the report?

If the auditor determines that the risk of noncompliance is high, then a second person's review or approval of the report may be necessary. If the auditor determines that the risk of noncompliance is low, then the entity's policies and procedures establishing a commitment to hiring and developing competent personnel, assignment of authority, responsibility and accountability may be sufficient. See AU-C 315 .A68 and .A69 for additional guidance.

If the auditor identifies risks of material noncompliance, the auditor should design and perform further audit procedures in response to such risks. These procedures should include performing tests of controls over compliance if the auditor expects controls over compliance to be adequate or if substantive procedures (tests of transactions) alone do not provide sufficient appropriate audit evidence. When tests of controls are performed, the auditor should test the operating effectiveness of controls over each applicable compliance requirement to which the conditions apply in the compliance audit.

REPORTING

A report on compliance as well as a report on internal controls over compliance is required by this *Guide*. Such communications on internal control over compliance can be combined with the report on state legal compliance. The auditor should report as audit findings:

- Material noncompliance with compliance requirements as described in this *Guide.*
- Significant deficiencies and material weaknesses in internal control over compliance requirements.

Utah Administrative Code Rule R123-5-5(6), AU-C 935, and GAS also require the auditor to report the views of responsible officials and planned corrective actions for findings related to the compliance requirements.

Findings and deficiencies reported under OMB Circular A-133, as well as views of responsible officials and their planned corrective action for those findings and deficiencies, are also to be included with the report on compliance or in accompanying schedules.

Other instances of noncompliance that do not result in an opinion modification but are more than inconsequential should also be reported to management and those charged with governance, but can be communicated in either a letter to management and those charged with governance or with the report. When a management letter is used to communicate other instances of noncompliance (immaterial or inconsequential findings), the state legal compliance report should refer to the management letter and include a response from management either in the report or by referring to management's response in the letter to management.

The auditor is to use professional judgment to determine whether and how to communicate to the entity violations of compliance requirements that are inconsequential and to document any such communications. Although not required, the auditor may decide to communicate such findings in a letter to management. The letter to management and the governing body's response to the recommendations need not be bound with the financial statements and related auditor's report, but the audit report will not be considered complete until all required elements have been received by the OSA.

In accordance with this *Guide*, AU-C 935, and GAS, the auditor should form an opinion on whether the entity complied in all material respects with the applicable compliance requirements and the auditor's consideration of internal controls over those requirements and report appropriately.

State Legal Compliance Requirements for Reporting Findings			
	Report On Compliance and on Internal Controls Over Compliance	Communicate in Writing	Auditors Use Professional Judgment to Determine Reporting
Instances of noncompliance with general or major state program compliance requirements:			
• Those that have a material effect	X		
• Less than material but more than inconsequential [1]		X	
• Those that are inconsequential			X
Deficiencies in internal control over general or state major program compliance requirements:			
• Material weakness	X		
• Significant deficiency	X		
• Deficiency in internal control			X

[1] Communication can be in the report or in a letter to management.

Illustrative auditor's combined reports on legal compliance and internal control over compliance are shown in Chapter 5 of this *Guide*.

Schedule of Expenditures of State Grants, Contracts, and Loan Funds

Local government entities other than LEAs are required to submit a Schedule of Expenditures of State Grants, Contracts, and Loan Funds for the period. The schedule should list (1) the State agency, (2) the name of the grant, contract or loan funding source, (3) total expended, and (4) the year the grant, contract, or loan funds were subject to audit by this *Guide*. This schedule should be emailed to OSA at sao@utah.gov as part of the audit report submission (see Chapter 4, Appendix 4-1 for an example of this schedule).

QUESTIONS AND COMMENTS

The OSA welcomes questions, comments and suggestions on this *Guide*. Please submit them to Patricia Nelson, Audit Supervisor, Local Government, at patricianelson@utah.gov.