

## **AUDIT REPORTING: DEVELOPING, ISSUING AND FOLLOWING UP ON FINDINGS**

Each of the functions in the Legislative Audit Division (LAD) is obligated to develop and report on audit findings. While there are minor differences in the way these findings are identified, developed, and reported, they all share the same fundamental requirements based upon accepted auditing standards. Previous committee education sessions have touched on risk assessment, development of audit objectives, and procedures for gathering evidence to address risk and support any potential findings. The following sections outline the elements of an audit finding; how recommendations are developed; how findings are reported and the opportunities for audited entities to respond to findings and recommendations; and how LAD follows up on its recommendations to determine whether agencies have taken action to implement them.

### **The Yellowbook and Single Audit Elements of an Audit Finding**

What is a finding? According to the Yellowbook, a finding is an issue that "...may involve deficiencies in internal control; noncompliance with provision of laws, regulations, contracts, or grant agreements; or instances of fraud." Put another way, an audit finding is the discovery (through audit work) and written reporting of errors, weaknesses, deficiencies, adverse conditions, or the need for improvements or changes in a program, system, or agency being audited. It should be presented as constructive commentary on actions or inactions by staff or management, which in the auditor's professional judgment hinder the accomplishment of a program's or agency's desired objectives. An audit finding is usually accompanied by a recommendation for corrective action. So, where do findings and recommendations come from?

In practice, an audit finding consists of four elements:

**Condition:** "What is." The status of the subject at hand. What did the audit team observe during fieldwork? How is the program actually operating on the ground? When observing condition, the audit team should also consider "context and significance." If there is a departure from established criteria (see below) for the program or activity being observed, is it significant enough to merit additional audit work to develop a finding and recommendation?

**Criteria:** "What should be." This could be the framework of the program as defined in Montana Code, as well as administrative rules and agency policy and procedure documents. However, it can also be broadened to include industry standards or other generally recognized best practices; outside experts and consultants, as expressed in trade journals, technical publications, news articles, and other publications; and practices of other government organizations, either federal or state.

**Effect:** The result of the difference between the condition ("what is") and the criteria ("what should be"). Effect can be measured in many ways: dollars lost; inequitable program results; unnecessary work product or service; untimely delivery of services; failure to accomplish a needed and desired purpose; non-compliance with laws or regulations; questioned costs for federal programs. Effect can also be presented as "potential effect," if no negative results were

observed due to the gap between criteria and condition, but auditors identify the potential for negative outcomes.

**Cause:** The reason the condition occurred and the basis for making the recommendation. Recommendations address the cause, and a poorly developed cause will result in a weaker recommendation. Generally, cause should be related to the functions of the management system. These could include inappropriate agency policy, lack of resources, failure to adequately review an activity's performance and results, lack of personnel training, or failure to seek change or otherwise react to an external change or cause.

Federal findings included in the Single Audit report contain additional elements:

**Identification of Federal Program:** This includes the name of the federal agency or pass-through entity, the program's title and Assistance Listing Number, and the federal award identification (grant award number) and year.

**Questioned Costs:** Identification of know or likely questioned costs and how they were computed.

**Context:** Information to provide perspective on the prevalence and consequences of the audit finding.

**Identification as a Repeat Finding:** This includes whether the finding occurred in the preceding audit and the associated audit finding numbers.

A recommendation should be directly related to cause and should be developed with a goal of accomplishing purposeful change.

### **A Finding in Practice**

When developing an audit finding and recommendation, the audit team fills out an Audit Point Sheet, an internal document spelling out each of the elements of the finding and providing links to the work papers that provide the supporting evidence for each element. This allows supervisors, managers, and division leadership to more easily confirm that all of the elements of a finding are present and merit a formal recommendation.

The table on page 3 spells out an example of a recent finding, as constructed in an Audit Point Sheet from the most recent Information Systems audit of Montana Lottery Security.

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Audit Point Sheet Elements of a Finding Lottery Security Report Example	
Condition	Lottery's business continuity plan is incomplete. Details for essential functions and the processes and associated requirements for restoration are not defined. Important signatures, contact information, and dates are missing or are incorrect.
Context and Significance	A business continuity plan outlines the potential impact of disruptive situations to business operations and how to recover affected business operations. It creates policies that respond to various situations to ensure a business will recover quickly after a crisis. The main goal of the plan is to protect people, property, and assets.
Criteria	According to the Montana Operations Manual, contingency plans are to be reviewed annually and revised to address changes not reflected in the plan. The plan is to include and outline clear definitions of essential functions and the processes to recover those essential functions within an acceptable recovery timeframe.
Effect	A plan that isn't managed may not be up to date and reflect recent changes to operations, which could lead to: Potential loss of revenue to the state. Inability to procure materials or systems to restore essential functions. Inability to restore essential functions within objective recovery time, if at all.
Cause	Lottery does not manage its contingency plan and instead relies on Department of Administration to request updates to the plan. Lottery isn't clear on its responsibilities regarding the DOA continuity program, and its business continuity plan was constructed using only minimal guidance from DOA. Lottery doesn't have protocols in place to dictate when and how the plan is reviewed and updated.
Recommendation	Lottery should define protocols for managing its continuity plan, including review and maintenance so the plan is current and complete, including: required dates, signatures, and contact information for all continuity personnel; clear definitions of essential functions, processes, and recovery times; and an inventory of critical information systems and assets required to restore each essential function, including how information systems are backed up, stored, and preserved.

**Agency Response**

Audit standards require that a written response from the agency being audited is included in the final audit report, and this response is considered part of the report. The Yellowbook says: "Auditors should obtain and report the views of responsible officials of the audited entity concerning the findings, conclusions, and recommendations in the audit report, as well as any planned corrective actions." In practice, the "responsible officials" are most often agency directors, and they are the people expected to sign the written response.

Historically the Legislative Audit Committee has had certain expectations of agencies when responding to audit recommendations, and the Montana Operations Manual provides guidance to agencies when responding to audit reports.

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Upon receipt of an audit report, the respective agency should provide a written response to each recommendation directed to it in the report. In addition to the recommendation responses, the agency should also include a concise Corrective Action Plan (CAP), including implementation dates for each recommendation with which the agency concurs, partially concurs, or conditionally concurs (see response definitions below). Due to the complexity of some audit recommendations, combined with the short turnaround time that may be required for some agency responses, the CAP and implementation date provided in response to the audit report are considered preliminary.

Agencies have several options for indicating their level of concurrence with audit recommendations:

Agency Concurrence Levels	
Concur	Agency management agrees with the substance of the recommendation and will implement the recommendation.
Partially concur	Agency management agrees with the substance of a portion of the recommendation and will implement that portion of the recommendation. Agency management should document the specific reasons for the portion of the recommendation agency management does not concur with and will not implement.
Conditionally concur	Agency management agrees with the substance of the recommendation but doesn't believe it can implement the recommendation, whether in part or in its entirety, because of insufficient resources, unalterable time constraints, or other documented justification.
Do not concur	Agency management may or may not agree with the audit findings but does not agree with the legislative audit recommendation and will not implement that recommendation for specific, documented reasons.

Federal findings included in the Single Audit report also report views of responsible officials. For these findings, the auditor obtains and reports the responsible official views regarding findings, conclusions, and recommendations, including planned corrective action.

**Report Distribution and the Role of the Audit Committee Hearing in the Report Process**

According to the Yellowbook, an audit organization in a government entity, like LAD, should distribute audit reports to those charged with governance, to the appropriate audited entity officials, and to the appropriate oversight bodies or organizations requiring or arranging for audits. As appropriate, reports should also be provided to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations.

As required by state law, the audit division provides a copy of each audit report to all members of the audit committee, the audited agency, Legislative Services Division, and Department of Administration. As a matter of practice LAD also provides a copy of every report to the Legislative Fiscal Division; the Governor's Office of Budget and Program Planning; and the State

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Library. After each meeting of the audit committee, a memo is sent to all legislators summarizing the contents of each audit heard by the committee at the meeting.

In Montana, the Legislative Audit Committee's noticed hearing is an integral part of the report process, and the audit division does not consider a report to be complete until a public hearing is held. In addition to a public report presentation by the audit team, this hearing consists of a response from the agency, questions from the audit committee to both the audit team and the agency, and an opportunity for the public to comment on the contents of the report. The audit committee strongly prefers that the director of the audited agency appear at the committee meeting to speak to the agency's response to the audit and to field questions from the committee.

**Follow-Up Procedures**

The audit process doesn't end with a report to the Audit Committee. For audits of all types, follow-up work is typically completed within 12 to 24 months to assess the implementation status of recommendations, and to measure the impact of that implementation on program operations or reporting.

For performance and information systems audits, separate follow-up work is scheduled and completed, typically 12-18 months after a report is presented to the audit committee. A letter is sent to the agency, requesting information on the implementation status of the recommendations. Based upon the agency response, a follow-up audit plan is developed, to include any additional work needed at the agency to measure the agency's progress in implementing recommendations. Follow-up memos are prepared and presented to the audit committee, but the audited agency is not required to attend follow-up presentations.

For financial compliance audits, follow-up work is completed during the next regularly scheduled financial audit of an agency. The audited agency will be at the meeting as the audit follow-up work is discussed in conjunction with the current audit report of the agency.

Implementation status is judged to fit one of the following descriptions:

Implementation Status Descriptions	
<b>Implemented</b>	The agency has implemented the recommendation.
<b>Being Implemented</b>	The agency started, but has not completed, implementing the recommendation.
<b>Partially Implemented</b>	The agency implemented a portion of the recommendation, but has not acted, or does not intend to fully implement the recommendation.
<b>Not Implemented</b>	The agency decided not to implement the recommendation or has not acted to implement the recommendation.

The audit committee may, at its discretion, request additional follow-up work on recommendations not fully implemented, and may request that the audited agency attend a future committee meeting to discuss implementation status.

**ADDITIONAL REPORTING STANDARDS SPECIFIC TO FINANCIAL AUDITS**

Reporting standards for financial audits are primarily established through the auditing standards issued by the American Institute of Certified Public Accountants (AICPA). The AICPA Professional Standards align with the Yellowbook. The auditor's primary responsibility is to report on whether the financial schedules/statements, including notes thereto, are presented fairly in accordance with the applicable financial reporting framework.

The auditor must consider the potential impact identified misstatements have on the user's anticipated reliance on the financial information in determining the opinion to render. The primary user audience for our auditor's reports are outlined in Table 1 of the February 2022 education materials. As required by the AICPA standards, both quantitative and qualitative considerations drive our final decision on the opinion to render. This consideration heavily depends on the specific circumstances of the misstatement and its importance in context of current financial and economic pressures for the state.

When the financial reporting package contains required supplementary information, such as Management's Discussion and Analysis, or supplementary information, such as combining statements, the auditor has additional audit and reporting responsibilities.

Each financial schedule and financial statement audit includes two independent auditor's reports, as summarized in the following sections. For the remainder of the education materials, financial schedules/statements will be referred to as financials, unless a more specific reference is warranted

**Independent Auditor's Report**

Auditing standards prescribe the format of the Independent Auditor's Report, more commonly referred to as the audit opinion. The current format is discussed on the next page.



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New auditing standards effective for the fiscal year 2022 audit cycle will change the organization and wording of the auditor's report.

Based on audit evidence accumulated, the auditor issues an opinion on each opinion unit in the financial reporting package. The concept of opinion units was addressed in the February 2022 education materials. The following table summarizes the types of auditor's opinions and the reader's expected response to that information.

Auditor's Opinion	Description	Reader's Expected Response
<b>Unmodified</b>	The auditor should express an unmodified opinion when the financials present fairly, in all material respects, the results of operations, the financial position, changes in fund equity or net position, and changes in cash flow, as applicable and in accordance with the specified financial reporting framework	Reader can rely on information in the financials when making decisions
<b>Qualified</b>	The auditor should express a qualified opinion when: <ol style="list-style-type: none"> <li>a. The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are <b>material but not pervasive to the financials</b>, or</li> <li>b. The auditor is <b>unable to obtain sufficient appropriate audit evidence</b> on which to base the opinion, but the auditor concludes that the <b>possible effects of undetected misstatements could be material but not pervasive</b>.</li> </ol>	Use caution when making decisions based on the financials
<b>Adverse</b>	The auditor should express an adverse opinion when the auditor, <b>having obtained sufficient appropriate audit evidence</b> , concludes that <b>misstatements</b> , individually or in the aggregate, <b>are both material and pervasive to the financials</b> .	Do not use the financials when making decisions
<b>Disclaimer</b>	The auditor should disclaim an opinion when the auditor is <b>unable to obtain sufficient appropriate evidence</b> on which to base the opinion, and the auditor concludes that the possible effects on the financials of undetected misstatements, if any, could be both material and pervasive.	

Similar to requirements in the auditing standards for audit planning, the auditor must consider the needs of users of the financials in the reporting process. Specifically, the auditor should evaluate whether the financials provide adequate disclosures to enable the intended users to understand the effect of material transactions and events contained in the financials, including an adequate description of the applicable financial reporting framework.

**Emphasis of Matter (EOM)**

When used, the EOM paragraph(s) flow immediately after the last auditor's opinion paragraph. Each EOM paragraph draws users' attention to information considered fundamental to the users' understanding of the financials. EOM paragraphs often discuss implementation of new accounting standards or changes in the financial presentation and point the user to the location of the

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information in the financials or disclosures. This provides important context for decision making. EOM paragraphs also specify the impact of the referenced information on the auditor's opinion.

**Other Matter (OM)**

When used, the OM paragraph(s) flow immediately after the last EOM paragraph or, in instances where EOM paragraphs are not used, the last auditor's opinion paragraph. Each OM paragraph draws the users' attention to information relevant to the users' understanding of the audit, auditor's responsibilities, or the auditor's report. OM paragraphs are rarely used in financial schedule audits but are commonly used in financial statement audits related to the following subject matter.

Other Matter Paragraph Subject Matter	
Required Supplementary Information (RSI)	Identifies the RSI, discusses its importance, and outlines the procedures the auditor applied to the RSI. When RSI is omitted or is incomplete, or in instances when the auditor is unable to complete the required procedures over the RSI, those circumstances would be discussed here.
Supplementary Information (SI)	Specifies the purpose of the SI is for additional analysis and is not a required part of the financial statements, discusses management's responsibility for the SI and that it was derived from and directly relates to the underlying accounting and other records used to prepare the financial statements, outlines the auditing procedures applied to the SI, and provides an auditor's opinion as to whether the SI is fairly stated in relation to the financial statements taken as a whole.
Other Information (OI)	Communicates the auditor's responsibility and procedures performed over other financial and nonfinancial information that is included in the financial reporting package.

**Differences Between Financial Schedule and Financial Statement Audits****Adverse Opinions on U.S. Generally Accepted Accounting Principles (GAAP)**

Financial schedule audits are prepared on a regulatory basis financial reporting framework and are intended for general use, meaning they are distributed to parties other than regulatory agencies, either voluntarily or on request. As such, the independent auditor's report for financial schedule audits contains an adverse opinion on GAAP in addition to the auditor's opinion on the entity's financial schedules prepared on the regulatory basis financial reporting framework. In contrast, financial statement audits include only the auditor's opinion paragraphs on the entity's financial statements prepared in accordance with GAAP. The AICPA considers the adverse opinion necessary to properly notify the readers of the financial schedules of the use different financial reporting framework and avoid misunderstanding of associated financial information.

**Other Uses of Independent Auditor's Report**

There are parties external to state government who use or rely on our auditor's reports. Examples of these situations include:

- Inclusion of the auditor's report over the state's Annual Comprehensive Financial Report (ACFR) in the biennial Single Audit report,



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- Inclusion of the auditor’s report in a Preliminary Official Statement (POS) in support of a bond issuance, or
- Inclusion of the auditor’s report in a separate document, such as the agency’s annual report. Some agencies use these annual reports to meet their bond related continuing disclosure requirements.

In these instances, we are required to review the other information included in the agency documents and compare that information to what we opined on. We are also responsible for reevaluating subsequent events, possible contingencies, and other reporting considerations.

**Yellowbook Report**

The AICPA requires us to communicate significant deficiencies and material weaknesses in internal control and noncompliance with laws and regulations that have a direct and material effect on the financial statements identified during and audit. These types of issues are the basis for the report required under *Government Auditing Standards*, more commonly known as the Yellowbook report. Definitions for material weakness and significant deficiency in internal control are provided in the following table.

Material Weakness and Significant Deficiency Definitions	
Material Weakness	A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. Auditing standards define ‘reasonably possible’ as the chance of the future event or events occurring is more than remote but less than likely.
Significant Deficiency	A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting

The report also describes the scope of the auditor’s testing of internal controls over financial reporting and presents the results of those tests, as well as relevant information about noncompliance and fraud when the auditors identify or suspect:

- Noncompliance with provisions of laws, regulations, contracts or grant agreements that has a material effect on the financials, or
- Fraud that is material, either quantitatively or qualitatively, to the financials.