



Auditor of State Betty Montgomery

OHIO COMPLIANCE SUPPLEMENT

Preface

This is the latest revision to the *Ohio Compliance Supplement*, superseding the January, 2004 version. This revision incorporates significant new or revised legal and regulatory requirements as well as comments we have received from auditors and our clients. The following page, titled *Implementation Instructions*, explains how you can identify updates.

In accordance with *Government Auditing Standards*, auditors must design their audit to reasonably assure detecting material misstatements resulting from violations of provisions of laws, regulations, contracts, or grant agreements that directly and materially affect the determination of financial statement amounts (*Government Auditing Standards*, 4.17). Each public office is responsible for identifying the requirements with which the entity and its officials must comply and for implementing systems designed to achieve that compliance (*Government Auditing Standards*, 1.18b).

Ohio law requires audits of each public office. These audits help determine whether the government's financial statements are fairly presented and whether management has complied with significant laws and regulations.

The *Ohio Compliance Supplement* contains certain laws and regulations which are of considerable public interest, or are of the type auditors generally consider direct and material. Though the *Ohio Compliance Supplement* is not a comprehensive listing of applicable laws and regulations, it is designed to help auditors and public offices identify and familiarize themselves with certain laws and regulations which generally apply to a variety of local governments and colleges and universities.

The *Ohio Compliance Supplement* is available only in electronic format, via the Auditor of State's website at <http://www.auditor.state.oh.us/>. We trust you will appreciate that this method of distribution reduces our costs. However, if you are unable to access the website or have difficulty accessing these files, please contact the Accounting and Auditing Support Division at 1-800-282-0370.

As in the past, we plan annual revisions. Comments we receive from our staff and others have always been an important source of revisions and improvements. We appreciate your comments regarding the *Ohio Compliance Supplement* in our continual effort to improve it.

A handwritten signature in black ink that reads "Betty Montgomery".

Betty Montgomery
Auditor of State

March, 2006

Implementation Instructions

This March, *2006 Ohio Compliance Supplement* (OCS) replaces the January, 2004 version. The OCS is available at www.auditor.state.oh.us, under *Publications*, in both Word and Portable Document Format. (Auditor of State staff can also access MS Word versions in the Audit Briefcase.) Due to the wide availability of internet access, we no longer provide the OCS in paper or disc formats.

The seven chapters and appendices D, G, and H are available in MS Word format so auditors can document work or cross reference to other audit documentation in those seven documents. The Introduction and other appendices are only available in Portable Document Format, since we do not expect that auditors would document their work in these sections. Due to complexities regarding laws associated with court fines, it is not practical to summarize these requirements in an appendix. Therefore, this OCS does not include these fine distributions in what was formerly Appendix C.

The Table of Contents follows these Implementation Instructions. A table for each chapter is also located in the front of each chapter. The table of contents identifies legislative requirements. The table identifies new or revised requirements via shading. The table identifies superseded legal requirements using strikeout font. We have not deleted these sections since they may still apply to portions of incomplete audits. For example, Step 6-10 is a new legislative requirement / OCS step, and appears in the table of contents as follows:

6-10 ORC 3314.03 Sponsor monitoring of community schools24

In addition, we have included a box at the top left hand corner within each modified step indicating if the section is a revised or new legislative requirement. In both cases, the effective date also appears enable you to easily determine if the revision applies to the audit period. Below are examples appearing in the OCS:

**New section per HB 364,
effective 4/08/03**

**Revisions per OAG Opinion
99-026, SB 82 (effective
6/12/04); and per HB 168
(effective 6/15/04).**

In addition to the box described above, the OCS uses double underlining to indicate new or revised legislative requirements.

The OCS uses waved underlining to highlight:

- Pre-existing laws we have now determined auditors should test (i.e. requirements not appearing in former OCS editions).
- New or amended guidance. Most of these changes represent information we believe will enhance understanding compliance auditing or reporting.

The OCS uses ~~strike-out~~ font to indicate replaced or omitted legislative requirements. We have not deleted these sections since they may still apply to part of an audit period. Also, retaining this information will help users better understand the changes.

Auditors with engagements in process prior to the issuance of the *2006 Supplement* need not discard work performed using the 2004 OCS. However, they must compare the 2006 changes to their work from the 2004 OCS and assure they have tested the legal provisions applicable to their audit period. More than one legal requirement could apply if a legislative change was effective during the audit period.

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LEGAL COMPLIANCE AUDITING IN OHIO

Introduction

Citizens and their public officials want and need to know whether government funds are being handled properly and in compliance with laws and regulations. Public officials entrusted with public resources are responsible for complying with those laws and regulations.

Ohio Administrative Code Section 117-2-05 requires independent auditors of public offices in Ohio to follow the Comptroller General of the United States' generally accepted government auditing standards (*GAGAS*).

Under *GAGAS*, the compliance requirements independent auditors should test are limited to those for which non-compliance may materially affect the financial statements. The auditor's responsibility, as part of the engagement planning, is to identify those compliance requirements subject to these standards. This responsibility currently includes:

- Designing the audit to provide reasonable assurance of detecting material misstatements resulting from direct and material illegal acts;
- Applying procedures specifically directed at determining whether material **indirect** acts have occurred, if specific information comes to the auditors' attention providing evidence of the existence of such acts;
- Designing the audit to provide reasonable assurance of detecting material misstatements resulting from non-compliance with provisions of contracts or grant agreements that have a direct and material effect on the financial statements.

This *Supplement* provides the auditor with State laws and regulations (and some laws and regulations from other sources) the Auditor of State has identified as potentially significant in an audit of Ohio governments. As such, it is a practice aid designed to help auditors fulfill their responsibility. However, auditors should not consider this as a comprehensive list of compliance requirements for all governments.

The *Ohio Compliance Supplement's* first six chapters contain laws and regulations that AOS normally considers "direct and material" under the American Institute of Certified Public Accountants' (AICPA) criteria indicated below. However, ***it is the auditor's responsibility to determine which, if any, compliance requirements are material to the government.*** Particular attention should be paid to other laws and regulations that are created by the government being audited, such as charters of municipalities, municipal ordinances and resolutions (including income tax ordinances), and contracts, grant agreements, debt covenants and leases. If any of these requirements could materially affect the government's financial statements, then the auditor should test them similarly to the laws and regulations in this *Supplement*.

The procedures listed in the "direct and material" sections of the *Supplement* generally are: assess the compliance control environment, document applicable compliance controls, test and evaluate the controls (if applicable), and substantively test compliance.

In addition to the GAGAS requirements, the auditor should plan and test controls over “direct and material” laws, regulations, and provisions of contracts or grant agreements annually for the assertions relevant to these compliance requirements. The auditor should, at a minimum, document controls and determine whether they have been placed in operation. If controls are not likely to be effective, or if the auditor deems it more efficient not to *test* controls for operating effectiveness, then the auditor should document those considerations and apply more extensive substantive compliance tests.

If an item of compliance listed in Chapters 1 through 6 applies but the auditor deems it not direct and material to the entity, then the auditor generally should use the less-extensive documentation and testing procedures Chapter 7 describes. Similarly, if the auditor deems an item in Chapter 7 to be direct and material to the entity, she or he generally should use the more extensive procedures similar to those chapters 1 through 6 describe. If an item of direct and material compliance is not found in the *Supplement* at all (for example, municipal income tax provisions), then the auditor should document and test it similar to procedures found in chapters 1 through 6.

To the extent that a public office does not fall within the classes of public offices addressed in the *Ohio Compliance Supplement*, the auditor should follow the guidance from AU 801.07 in determining legal requirements subject to testing:

“The auditor should obtain an understanding of the possible effects on financial statements of laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of amounts in an entity's financial statements. The auditor should also assess whether management has identified laws and regulations that have a direct and material effect on the determination of amounts in the entity's financial statements and obtain an understanding of the possible effects on the financial statements of such laws and regulations. The auditor may consider performing the following procedures in assessing such laws and regulations and in obtaining an understanding of their possible effects on the financial statements.

- a. Consider knowledge about such laws and regulations obtained from prior years' audits.
- b. Discuss such laws and regulations with the entity's chief financial officer, legal counsel, or grant administrators.
- c. Obtain written representation from management regarding the completeness of management's identification.
- d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.
- e. Review the minutes of meetings of the legislative body and governing board of the governmental entity being audited for the enactment of laws and regulations that have a direct and material effect on the determination of amounts in the governmental entity's financial statements.
- f. Inquire of the office of the federal, state, or local auditor, or other appropriate audit oversight organization about the laws and regulations applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- g. Review information about compliance requirements, such as the information included in the Compliance Supplements issued by OMB;

Compliance Supplement for Single Audits of State and Local Governments and Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions, Catalog of Federal Domestic Assistance, issued by the Government Printing Office, and state and local policies and procedures.”

The materials included for other public offices in the *Ohio Compliance Supplement* may also serve as guidance in applying these criteria. Guidance for selecting these compliance requirements may also be obtained from the Auditor of State's regional chief auditors. Additionally, Appendix F provides guidance in determining the applicability of certain requirements contained in the *Ohio Compliance Supplement* to certain additional classes of public offices.

Direct and Material Laws and Regulations

The AICPA Audit and Accounting Guide *State and Local Governments*, sections 4.43 through 4.48, discusses legal requirements which might directly and materially affect financial statement amounts for a governmental entity. These include:

- *Generally accepted accounting principles (GAAP) requirements* – governments often are subject to legal or contractual provisions requiring them to prepare GAAP financial statements. Determining the financial reporting entity under GAAP requires applying certain criteria, including laws and regulations governing the organization and accountability for activities. Failure to conform to statutory requirements may affect the determination of the reporting entity.
- *Federal and state taxes and tax reporting* – governments are subject to various federal and state tax requirements, including those relating to employment taxes, employee benefits, and tax-exempt debt (such as arbitrage rebate requirements). The entity must account for and report taxes (and other such items, such as retirement system contributions) withheld and payable from employees' wages, and prepare and file appropriate tax information forms, such as debt issuance notices and forms 1099.
- *Legal authority for transactions* – Governments often cannot execute transactions unless authorized by law. (E.g., for appropriations - resources expended should be as authorized by the legislative authority.)
- *Establishment of funds* - various statutory provisions affect the fund structure of governmental units and the allocation of revenues. For example, Ohio Rev. Code Section 5705.09 establishes the basic fund structure for political subdivisions in the State of Ohio, and Ohio Rev. Code Section 5705.10 establishes basic legal requirements for allocating receipts to funds. Failure to comply with these statutory requirements may materially affect financial statement amounts.
- *Time and other eligibility requirements and purpose restrictions on nonexchange transactions* - time and other eligibility requirements and purpose restrictions affect the recognition and reporting of nonexchange transactions. Failure to comply with a provider's eligibility requirements and purpose restrictions may cause the provider to withdraw the intended support or request a refund of amounts previously paid (e.g., unallowable costs for federal programs under Office of Management and Budget Circular A-87, *Cost Principles for State and Local Governments*, that were inappropriately charged to those programs). Governments are often subject to constitutional and statutory limitations upon the purpose for which monies may be legally expended (e.g., the constitutional prohibition in Ohio upon expending motor vehicle and license tax monies for purposes other than highway maintenance and repair).
- *Other legal- and contract-based compliance requirements* – resource providers may impose other compliance requirements on recipients (e.g., federal financial assistance programs often require recipients to adhere to specific procurement and cash management policies). These compliance requirements may also include: matching requirements whereby grantors impose matching requirements as a condition of receipt of a grant, revenue recognition may be contingent upon compliance with those requirements; and procurement requirements whereby contracts and other procurement should be in accordance with applicable bidding or other purchasing requirements.

- *Budgets* - GAAP requires that governmental entities report budgetary data for certain governmental funds for which annual budgets are legally required. A failure to conform to statutory budgeting requirements directly affects the budgetary data required to be reported under GAAP
- *Tax and debt limitations* - Constitutional and statutory limitations may prohibit levying taxes or incurring debt. Levying a tax in violation of such a prohibition directly affects the financial statement treatment of the proceeds.
- Note disclosure (SLG 4.48) – GASB Cod. 2300.106(h) requires *financial statement note disclosure* of significant violations of “finance-related legal or contractual provisions” *and actions taken to address such violations*. Failure to include the required disclosures could require modifying the auditor’s opinion. The GASB Codification does not define “finance-related legal or contractual provisions. However, the following sources provide the examples listed below:

<p><u>a. The accounting system must include all funds required by law or regulation to help assure restrictions on expenditures are met.</u></p>	<p><u>NCGA 1, par. 8 Cod. 1200.106</u></p>
<p><u>b. 1. Any excesses of expenditures over appropriations in the general or major special revenue funds included in budgetary statements. (Disclose in footnotes to RSI if presented as RSI.)</u></p> <p><u>2. Disclose significant excesses of expenditure over appropriations for other funds.</u></p>	<p><u>GASB 37, par. 19 Cod 2200.180</u></p> <p><u>GASB Comprehensive Implementation Guide 7.390</u></p>
<p><u>c. Violations of debt covenants or contracts.</u></p>	<p><u>Cod 2300.903, Illustrations 4, 5, 6</u></p>
<p><u>d. <i>Governmental Accounting, Auditing and Financial Reporting (GAAFR)</i> suggests the following constitute “finance-related legal and contractual requirements:”</u></p> <ul style="list-style-type: none"> • <u>Budgetary</u> • <u>Grant requirements</u> • <u>Bond covenants</u> • <u>Deposits and investments</u> 	<p><u>GAAFR 224</u></p>

The AOS also considers that the following would be finance-related legal or contractual noncompliance, requiring disclosure:

- Expending tax levy proceeds in violation of limitations upon expenditure.
- Issuing debt in excess of statutory limitations.
- Tax reporting - reporting in accordance with federal, state, and local requirements. This could include such things as arbitrage rebates, federal and state tax withholdings and matching employer liabilities, and reporting bonded debt issuances.
- Procurement - whether contracts for goods and services are properly bid or negotiated.

Immaterial Laws and Regulations

The Auditor of State has audited compliance by public offices with legal requirements since 1902. Audits of Ohio public offices have been subject to Ohio Rev. Code Chapter 117, or its predecessor, since that time. Section 117.11 (A) states in part that when auditing Ohio public offices:

. . . [i]nquiry shall . . . be made into . . . whether the laws, ordinances, and orders pertaining to the office have been observed, and whether the requirements and rules of the auditor of state have been complied with.

Although a literal interpretation of Ohio Rev. Code Section 117.11 (A) would require testing all applicable legal requirements during an audit, the Auditor of State has determined that it is appropriate in an audit to limit the compliance requirements included in an audit of a given public office to:

- Compliance requirements for which non-compliance may materially affect the financial statements of the entity (i.e. the *GAGAS* requirement); and
- Compliance requirements which, although possibly not material to the financial statements, the Auditor of State deems to be of significant public concern regarding public policy, public stewardship, or public accountability. Chapter 7 generally includes these requirements.

Since Chapter 7 contains laws and regulations that are probably not, in most circumstances, “direct and material,” the auditor should inquire of management and perform certain other limited substantive tests. If existing controls or substantive compliance tests already satisfy these objectives, the auditor should cross-reference such work to these sections.

Compliance Risk and Controls

Generally accepted auditing standards indicate that the auditor is responsible for planning and auditing to reasonably assure whether the financial statements are free of material misstatement, whether caused by error or fraud. For direct and material “illegal acts,” the auditor’s detection responsibility for these misstatements is the same as that for errors.

Audit procedures sufficient to detect a misstatement arising from an error may not be sufficient to detect a misstatement arising from fraud, due to the possibility of collusion among employees or management personnel or other schemes to conceal the fraud. For this reason, the auditing standards stress the need to exercise due care in planning, performing, and evaluating the results of audit procedures as well as the need to exercise an appropriate degree of professional skepticism.

As part of audit planning, the auditor must consider factors affecting audit risk and understand internal controls. Based on this understanding, the auditor's concern about the risk of material misstatement should either be heightened or mitigated. General factors to consider in assessing financial audit risk include:

- *Management’s characteristics and influence over the control environment.* These pertain to management’s abilities, pressures, style, and attitude relating to internal control and the financial reporting process.
- *Governmental conditions.* These involve the economic and regulatory environment in which the entity operates.
- *Operating characteristics and financial stability.* These pertain to the nature and complexity of the entity and its transactions, the entity’s financial condition, and its operating stability.
- *Susceptibility of assets to misappropriation.* These pertain to the nature of an entity’s assets and the degree to which they are subject to theft.
- *Controls.* These involve the lack of controls designed to prevent or detect misappropriations of assets.

The auditor should understand internal controls relevant to financial statement assertions affected by laws and regulations. Auditors use that understanding to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests.

Taking a control assessment approach to a compliance audit of Ohio laws and regulations involves documenting each of the five components of internal controls -- the control environment, risk assessment, control activities, information and communication, and monitoring -- that the auditor considers relevant to preventing or detecting non-compliance with such laws and regulations, and assessing control risk that such non-compliance could occur and not be detected in a timely manner.

In assessing the compliance controls environment, the auditor might consider:

- Existence of a monitoring system for compliance with such areas as debt issuance, budgets, contracts, and intergovernmental assistance;
- Management's attitudes toward compliance with laws and regulations;
- Legal actions brought against the government, and/or its elected and appointed officials;
- Involvement of the governing authority and management in the control structure to assure compliance.

The following factors may influence the auditor's assessment of risk of significant non-compliance with laws and regulations:

- *Elected officials and management should convey the message that integrity and ethical values with the organization cannot be compromised and employees must receive and understand that message.*

Management should make it clear through personal actions and policy statements the importance of ethical and honest behavior. If management is unable to communicate this message it is doubtful that they can remove or reduce incentives for an employee to engage in dishonest, illegal, or unethical acts.

- *Management must specify the level of competence needed for particular jobs, and translate the desired levels of competence into requisite knowledge and skills.*

Management should analyze, on a formal or informal basis, the tasks comprising particular jobs, considering such factors as the extent to which individuals must exercise judgment and the extent of related supervision. If employees are not trained and they do not know what is expected of them, there is an increased risk of error which could result in material non-compliance.

- *An active and effective governing board, or committees thereof, provides an important oversight function and, because of management's ability to override system controls, the board plays an important role in ensuring effective internal control.*

The board should constructively challenge management's planned decisions (e.g., letting of contracts, issuance of debt, depository agreements) and probe for explanations of past results (e.g., budget variances).

- *The philosophy and operating style of management normally have a pervasive effect on an entity.*

Management should move carefully, proceeding only after carefully analyzing the risks and potential benefits of a venture. For example, if management does not move carefully, there is an increased risk that they might purchase riskier investment types or issue significant amounts of debt that approach or exceed the legal debt limit.

- *The organizational structure should be neither so simple that it cannot adequately monitor the entity's activities nor so complex that it inhibits the flow of necessary information.*

Non-elected officials, senior management, and others in key management positions (particularly those that have direct responsibility for compliance with material laws and regulations) should fully understand their control responsibilities and possess the requisite experience and levels of knowledge commensurate with their positions.

- *The assignment of responsibility, delegation of authority and establishment of related policies provide a basis for accountability and control, and set forth individuals' respective roles.*

Management should make sure that the employees understand the scope of their assigned duties. If management is unable to communicate to an employee his or her responsibilities, it is doubtful that they can reduce the likelihood of unnecessary mistakes made by employees.

- *Human resources policies are central to recruiting and retaining competent people to enable the entity's plans to be carried out so its goals can be achieved.*

Management should establish personnel policies and procedures that result in recruiting or developing competent and trustworthy people necessary to support an effective internal control system. If management does not strive to hire competent people, there is an increased risk that an employee may engage in dishonest, unethical or illegal acts.

If adequate controls exist to reduce the risk that significant non-compliance could occur and not be detected on a timely basis, the auditor may be able to reduce substantive testing of those compliance items. However, to use a controls reliance approach (an assessment that control risk is less than maximum or low), the auditor must:

1. Identify controls relevant to preventing or detecting material or significant non-compliance with these identified laws and regulations;
2. Test controls to obtain sufficient evidence controls' operating effectiveness, as well as placed in operation;
3. Document the tests of controls.

Generally accepted auditing standards note that:

- The lower the assessed level of control risk, the greater the assurance evidential matter must provide that controls were operating effectively [AU 319.80];
- Inquiries alone will not support an assessment at less than maximum [AU 319.95];

- The auditor should consider that the evidential matter obtained by some tests of controls, such as observation, pertains only to the point in time at which the auditing procedure was applied. Consequently, such evidential matter may be insufficient to evaluate the effectiveness of the design or operation of controls for periods not subjected to such tests. [AU 319.96];
- Tests of controls from prior audits or from interim audit work may be used, however, the auditor must obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel [AU 319.98];
- Risk assessments may require reconsideration when substantive tests indicate misstatements [AU 319.104].

Organization of The Ohio Compliance Supplement

The *Ohio Compliance Supplement* includes, for each compliance requirement:

- a reference to the underlying legal authority, including statutory provisions, administrative rules, court decisions, and opinions of the Attorney General;
- a summary of the requirement; and
- for potentially **direct and material** laws and regulations, “points of (control) focus” and recommended audit procedures; or
- for **other** laws and regulations, suggested questions for management.

In addition, for both types of law or regulation, there are sections provided to document persons interviewed, tests performed (including, if appropriate, cross-references to working papers where tests of controls and substantive tests of legal compliance were performed) and conclusions and tentative recommendations.

While the auditor may exercise professional judgment in determining specific compliance requirements to test in a given audit, the AOS anticipates that:

- Compliance requirements material to the financial statement shall be tested in each audit (generally, Chapters 1 through 6);
- Compliance requirements not material to the financial statements identified in the *Ohio Compliance Supplement* (generally, Chapter 7) shall be the subject of audit tests on at least a biennial basis, as provided in Ohio Rev. Code Section 117.11. Auditors can cycle some Chapter 7 tests every other audit. Chapter 7 labels which tests the auditor can cycle.

Although the *Ohio Compliance Supplement* sets forth recommended audit procedures for each compliance requirement, ***determining the specific audit procedures to be applied, both as to material and non-material compliance requirements, is a matter of professional judgment.***

Reporting

Government Auditing Standards (GAGAS) require the auditor to report on the client's compliance with laws and regulations.

There currently are three possible ways to report on perceived non-compliance findings:

1. A *GAGAS* report on “reportable” findings of non-compliance.
This is a published report.
2. A management letter.
This is a non-published report to management. However, the auditor's report on compliance required by *GAGAS* refers to it and it is subject to release to any requesting party under Ohio's public records laws.
3. Orally.
Inconsequential non-compliance may be brought to management's attention orally during the course of the audit. The audit working papers should document these discussions.

Examples of the *GAGAS* and “management letter” reports follow. The auditor should refer to the AICPA's accounting and auditing guide, *Government Auditing Standards and Circular A-133 Audits*, for reporting examples. (AOS staff can access these examples in the Audit Briefcase.)

**INDEPENDENT ACCOUNTANTS' REPORT ON INTERNAL CONTROL OVER
FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS
REQUIRED BY GOVERNMENT AUDITING STANDARDS**

Governing Body
Any Local Government
ABC County

To the Governing Body:

We have audited the financial statements of the governmental activities, the business-type activities, the discretely presented component unit, each major fund, and the aggregate remaining fund information of Any Local Government, ABC County (the Government) as of and for the year ended December 31, 2005, which collectively comprise the Government's basic financial statements and have issued our report thereon dated February 28, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in the Comptroller General of the United States' *Government Auditing Standards*.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered the Government's internal control over financial reporting to determine our auditing procedures in order to express our opinions on the financial statements and not to opine on the internal control over financial reporting. However, we noted a certain matter involving the internal control over financial reporting and its operation that we consider a reportable condition. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect the Government's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements. A reportable condition is described in the accompanying schedule of findings as item 20XX-02.

A material weakness is 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 material to the financial statements we audited may occur and not be timely detected by employees when performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered material weaknesses. However, we do not believe the reportable condition described above is a material weakness.

Compliance and Other Matters

As part of reasonably assuring whether the Government's financial statements are free of material misstatement, we tested its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could directly and materially affect the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express an opinion. The results of our tests disclosed an instance of noncompliance or other matters we must report under *Government Auditing Standards*, which is described in the accompanying schedule of findings as item 20XX-01.

We noted a certain matter that we reported to management of Example Entity in a separate letter dated February 28, 2006.

We intend this report solely for the information and use of the audit committee, management, the Governing Body, federal awarding agencies, and pass-through entities. It is not intended for anyone other than these specified parties.

Betty Montgomery
Auditor of State

February 28, 2006

SCHEDULE OF FINDINGS AND QUESTIONED COSTS
OMB CIRCULAR A -133 § .505

ANY LOCAL GOVERNMENT
ABC COUNTY
DECEMBER 31, 2006

1. SUMMARY OF AUDITOR'S RESULTS		
<i>(d)(1)(i)</i>	<i>Type of Financial Statement Opinion</i>	Unqualified
<i>(d)(1)(ii)</i>	<i>Were there any material control weakness conditions reported at the financial statement level (GAGAS)?</i>	No
<i>(d)(1)(ii)</i>	<i>Were there any other reportable control weakness conditions reported at the financial statement level (GAGAS)?</i>	Yes
<i>(d)(1)(iii)</i>	<i>Was there any reported non-compliance at the financial statement level (GAGAS)?</i>	Yes
<i>(d)(1)(iv)</i>	<i>Were there any material internal control weakness conditions reported for major federal programs?</i>	No
<i>(d)(1)(iv)</i>	<i>Were there any other reportable internal control weakness conditions reported for major federal programs?</i>	Yes
<i>(d)(1)(v)</i>	<i>Type of Major Programs' Compliance Opinion</i>	Unqualified
<i>(d)(1)(vi)</i>	<i>Are there any reportable findings under § .510?</i>	Yes
<i>(d)(1)(vii)</i>	<i>Major Programs (list):</i>	Medical Assistance Program – Title XIX (CAFS) - CFDA #93.778 Highway Planning and Construction - CFDA#20.205
<i>(d)(1)(viii)</i>	<i>Dollar Threshold: Type A\B Programs</i>	Type A: > \$300,000
<i>(d)(1)(ix)</i>	<i>Low Risk Auditee?</i>	Yes

**2. FINDINGS RELATED TO THE FINANCIAL STATEMENTS
REQUIRED TO BE REPORTED IN ACCORDANCE WITH GAGAS**

<i>Finding Number</i>	20XX-001
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Ohio Rev. Code Section 5705.38 requires in part that each fiscal year, subdivisions and other taxing units are to certify to the County Auditor the total amount from all sources available for expenditure from each fund in the tax budget, along with any balances that existed at the end of the preceding year.

The County’s Certificate of Estimated Resources filed with the County Budget Commission did not report estimated resources on an individual fund basis. The County budget commission was unable to certify the availability of resources for appropriation to any given fund as a result.

The County Auditor stated he did not understand this requirement. He agreed to review this Revised Code requirement.¹

We recommend the County prepare future Certificates with the required individual fund information.

<i>Finding Number</i>	20XX-002
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See (federal) finding # 20XX-002 below. We must also report this finding in this report.

3. FINDINGS AND QUESTIONED COSTS FOR FEDERAL AWARDS

1. DATA PROCESSING - SYSTEMS SECURITY

<i>Finding Number</i>	20XX-002
<i>CFDA Title and Number</i>	Medical Assistance Program – Title XIX (CAFS) - CFDA #93.778
<i>Federal Award Number / Year</i>	NN - N4 / FYE 6/30/20XX
<i>Federal Agency</i>	Department of Jobs & Family Services
<i>Pass-Through Agency</i>	Ohio Department of Education

INTERNAL CONTROLS - REPORTABLE CONDITION

Logical access to automated information should be properly restricted by a password associated with access rules. Passwords should be of adequate length, difficult to guess, and contain no repeating characters. Also, procedures should provide for suspending user identification codes or disabling terminal, microcomputer, or data entry device activity after a particular number of unsuccessful attempts to access the system or applications.

The personal identification code (similar to an individual user password) used for the Transaction Interface Processing (TIP) control software package does not have minimum length requirements. Instead, the personal identification code is a five-digit random number, generated by the computer system. Also, the TIP system did not have log-in parameters to limit the

¹ See *Client Responses* later in this Introduction.

number of unsuccessful log-in attempts. Although log-in parameters for the system were set to five attempts, this control did not prevent access, when tested.

Not setting minimum length and alphanumeric passwords, in conjunction with not limiting the number of unsuccessful log-in attempts, could allow an individual to try repeatedly to log into the system. This could result in an unauthorized individual gaining access to the system and accidentally or intentionally deleting or altering a computer program or information.

The Government has not changed the personal identification code because it is part of the Univac operating system. Any changes to the personal identification code would require a major re-write to the system, and may need to be performed by the vendor.

In addition, the Government believed there was an automated control that limited the number of log-in attempts to the system.

We recommend the Government set passwords to a minimum of six characters and require the passwords be alphanumeric to provide more permutations and reduce the risk of gaining unauthorized access to the computer system. We also recommend the Government establish a sign-on parameter with a value of less than or equal to five attempts in order to decrease the possibility of unauthorized users accessing the computer system. All users should sign-off on the security policy to demonstrate their understanding of the policies contained therein.

Management Letter

Governing Body
Any Local Government
ABC County, Ohio

In accordance with *Government Auditing Standards* applicable to financial audits, we have audited the financial statements of Any Local Government, ABC County, Ohio (the Government), as of and for the year ended December 31, 2005, and have issued our report thereon dated February 28, 2006.

Government Auditing Standards also require that we describe the scope of our testing of compliance with laws and regulations and internal control over financial reporting and report any irregularities, illegal acts, other material noncompliance and reportable conditions in the internal controls. We have issued a report dated February 28, 2006 on compliance and internal control over financial reporting required by *Government Auditing Standards* as of and for the year ended December 31, 2005.

Office of Management and Budget Circular A-133 requires that we report all material, and certain immaterial, instances of noncompliance, and to report on internal control, related to major programs. We have issued a report dated February 28, 2006 on compliance and on the internal controls required by *Office of Management and Budget Circular A-133* as of and for the year ended December 31, 2005.

We are submitting for your consideration the following comments on the Government's compliance with applicable laws and regulations and on its internal controls. These comments reflect matters that, while in our opinion do not represent material instances of noncompliance or reportable internal control conditions, we believe represent matters for which improvements in compliance or internal controls or operational efficiencies might be achieved. Due to the limited nature of our audit, we have not fully assessed the cost-benefit relationship of implementing the recommendations suggested below. However, these comments reflect our continuing desire to assist your government. If you have any questions or concerns regarding these comments please do not hesitate to contact us.

Audit Committee

The County should establish an audit committee. Audit committees can serve as “informed, vigilant, and effective overseers of the financial reporting process and internal controls.” An audit committee should perform the following functions:

- Review the annual unaudited financial report submitted to the Auditor of State;
- Periodically review the process used to prepare interim financial information submitted to the County;
- Review audit results;
- Assure that audit recommendations are appropriately addressed;
- Assure auditors' independence from management;
- Serve as liaison between management and independent auditors.

Generally accepted auditing standards require that auditors communicate the following information to an audit committee:

- The auditors' professional responsibility under generally accepted auditing standards;
- Selections of accounting policies;
- Sensitive accounting estimates;
- Significant audit adjustments;
- Disagreements with management;
- Difficulties encountered in performing the audit.

The audit committee can include officials of the Government. However, the Government Finance Officers Association recommends also including representation independent from elected officials and management. The committee could include professionals knowledgeable in the Government's operations and in accounting, such as attorneys or bankers. The audit committee should meet regularly (perhaps quarterly) to monitor the Government's financial reporting and control activities, and should meet with its independent auditors before and after each audit.

We intend this comment for the information and use of the audit committee, the Governing Body and management. These comments are not intended for anyone other than these specified parties.

Betty Montgomery
Auditor of State

February 28, 2006

Audit Findings

An audit *finding* is a conclusion of fact drawn by an auditor as part of the audit process. Findings of legal non-compliance in Ohio fall into three categories²:

- noncompliance citations,
- findings for adjustment, and
- findings for recovery.

Non-Compliance Citations

Non-compliance citations should include formal citations to appropriate legal authority (i.e. the *criteria* GAGAS 5.15 requires in written noncompliance findings). Legal authorities auditors can cite in an audit report include the Federal and State constitutions, the United States Code and rules, the Ohio Revised Code and rules, Federal and State court decisions, Federal and State regulations, opinions of the Attorney General, and opinions of the Ohio Ethics Commission. Auditors may refer to bulletins and other advisory materials within the text of a finding as additional guidance, but bulletins and advisory materials are not legally binding criteria.³

For example, AOS Bulletin 2002-004 states the AOS' position is that local governments should record and budget Ohio Public Works Commission infrastructure project (Issue II money) receipts and disbursements when the local government does not directly receive or disburse this money. When a government fails to record or budget this money, the citation would be to the sections within Ohio Rev. Code Chapter 5705 requiring budgeting and recording this money, not Bulletin 2002-004. However, it is desirable for the finding to *suggest* the local government officials review and follow the accounting and budgeting guidance from AOS Bulletin 2002-004.

Also, as described in *Government Auditing Standards*, auditors should report material non-compliance with provisions of contracts or grant agreements.

Appendix A to the *Ohio Compliance Supplement* sets forth guidelines for the appropriate form for citing legal authority.

GAGAS 5.19 requires each non-compliance citation to include, *to the extent possible*, the:

- *Condition*
- *Criteria*

² Questioned costs normally apply only to A-133 audits of Federal programs. This discussion does not pertain directly to A-133 audits.

³ RC 117.20(C) states that the Auditor of State may prepare and disseminate to public offices and other interested parties advisory bulletins, directives and instructions relating to accounting and financial reporting systems, budgeting procedures, fiscal controls and constructions by the Auditor of constitutional and statutory provisions, court decisions and opinions of the Attorney General. These bulletins, directives and instructions are of an advisory nature.

- *Effect*
- *Cause*

Also, per GAGAS 5.15, “If auditors are able to sufficiently develop the findings,” they should recommend actions to correct the matter.

Client Responses

GAGAS 5.26 states

“..... Auditors should obtain and report the views of responsible officials concerning findings, conclusions, and recommendations, as well as planned corrective actions . . . Auditors should include in their report a copy of the officials’ written comments or a summary of the comments received.”⁴

Therefore, if an auditee responds to a finding, we must include their response in the applicable report (i.e., GAGAS or A-133 report).

If an auditee responds verbally to a finding (for example, at the post audit conference) we should ask if they wish to include their response in the report.

We should recognize that the tone of these responses will vary. Some officials will prepare thoughtful responses, perhaps even acknowledging responsibility for the error. Conversely, other officials will feel we have been unfair, that we do not understand the *criteria* (e.g. law) we are citing or draft a response impugning our abilities or motives. Regardless, we should carefully consider these responses. If there is significant disagreement regarding a finding, we should attempt to resolve the disagreement, if practical. For example, if there is disagreement regarding a grant requirement, we might contact the grantor and obtain the grantor’s interpretation of the requirement.

GAGAS 5.30 states that when we believe the responses lack validity or when planned corrective action does not adequately address the issue, we should state our reasons for disagreeing with the client’s response or corrective action. However, we should always attempt to resolve disagreements before issuing the final report. If we can resolve the differences, the report should not include the client’s original response. (We can include an updated response, if requested.) The report should not refer to a disagreement, since the disagreement no longer exists.

If we cannot agree with the client, we should summarize the client’s substantive reasons for disagreeing and our reasons, per GAGAS 5.30. Responses indicating significant disagreement require review by the Accounting & Auditing Support Group. (This review requirement does not apply to IPA audits.)

⁴ GAGAS 5.28 suggests auditors should normally request the responsible officials to submit their response in writing. Auditors should retain a copy in their audit documentation. See GAGAS 5.26 – 5.30 for the complete text of the requirements.

Important: In some instances, we should include most of the text of the client's response, if the issue is complex or if there is substantial disagreement. However, often we need not include the complete text of the client's response in our reports. For brevity, we prefer a summary within the body of the finding in question, indicating their general agreement or disagreement and planned corrective action.⁵ Deciding whether to summarize versus including the complete text requires auditor judgment. When we summarize the response, we must allow the client to read the draft finding, our summary of their response, and our rebuttal to their response if we disagree with it. We should include their signature on a draft of the finding in the audit documentation indicating they have read the final draft, including their response (and our rebuttal, if there is one).

Findings for Adjustment

Audit procedure results may determine an audited entity has posted receipts to a fund having no authority to receive them, or has made expenditures not authorized to be made from one fund but permissible from another.

In these instances, it may be appropriate to make a *finding for adjustment*, that is, a reallocation of receipts or disbursements to the proper funds. Whether the auditor recommends an adjustment, and the manner in which it is recommended, will depend on: (1) the nature of the adjustment, i.e., whether it is material, clearly inconsequential, or immaterial; (2) whether the auditee agrees with the adjustment; and (3) whether the misallocation of funds also constitutes a violation of law warranting a non-compliance citation.

All adjustments fall into one of the following categories:

- 1 Material adjustments with which the auditee agrees, which have been posted to the accounting records and which are reflected in the audited financial statements;
- 2 Material adjustments with which the auditee disagrees and which are neither posted to the accounting records nor reflected in the financial statements;
- 3 Clearly inconsequential adjustments are those \$100 and under.
- 4 Immaterial adjustments which are more than clearly inconsequential.

Treatment of Findings for Adjustment in Audit Reports

Adjustments in the first category and which are based on a violation of legal authority will result in a noncompliance citation reported in the GAGAS report. The auditor should not use a "finding for adjustment statement" (i.e. "In accordance with the foregoing facts, we hereby issue a finding for adjustment . . .") but the finding should briefly state the client has posted adjustments which are also reflected in the financial statements. No qualification of the auditor's opinion on the financial statements is necessary.

⁵ An example of a summarized response appears in Example Finding 20XX-001 in this Introduction: "The County Auditor stated he did not understand this requirement. He agreed to review this Revised Code requirement."

Adjustments in the second category and which are based on a violation of legal authority will result both in a noncompliance citation and, normally, a qualification paragraph in the auditor's report on the financial statements. The noncompliance citation will also include the finding for adjustment statement. The qualification paragraph in the report should briefly disclose the pertinent facts, eliminating the need for further explanation in a note to the financial statements.

Adjustments in the third category will simply be noted in the audit working papers.

Adjustments in the fourth category, if the misallocation of funds also constitutes a violation of law which warrants a non-compliance citation, will be reflected *either* in the GAGAS report (and include a finding for adjustment statement), if significant or sensitive, *or* in the management letter (and exclude a finding for adjustment statement) if of lesser significance or sensitivity. Judgment is necessary to determine the proper placement of adjustments that fall into this category. Some factors to consider in judging this are whether an individual fund will be significantly misstated if the adjustment is not made, if there is a heightened public awareness of a transaction, and if the dollar amount is large in an absolute sense, rather than relative to some other measurement of financial position or results of operations.

The matrix on the following page summarizes our reporting for findings for adjustment.

Summary of Finding For Adjustment Reporting Treatment

	<i>Material adjustments with which the auditee agrees, which have been posted to the accounting records and which are reflected in the audited financial statements:</i>	<i>Material adjustments with which the auditee disagrees and which are neither posted to the accounting records nor reflected in the financial statements:</i>	<i>Immaterial adjustments which are more than clearly inconsequential (< material & > \$100):</i>	<i>Clearly inconsequential adjustments (≤ \$100):</i>
GAGAS Report	If based on a violation of legal authority, noncompliance citation reported in the GAGAS report.	If based on a violation of legal authority, noncompliance citation reported in the GAGAS report. <u>AOS staff should include a finding for adjustment statement. IPAs should not include a finding for adjustment statement.</u>	If the misallocation of funds also constitutes a violation of law which warrants a non-compliance citation, a citation will be reflected in the GAGAS report if the matter is <u>significant or sensitive.</u>	Not reported in the GAGAS report.
Auditor’s report (opinion) on the financial statements	No qualification of the auditor’s opinion.	Adjustments which are based on a violation of legal authority will result in an additional, qualification, paragraph in the auditor’s report on the financial statements.	No effect on the auditor’s report.	No effect on the auditor’s report. Adjustments will be noted in the audit working papers.
Management letter	Not applicable	Not applicable	If the misallocation of funds also constitutes a violation of law which warrants a non-compliance citation, a citation will be reflected in the management letter if the matter is of <u>lesser significance or sensitivity.</u>	Not applicable

Financial Statement Opinion Qualification Paragraph

During 20XX, Any Local School District expended \$584,000 from the Bond Retirement Fund to pay employees' salaries. Section 5705.10 of the Revised Code restricts the use of the Bond Retirement Fund to debt retirement. Had this amount been properly expended from the General Fund, the effect would have been to increase the cash balance and decrease disbursements of the Bond Retirement Fund by \$584,000 to \$631,675 and to decrease the cash balance and increase disbursements of the General Fund by \$584,000 to a deficit of \$347,000 as of and for the year ended December 31, 20XX.

In our opinion, except for the matter referred to in the preceding paragraph, the financial statements present fairly . . .

Such a paragraph will result in either a qualified ("except for") or adverse opinion. A government can avoid a qualified or adverse opinion only if they agree to adjust their accounting records. A mere commitment by the public office to adjust is insufficient. Auditor of State staff should document that the client posted the adjustment in accordance with AOSAM § 37700.27.

A deviation from this paragraph may arise if the AOS refers the disagreement to a third party for resolution. For example:

Any Local has distributed income tax receipts to various funds, in accordance with Any Local Ordinance 98-77, which, in the opinion of Any Local's counsel, is proper. The Auditor of State, however, is of the opinion that these receipts should have been distributed in accordance with Any Local Ordinance 99-09. If the Auditor's opinion is found to be correct, the effect would be to reduce the General Fund cash balance and receipts as reflected on the accompanying Exhibit A-2 by \$55,291 and to increase the Special Revenue Fund cash balance and receipts as of and for the year ending December 31, 20XX by a corresponding amount. An opinion is currently being sought from the Attorney General of the State of Ohio⁶ concerning the proper allocation Any Local should use. As of the date of this report, however, the Attorney General has not rendered an opinion.

In our opinion, except for the adjustments, if any, that might have resulted from the matter referred to in the preceding paragraph, the financial statements present fairly. . .

⁶ Auditors cannot include a paragraph indicating that an Attorney General's opinion will be or is being sought unless the Legal Division of the Auditor's Office has concurred with the need for an opinion request, or unless this request has already been submitted.

Findings for Adjustment Procedures for Independent Public Accountants (IPA)

IPAs should follow the preceding guidance regarding Findings for Adjustment with the following exceptions.

IPAs should report a noncompliance finding for material matters they deem to require adjustment. However, these findings should not include the “finding for adjustment statement” (i.e. “In accordance with the foregoing facts, we hereby issue a finding for adjustment . . .”). When the IPA believes a Finding for Adjustment condition exists and the client does not agree with and does not make the adjustment, the following procedures apply.

- As soon as the IPA has an indication there could be Findings for Adjustment, the IPA should contact the regional chief auditor.
- The IPA should provide the regional chief auditor with all relevant supporting documentation for the Finding.
- After notifying the Chief Auditor of Quality Assurance that a finding for adjustment may be issued, the regional chief auditor or his designee will prepare a preliminary Finding, and submit it to the Auditor of State Legal Division for review. Included will be any needed supporting documentation.
- The Legal Division will review the proposed Finding and may ask the chief auditor or the IPA for any needed additional information.
- After the Legal Division has approved the Finding, the chief auditor or his designee will send the proposed Finding for Adjustment to all applicable parties. These parties normally have five days to respond. If there is a response, the chief auditor evaluates the response and decides whether the Finding should be withdrawn or modified.
- The regional chief auditor must send a copy of the approved finding to the Chief Auditor, Quality Assurance or his designee for inclusion with the Acceptance Letter. The Chief Auditor, Quality Assurance or his designee certifies the report with the Clerk of the Bureau.
- The Auditor of State will describe material, unadjusted Findings for Adjustment in the Acceptance Letter we include in the front of each report.

Findings for Recovery

Ohio Rev. Code Section 117.28 authorizes the Auditor of State to report a *finding for recovery* in audit reports when legal action may be appropriate to recover public money or property.

Ohio Rev. Code Section 117.01 (C) defines *public money* as "any money received, collected by, or due a public official under color of office, as well as any money collected by any individual on behalf of a public office or as a purported representative or agent of a public office."

Under Ohio Rev. Code Sections 9.24(H)(3) and 117.28, a finding for recovery may exist under the following circumstances:

- Where public money has been illegally expended;
- Where public money that has been collected has not been accounted for;
- Where public money that is due has not been collected; and
- Where public property has been converted or misappropriated.

Each of these is discussed below.

1. Illegal Expenditure

A finding for recovery for an illegal expenditure may be made only where the auditor (after consultation and advice from the Legal Division) has concluded that the public office does not possess the legal authority for the expenditure in question. This generally may occur where the government either has no statutory authority (or the authority they possess was exceeded) for the expenditure or there is no public purpose for the expenditure.

Governmental units other than municipal corporations generally possess only the authority expressly granted by statute or necessarily implied to carry out an express statutory function. Thus, a governmental entity such as a county or township may act only where a statutory grant of authority exists and, if any doubt as to the authority exists, it must be resolved against the expenditure of public monies. If the basis for a finding for recovery is that the governing body exceeded its statutory authority, a citation to a court decision containing a general description of the limited authority of the governmental unit is sufficient.

Proper Public Purpose

Governmental entities, without regard to their specific nature, may not make expenditures of public monies unless they are for a proper (i.e. valid) public purpose.

State ex rel. McClure v. Hagerman, 155 Ohio St. 320, provides that governmental expenditures should serve a public purpose. In McClure, the Ohio Supreme Court offered the following guidelines to determine a public purpose:

1. Whether the expenditure is for or promotes the public health, safety, morals or general welfare;

2. Whether the primary objective is to promote a public purpose, although it may incidentally advance a private interest;
3. If there has been a prospective legislative determination of a proper public purpose.

See AOS Bulletins 2003-005 and 2004-002 for further guidance regarding *proper public purpose*.

The courts will not substitute their judgment for that of the authorities unless the latter's exercise of judgment or discretion is shown to have been unquestionably abused.

In general, if the principal benefit is for the public, an expenditure is not invalidated merely because an incidental benefit is derived by a private party. The determination by a public office's governing body that a contemplated expenditure serves a valid public purpose is generally not subject to question unless this determination is "palpable and manifestly arbitrary and incorrect." (However, disbursing public money for alcohol will result in a finding for recovery.)

Before the discretionary determination of the governing body that a given expenditure serves a public purpose may be overruled, the auditor must consult with the Legal Division and have a citation referring to a specific prohibition against the class of expenditure in question or must have facts to support a conclusion that the local determination was "palpable and manifestly arbitrary and incorrect."

While auditing expenditures, the auditor should scan or perform other analytical procedures looking for unusual or nonrecurring items and determine the reasonableness of designations of public purpose. Any questionable items can be discussed with the appropriate regional chief auditor, who should consult with the Legal Division.

2. Collected but Unaccounted For

A finding for recovery for public money collected but unaccounted for, should be made where the auditor, after consultation with and advice from the Legal Division, concludes that public money, as defined in Ohio Rev. Code Section 117.01, has been received by the public office, but cannot be adequately accounted for by authorized disbursements of public moneys. A mere unidentified shortage of public moneys is a sufficient basis for a finding for recovery, as public officials are strictly liable without fault to account for public funds entrusted to their care.

3. Due but Not Collected

Public money that is due a public office but which has not yet been collected may also be subject to a finding for recovery. Money may become due the public office by operation of statute, by contract, or by court order. The decision as to whether a particular obligation is sufficiently overdue to justify the issuance of a finding for recovery requires judgment based upon the facts of an individual audit. Auditors should consult with and seek advice from the Legal Division. In general, amounts are to be considered overdue and a proper subject for a finding for recovery if they have been outstanding in excess of one year and are not the subject of either a statutory collection process or ongoing collection efforts by the client.

Findings for recovery for public money due but not collected are normally identified in the audit of the public office to which the moneys are due. In some circumstances, however, the information necessary to identify the obligation is available only in the records of the obligor. Where such circumstances exist, a finding for recovery is issued in the audit report of the obligor and in favor of the obligee. For example, if a village is not collecting statutory fees for remittance to the State, a finding for recovery for the amounts in question should be issued against the village and in favor of the State in the village's audit report.

The citation justifying the findings for recovery for public money due but not collected should include not only statutes, regulations, or Attorney General Opinions, but also the document evidencing the underlying obligation.

4. Public Property Converted or Misappropriated

A finding for recovery for public property converted or misappropriated should be issued only if the auditor has substantial evidence that a theft has occurred. This would include the ability to identify the individual responsible for the loss. Before any finding for recovery of this type can be issued, it is essential that the advice of legal counsel be obtained. If such circumstances arise during an audit, the matter should be directed to legal counsel for resolution.

In most instances, the auditor can only demonstrate that certain property was acquired by the client, and at the time of the audit it cannot be located. Under such circumstances, a finding for recovery may not be appropriate. A non-compliance citation should be issued instead, citing Ohio Rev. Code Section 117.28, stating the relevant facts, and indicating that the property may have been converted or misappropriated.

NOTE: Generally, no contract (generally, an acquisition subject to Ohio Revised Code competitive bidding requirements) may be awarded to a person or entity against whom a finding for recovery has been made if this finding is unresolved (Ohio Rev. Code Section 9.24 (A)). Ohio Rev. Code Section 9.24 (D) requires the Auditor of State to maintain a database, accessible to the public, listing persons against whom an unresolved finding for recovery has been issued, and the amount of the money identified in the unresolved finding for recovery. The Auditor of State currently has this database operational and updates the database periodically in accordance with Ohio Rev. Code Section 9.24 (D). AOS Bulletins 2003-009 and 2004-006 provide further guidance regarding this law.

Other Policies Concerning Findings for Recovery Audits Performed by the Auditor of State

If the auditor preliminarily determines a finding for recovery should be issued, the auditor should draft the proposed finding and send it, along with all factual information pertinent to the proposed finding, to the Legal Division and to Accounting & Auditing Support for review. The Legal Division reviews the proposed finding and sends it back to the auditor with a “Legal Division Cover Sheet” attached, stating that the proposed finding is approved as is, is approved as modified, is disapproved, or that more information is needed to evaluate the proposed finding. Accounting & Auditing Support will also send an approval.

If the Legal Division and Accounting & Auditing Support approve the proposed finding, the auditor should immediately prepare and send a “Notice of Proposed Finding for Recovery” to the Legal Division for review (a sample is provided on the second following page). This notice provides the person against whom the finding is contemplated an opportunity to rebut the allegations. The notice must include the language of the finding for recovery from the report and must be factually specific and detailed enough to allow the persons to understand the allegations made against them.

The notice also must state that the individual has five business days in which to respond in writing to the proposed finding. That five-day period may be extended in rare circumstances, but only upon approval of the Auditor of State, the Chief Deputy Auditor, the chief auditor (or equivalent), or Legal Counsel. The notice should be sent to the individual sufficiently in advance of any post-audit or exit conference so that he or she has time to respond and so that the Auditor of State’s Office has time to withdraw or modify the finding before that conference, if necessary.

If the person against whom the finding is contemplated responds within the time allowed with something other than a general denial of responsibility, the auditor should evaluate the response. If after the evaluation, the decision is made to delete the proposed finding from the draft report, the person should be notified of that decision. If the decision is made to retain the finding, the individual should be notified of the opportunity to attend the exit conference or to schedule a separate meeting to discuss the finding.

Post-Audit Conference Procedures

After the individual’s response to the notice is evaluated and a decision is made to delete it, retain or modify the finding, the post-audit conference or exit conference may be held. Under Ohio Rev. Code § 121.22(D), conferences between auditors and the audited public office are an exception to the “Sunshine Law” requiring meetings of public officials to be in public. In addition, under Ohio Rev. Code § 117.26, reports this Office prepares are not public records until certified copies of them are served upon certain officials of the public office. To comply with those two confidentiality provisions, this Office has traditionally held that the auditors conducting the post-audit conference have some discretion as to who may attend it. For example, auditors would have discretion not to conduct a post-audit conference if one of the public officials present invited the media to the conference.

If the person against whom the finding is contemplated is a public official or employee who would normally attend a post-audit conference (for example, the public office's chief financial officer, the chief executive officer, or the governing board or commission), a proposed finding may be discussed during the conference. If the person is an official or employee who would not ordinarily be present at a post-audit conference or the person is not an official or an employee of the public body, a separate meeting may be scheduled to discuss the proposed finding. In either situation, the person against whom the finding is contemplated may have legal counsel present. If so, the auditor may request that a lawyer from the Legal Division attend as well. In this meeting, the person against whom the finding is contemplated and/or his legal counsel may inspect (but not copy) the audit documentation related to the finding at issue.

The letter scheduling the post-audit conference should state the public body will have five business days after the conclusion of the conference to respond to the draft report presented. This period may also be extended upon approval of the Auditor of State, the Chief Deputy Auditor, the chief auditor (or equivalent), or the Auditor of State's Legal Division. If the public body's response after the post-audit conference contains any information questioning the validity or the amount of the proposed finding for recovery, the auditor, in consultation with the Legal Division, should evaluate the response and determine whether the finding should be maintained, deleted, or modified.

Notice of Finding for Recovery

When the Clerk of the Bureau certifies an audit report for release, the regional office shall send separate copies of the approved "Notice of Finding" (a sample is provided on the second following page) to each individual named in the Finding for Recovery ⁷ and the bonding company(ies).

An example of the *Notice of Finding* and the *Notice of Proposed Finding* follow. Note they are the same, except the title and the language changes to reflect whether the Finding for Recovery is proposed or issued.

⁷ IPA's follow different procedures. See the *Finding for Recovery Procedures for Independent Public Accountants (IPA)* discussion later in the Introduction.

Sample NOTICE OF (PROPOSED)⁸ FINDING

DATE

To: NAME
 STREET ADDRESS
 CITY, Etc.

The Auditor of State **[is auditing]** [has audited] Washington Township, Sandusky County for the period January 1, 2004 through December 31, 2005.

A “Finding for Recovery” **[may be]** **[has been]** issued against you. Issuance of a Finding for Recovery constitutes a preliminary determination by the Auditor of State, in accordance with Ohio Revised Code Section 117.28, that you may be liable to a public office for **SELECT ONLY THE APPLICABLE CATEGORIES>>>** public monies illegally expended; collected but unaccounted for; due but not collected; for public property which has been converted or misappropriated. It does not constitute a final determination that such legal liability exists and is not an accusation of criminal misconduct. The **[proposed]** Finding for Recovery **would / will** be issued against you **INSERT ANY OTHER RESPONSIBLE PARTIES, SUCH AS>>** [and your bonding company and/or NAME OF OTHER RESPONSIBLE PERSON, jointly and severally,] and **would / will** be in the amount of \$762.67, and in favor of _____.

We are **proposing / issuing** this Finding for Recovery for the following reason:

The Township Trustees approved NAME’s salary at \$XX.XX beginning [DATE] (\$XX.XX [PREVIOUS SALARY AND EFFECTIVE DATE]). Overtime pay at time and a half would be \$XX.XX for 200X (\$XX.XX for hours worked during the first pay of 200X at the 200X-1 rate). For the payroll checks issued 1/13/0X, 1/28/0X, 2/11/0X, 2/25/0X, 3/10/0X, 3/25/0X, and 5/27/0X Mr. NAME was paid \$XX.XX for overtime wages. Review of time sheets and payroll records indicated XX hours of overtime worked in 200X (XX hours in 200X-1). As a result, an overpayment of \$XX.XX occurred.

<u>Description</u>		<u>Rate</u>		<u>Total</u>
XX hours of overtime	x	\$X.XX per hour	=	\$ XX.XX
XX hours of overtime	x	\$X.XX per hour	=	XX.XX
				\$XX.XX
XX total hours of overtime paid	x	\$X.XX per hour	=	\$XX.XX
Overpayment				\$ X.XXX

In accordance with the foregoing facts and pursuant to Ohio Rev. Code Section 117.28, a Finding for Recovery for public monies illegally expended **may be / is** hereby issued against NAME in the amount of \$XXX.XX, and in favor of NAME OF GOVERNMENT NAME OF Fund, in the amount of \$XXX.XX.

⁸ This example is both for proposed and approved findings for recovery. The red font language applies to **proposed** notices of findings. However, do not use red font in the letter you issue!

Notice of Proposed Findings
July 14, 2005
Page 2

[If a Finding for Recovery were to be issued, the] [The] Auditor of State **[would be]** [is] required, under Ohio Revised Code section 117.28, to forward a copy of the audit report containing this Finding For Recovery to the statutorily designated legal counsel for the public office, who then has the discretionary authority to institute legal proceedings to collect the amount alleged to be due the public office. Under certain circumstances such action might also be instituted by the Attorney General of the State of Ohio.

DELETE THIS PARAGRAPH FROM NOTICES SENT TO BONDING COMPANIES>> In addition, pursuant to Ohio Revised Code section 9.24, a person against whom an unresolved finding for recovery has been issued by the Auditor of State is precluded from receiving, from a state agency or political subdivision, a contract for goods, services, or construction, paid for in whole or in part with state funds. (This preclusion does not apply to employment contracts.)

This “Notice of Proposed Finding for Recovery” has been prepared to permit you to submit any relevant information to this office for consideration. Please submit such information, as well as any questions concerning this Proposed Finding for Recovery, within five business days of receiving this Notice, to the Auditor of State at the following address:

**GOOD GUY, CPA
Senior Audit Manager
AOS OFFICE ADDRESS**

If you wish to review the working papers on which the Proposed Finding is based, please contact me immediately to schedule an appointment. Reviewing the working papers, however, will not result in an extension of the time in which to respond.

Very truly yours,

BETTY D. MONTGOMERY
Auditor of State

Additional Considerations

- Where a proposed finding for recovery has been paid in whole or in part prior to the completion of the audit, the audit report should disclose the repayment as a “Finding for Recovery Repaid Under Audit.”
- The Auditor of State does issue Findings for Recovery where the amounts in question aggregate \$100 or less. However, auditors should discuss the matter in the management letter. Amounts aggregating more than \$100 are to be reported in the GAGAS report.
- If a government identifies a finding for recovery *before* the auditors do and the entity or individual repays the money before the audit report is issued, the auditor should not report the matter as a Finding for Recovery. However, the auditor should evaluate the issue for other possible matters of audit interest, such as the possibility of fraud or reportable internal control weaknesses. Also, the matter might be a citation for an illegal expenditure of money or other violation of law. Conversely, the entity’s identification and resolution of the matter may indicate the internal control structure is properly detecting and correcting errors, in which case the auditor might determine not to report the matter.
- The auditor should determine the amount of a finding for recovery during audit field work. The method used to calculate the amount must be clearly set forth in the working papers. Any partial payment or reimbursement made prior to completing the audit should be noted in the audit report with appropriate credit given when calculating the amount.
- If a finding for recovery is issued because public property has been converted or misappropriated, the amount of the finding should reflect the fair market value of the property at the time that it was discovered to be missing. The basis for determining this amount must be disclosed in the working papers.
- Where the amount of the finding for recovery may change prior to or after the release of the audit report, the auditor should date the amount. Example: "As of December 31, 20XX, this amount is \$X,XXX." In these instances, the method of calculating the amount should be stated in the audit report so that the amount can be calculated on the day of repayment.

Finding for Recovery Procedures for Independent Public Accountants (IPA)

Ohio Rev. Code 117.12 prohibits IPAs from issuing Findings for Recovery. One result of this is that IPAs may not include the following statement in their noncompliance findings: “In accordance with the forgoing facts, and pursuant to Ohio Rev. Code Section 117.28, a Finding for Recovery for public money collected but not accounted for (or illegally expended, etc.) is hereby issued against” However, under GAGAS, if the amount is significant, the IPA should report a noncompliance finding without the “statement.”

The following procedures apply to IPA’s in instances where they determine a finding for recovery may be necessary.

- An IPA should NOT inform anyone other than the Auditor of State of possible Findings for Recovery either orally or in writing.
- As soon as the IPA has an indication there could be Findings for Recovery, the IPA should contact the regional chief auditor.
- The IPA should provide the regional chief auditor, with all relevant supporting audit documentation for the Finding.
- After notifying the Chief Auditor of Quality Assurance that a finding for recovery may be issued, the regional chief auditor or his designee will prepare a preliminary Finding, and submit it to the Auditor of State Legal Division for review. Included will be any needed supporting documentation and the Notice of Proposed Findings letters.
- The Legal Division will review the proposed Finding and may ask the regional chief auditor or the IPA for additional information.
- After the Legal Division has approved the Finding, the regional chief auditor or his designee will obtain the limited waiver from the IPA⁹ and send the Notice of Proposed Finding to all applicable parties. The applicable parties are normally given five days to respond. If they respond, the chief auditor evaluates the response along with the Legal Division and decides whether to withdraw or modify the Finding.
- The regional chief auditor will send a copy of the approved finding to the Chief Auditor, Quality Assurance or his designee for inclusion with the Acceptance Letter and send the Notice of Finding to the applicable parties upon release of the report.

⁹ NOTE: ORC 4701.19 provides that an IPA’s audit documentation remains the property of the IPA, even in the possession of the Auditor of State’s office, and states that these materials are not public records available for public disclosure. However, we will request a limited waiver of this statutory provision after the AOS Legal Department has approved the proposed finding for recovery. This limited waiver will request the IPA to make audit documentation supporting the proposed finding for recovery available for inspection by the person named in the finding and legal counsel. This waiver will include only documentation directly related to the finding for recovery. Documents subject to the waiver will also become subject to public records disclosure.

IPAs should refer any matters involving possible criminal activities to the regional chief auditor and to the Chief of the Auditor of State’s Special Investigations Unit, who is a law enforcement officer.

In addition, independent public accountants are to make an immediate, written report of all illegal acts or indication of illegal acts which may result in findings for recovery of which they become aware to the regional chief auditor.

Example Findings for Recovery

An example of a routine finding for recovery is included below:

Receipts issued for impounding fees by the County Dog Pound and Dog Warden totaled \$1,234 more than deposits made to the County Auditor. Ohio Rev Code Section 9.39 states all “public officials are liable for all public money received or collected by them or by their subordinates under color of office.”

In accordance with the forgoing facts, and pursuant to Ohio Rev. Code Section 117.28, a Finding for Recovery for public money collected but not accounted for is hereby issued against John Doe, County Dog Warden, and the Ace Insurance Company, his bonding company, jointly and severally, for \$1,234 and in favor of the County Dog and Kennel Fund.

(Note: Per the preceding discussion, IPAs would modify this finding by deleting the second paragraph and instead stating, for example, “We have referred this matter to the Auditor of State for resolution.”

Public officials are strictly liable to account for public funds entrusted to their care. “Strict liability” means a person may be found liable for the loss even though he or she may not have been personally at fault. Also, any public official who either authorizes an illegal expenditure of public funds or supervises the accounts of a public office from which such illegal expenditure is made is strictly liable for the amount of such expenditure. Mere unidentified shortages of public moneys, or such an illegal expenditure, are sufficient reasons for a Finding for Recovery against such a public official.

However, the form of reporting such a Finding should be modified accordingly. An example follows:

Joe’s Service Business, Inc. improperly submitted invoices for, and had expenditures paid on its behalf, of \$125,000 in excess of the amounts authorized by the City.

In accordance with the forgoing facts, and pursuant to Ohio Rev. Code Section 117.28, a Finding for Recovery for public money illegally expended is hereby issued against Joe’s Service Business, Inc., Joe Smith, and Frank Jones, jointly and severally, and in favor of the City of Anyplace, in the amount of \$125,000.

Fifteen thousand dollars of the net expenditures of \$125,000 illegally paid to, or on behalf of, Joe’s Service Business occurred when Jim Smith was the City Finance Director, and \$110,000 of these net illegal expenditures occurred when Bill Wilson was the City Finance Director.

Under Ohio law, any public official who either authorizes an illegal expenditure of public funds or supervises the accounts of a public office from which such illegal expenditure is made is strictly liable for the amount of the expenditure. Seward v. National Surety Corp., 120 Ohio St. 47 (1929); 1980 Op. Atty Gen. No. 80-074; Ohio Rev. Code Section 9.39; State, ex.rel. Village of Linndale v. Masten, 18 Ohio St. 3d 228 (1985). Public officials controlling public funds or property are secondarily liable for the loss incurred should such funds or property be fraudulently obtained by another, converted, misappropriated,

lost or stolen. Public officials will be liable if and to the extent that recovery or restitution is not obtained from the persons who unlawfully obtained such funds or property, 1980 Op. Atty Gen. No. 80-074.

Accordingly, a Finding for Recovery is hereby issued against Jim Smith, former City Finance Director, and Ace Insurance Corp., jointly and severally, in the amount of \$15,000 and in favor of the City of Anyplace, and a Finding for Recovery is hereby issued against Bill Wilson, City Finance Director, and Ace Insurance Corp., jointly and severally, in the amount of \$110,000 and in favor of the City of Anyplace. Jim Smith and Bill Wilson shall be secondarily liable for such illegal expenditures to the extent that recovery or restitution is not obtained from Joe's Service Business, Inc.

Referring Audit Reports

When an audit report contains a non-compliance citation which falls under the jurisdiction of a particular state agency, it often is desirable to refer a copy of the released audit report to the agency. Reports may also be referred to the Attorney General under the authority of Ohio Rev. Code Section 117.42, which empowers the Attorney General, at the request of the Auditor of State, to undertake appropriate action to secure compliance with the laws by a public office.

Referring Findings for Recovery to the Attorney General

Ohio Rev. Code Section 117.28 requires the Auditor of State to notify the Attorney General of Findings for Recovery, whether or not repaid before the audit report's release. Field auditors and IPAs who prepare reports containing Findings for Recovery should prepare a letter, substantially in the following form, for the Auditor of State to sign upon release of the reports:

[Date]
<p>The Honorable Jim Petro Attorney General of the State of Ohio 30 E. Broad St. Columbus, OH, 43266-0410</p>
<p>Re: Findings for Recovery in an Audit Report</p>
<p>Dear Attorney General Petro:</p>
<p>Attached is a copy of the audit report of [entity] for the year ended [date]. Certified copies of the audit report were filed with the public officials listed in Ohio Revised Code Section 117.26. Pursuant to Ohio Revised Code Section 117.28, you are being provided with a copy of this audit report because it contains a Finding for Recovery. In addition, a certified copy of the report has been sent to [entity]'s legal counsel as required by Ohio Revised Code sections 117.27 and 117.28.</p>
<p>If you have any questions, or if you need further information, please contact the Auditor of State's Legal Division at 752-8683.</p>
<p>Very truly yours,</p>
<p>Betty Montgomery Auditor of State</p>

Referrals to the Attorney General, involving matters other than Findings for Recovery, will be limited to situations involving gross malfeasance, repeated serious material budgetary violations, or any unusual non-compliance items that warrant legal action, and may only be done by the Legal Division.

Referrals to the Ethics Commission, Other State Agencies, and the IRS

GAGAS requires that auditors report illegal acts that have either occurred or are likely to have occurred unless they are clearly inconsequential. All such violations or potential violations that are considered to be consequential should be included in the report on compliance with laws and regulations. Illegal acts that are not material but are considered of consequence normally would be reported in the management letter. Illegal acts that are inconsequential could be reported in the management letter or could be brought to management's attention orally.

Ethics Commission Referrals

All potential "consequential" ethics law violations are to be submitted to the Auditor of State Legal Division. After review, the Auditor of State Legal Division will make appropriate referrals. The audit division should consult with the Legal Division in determining how or if to report this matter.

Referrals to Other Agencies

When referring an audit report to any other State or Federal agency, the regional audit office will prepare a letter to be sent with the report when it is submitted to the Clerk of the Bureau for release. The Regional office will also notify the Auditor of State's Legal Division. The regional office should retain a copy of the cover letter.

IRS and PERS Comments

The Internal Revenue Service and the Public Employees Retirement System have both requested that we notify them when AOS issues reports (in the case of the IRS, also management letters) containing comments or findings pertaining to their respective agencies. The Auditor of State has agreed to these requests. The Accounting & Auditing Support division will notify these agencies based upon being informed by either Auditor of State regional auditors or the Quality Assurance division that such reports (or management letters) exist.

Questions and Comments

The Auditor of State welcomes comments and suggestions on the *Ohio Compliance Supplement*. Please direct them to:

Betty Montgomery
Auditor of State
Frederick Kruse, Assistant Chief Auditor
Accounting and Auditing Support
88 E. Broad St., Columbus, OH 43215
Internet address: frkruse@auditor.state.oh.us