

Date of Hearing: April 27, 2016

ASSEMBLY COMMITTEE ON LOCAL GOVERNMENT

Susan Talamantes Eggman, Chair

AB 2613 (Achadjian) – As Introduced February 19, 2016

SUBJECT: County auditor: audits: special districts.

SUMMARY: Authorizes a special district, subject to specified conditions, to replace a required annual audit with an annual financial compilation and a review of the internal control procedures of the special district. Specifically, **this bill:**

- 1) Authorizes a special district, by unanimous request of the governing board of the special district and with unanimous approval of the county board of supervisors, to replace a required annual audit with an annual financial compilation and a review of the internal control procedures of the special district performed by the county auditor in accordance with professional standards, if all of the following conditions are met:
 - a) All of the special district revenues and expenditures are transacted through the county's financial system;
 - b) The special district's annual revenues do not exceed \$150,000; and,
 - c) The special district pays for any costs incurred by the county auditor in performing the financial compilation and evaluation of the internal control procedures.
- 2) Requires the special district to pay for costs incurred by the county auditor as a charge against any unencumbered funds of the special district available for that purpose.

EXISTING LAW:

- 1) Requires a county auditor to either make or contract with a certified public accountant to make an annual audit of the accounts and records of every special purpose district within the county for which an audit by a certified public accountant or public accountant is not otherwise provided. Requires the minimum requirements of the audit to be prescribed by the Controller and to conform to generally accepted auditing standards.
- 2) Requires the report, where an audit of a special districts accounts and records is made by a certified public accountant, to be filed with the Controller and with the county auditor in which the special district is located within 12 months of the end of the year or years under examination.
- 3) Authorizes a special district, by unanimous request of the governing board of the special district, and unanimous approval of the board of supervisors, to replace the required annual audit with one of the following:
 - a) A biennial audit covering a two-year period;
 - b) An audit covering a five-year period, if the district's annual budget does not exceed an amount specified by the board of supervisors;

- c) An audit conducted at specific intervals, as recommended by the county auditor, completed at least once every five years; or,
- d) A financial review, if the following conditions are met:
 - i) All of the special district revenues and expenditures are transacted through the county's financial system; and,
 - ii) The special district's annual revenues do not exceed \$150,000.
- 4) Authorizes a dependent special district, if the board of supervisors is the governing board of the special district and with unanimous approval, to replace the required annual audit with a financial review done in accordance with appropriate professional standards as determined by the county auditor, if the conditions in 3), d), above are met.
- 5) States that a special district shall be exempt from the requirements of an annual audit, if the financial statements are audited by the Controller to satisfy federal audit requirements.
- 6) Requires the officer of each local agency, city, county, and district, who has charge of the financial records to furnish to the Controller a report of all the financial transactions of the local agency during the next preceding fiscal year.
- 7) Requires the California State Controller, on or before January 1, 2015, to develop internal control guidelines applicable to each local agency to prevent and detect financial errors and fraud.

FISCAL EFFECT: None

COMMENTS:

- 1) **Background.** Pursuant to existing law, special districts are required to submit an annual Financial Transactions Report, a Compensation Report, and an annual audit to the Controller. County auditors are required to annually audit each special district or contract with a certified public accountant or public accountant for this work. Existing law requires that the audit conforms to standards established by the Controller and to generally accepted auditing standards. Special districts must pay for the annual audit. Due to the costs of annual audits, AB 2510 (La Malfa), Chapter 244, Statutes of 2008, expanded the options available to special districts to satisfy the annual audit requirement with less formal financial reviews and less frequent audits. Proponents of this bill provided several examples of the percentage of an annual budget that is expended to comply with audit requirements in existing law: Tucker Oakes Water District 16%, Allegheny County Water District 10%, Bayshore Sanitary District 8%, Mokelumne Cemetery District 9%, and Beaumont Library District 8%.

Due to the changes made by AB 2510, special districts that meet specified conditions have several options to replace the required annual audit. Upon the unanimous request of a special district's governing board and the unanimous approval of the county board of supervisors, a required annual audit may be replaced by a biennial audit, a five-year audit (if the district's revenues do not exceed a specified amount by the board of supervisors), or an audit conducted at specific intervals, as recommended by the county auditor. Additionally, if a

special district's transactions go through the county's financial system and the district's annual revenues are less than \$150,000, a special district may replace the required annual audit with a financial review.

- 2) **Bill Summary.** This bill provides an additional option for special districts in meeting the annual audit requirement in existing law. This bill authorizes a special district, by unanimous request of their governing body and with the unanimous approval of the county board of supervisors, to replace the required annual audit with an annual financial compilation and review of the internal control procedures of the district in accordance with professional standards performed by the county auditor, if the district's transactions go through the county's financial system and the district's annual revenues are less than \$150,000. This bill is sponsored by the California Special Districts Association.
- 3) **Author's Statement.** According to the author, "AB 2613 will allow special districts to carry out a financial compilation and review of internal control and procedures in lieu of an annual audit when revenues do not exceed \$150,000. This bill will give special districts in good standing the opportunity to utilize a less costly alternative to the regular audit or financial review, while continuing to maintain the proper financial oversight and accountability of these government entities."
- 4) **Audit, Financial Review, and Financial Compilation.** There are key differences between an audit, financial review and financial compilation and the scope, activity, and assurance of financial stability provided by each. An audit is the highest level of financial oversight that can be provided. Its purpose is to provide financial statement users with an opinion by the auditor on whether the financial statements are prepared in accordance with the proper financial reporting framework. The auditor evaluates the internal control system and obtains reasonable assurance about whether the financial statements are free from misstatement and free from error or fraud.

A financial review provides less assurance than an audit because there is only limited assurance that there are no material modifications that should be made to the financial statements for them to be in conformity with the financial reporting framework. The auditor does not perform any audit procedures in a financial review. A financial compilation provides less assurance than an audit or financial review because the auditor's report will not express an opinion or provide any assurance regarding the financial statements. The objective of a financial compilation is to present the financial information.

- 5) **Policy Considerations:** The Committee may wish to consider the following:
 - a) **Financial Compilation vs. Financial Review.** The Committee may wish to take into consideration some of the inherent differences between a financial review and a financial compilation. Current law authorizes specified districts to replace the annual audit with a financial review. A financial review is second to an audit and still requires an auditor or accountant to perform analytical procedures and inquiries. A financial compilation requires no analytical procedures and inquiries, and requires the auditor to assist in the presentation of a financial statement. The Committee may wish to consider if this is an appropriate level of review despite the more limited number of special districts that would be authorized to utilize this option.

- b) **The Cost of Transparency.** This Committee has seen several bills seeking to increase transparency among local governments. In particular, following the City of Bell and other local government scandals, several bills have sought to increase the auditing authority of the Controller's Office arguing that the current reporting requirements, including audit requirements in existing law, do not provide sufficient oversight of local governments. Additionally, AB 1248 (Cooley), Chapter 190, Statutes of 2013, required the Controller to develop internal control guidelines applicable to local governments to assist the local agencies in establishing a system of internal controls to safeguard assets and prevent and detect financial errors and fraud. The bill did not contain a requirement that the local governments must adopt the tools developed.

The Committee may wish to consider if this bill goes in the wrong direction. Proponents would argue that this bill only applies to smaller special districts with revenue below \$150,000 and that those special districts must receive unanimous approval from the board of supervisors which will provide protection against special districts inappropriately utilizing the alternative to an annual audit that this bill provides.

- 6) **Committee Amendments.** The Committee may wish to ask the author to accept the following amendments to ensure that this bill strikes the appropriate balance in the consideration of transparency and the costs of annual audits and the other options under existing law.
- a) **Sunset Date.** The Committee may wish to ask the author to sunset the bill's provisions in 10 years. At that point, the Legislature would have the opportunity to review a special district's utilization of the financial compilation options and any cost savings achieved.
- b) **Up to 5 years.** The Committee may wish to ask the author to limit the provisions of the bill by authorizing a special district to perform an annual financial compilation for up to five consecutive years at which point they would need to return to an annual audit.
- 7) **Arguments in Support.** The California Special District Association argues, "For some special districts, the cost of the audits has surpassed 33% of their entire operating budget for the year. Special districts are authorized under existing law to utilize a biennial audit, or a financial review if they meet similar thresholds, but even those cost saving alternatives remain too costly for many of the smallest district. By allowing qualified special districts to submit a financial compilation instead of an audit, district's limited funds can now be directed towards providing intended services."
- 8) **Arguments in Opposition.** None on file.

REGISTERED SUPPORT / OPPOSITION:

Support

California Special Districts Association [SPONSOR]
Alpine Village-Sequoia Crest Community Services District
Association of California Healthcare Districts
California Fire Chiefs Association
Carmel Valley Recreation & Park District
Fire Districts Association of California
McKinleyville Community Services District
Pilocene Ridge Community Services District
Plumas Eureka Community Services District
Resource Conservation District of the Santa Monica Mountains
Sausalito-Marín City Sanitary District
Spreckels Community Services District
Spreckels Memorial District

Opposition

None on file

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