

Board's Roles in the Special Audit and Examination Process: Update on Special Audit and Special Examination Rule Changes

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Introduction

- ❑ The laws governing public school finance and boards' fiduciary duties during Special Audits are tricky to navigate for Board members and administrators. Recent rule changes for special audits will have significant impact on a Board Member's role. This session will provide a legal overview of Board Member's roles in the special audit process, including district-initiated audits, emphasizing recent rule changes.



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Not New: NMSA 1978, § 12-6-6. Criminal violations

- ❑ “Immediately upon discovery of any violation of a criminal statute in connection with financial affairs, the state auditor shall report the violation to the proper prosecuting officer and furnish the officer with all data and information in his possession relative to the violation. An agency or independent auditor shall report a violation immediately to the state auditor.” NMSA 1978, § 12-6-6
- ❑ “Pursuant to Section 12-6-6 NMSA 1978 (criminal violations), an agency, LPB, or IPA shall notify the state auditor immediately upon discovery of any apparent violation of a criminal statute in connection with financial affairs. If an agency or IPA has already made a report to law enforcement that fact shall be included in the notification. If not immediately known, a follow-up notification shall include an estimate of the dollar amount involved, if known or estimable, and a description of the apparent violation, including names of persons involved and any action taken or planned.” 2.2.2.10(N)(2) NMAC.

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Not New: OSA-Initiated Special Audits

- ❑ “Pursuant to Section 12-6-3 NMSA 1978, in addition to the annual audit, the state auditor may cause the financial affairs and transactions of an agency to be audited in whole or in part” NMAC 2.2.2.15(B)(1). This is an OSA-initiated Special Audit.
- ❑ There are no changes in the regulations governing an OSA-initiated Special Audit.
- ❑ See NMAC 2.2.2.15(B) for the detailed process.

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Rule Changes

- ❑ Every year the Office of the State Auditor makes changes to its rules.
- ❑ Prior to issuing new rules, on April 23, 2024, the proposed rules were published on the OSA website and in the New Mexico Register, Volume XXXV, Issue 8, to allow for public comment.
- ❑ The Office of the State Auditor received twenty-four public comments during the public comment period from April 23, 2024, to May 30, 2024.
- ❑ On May 29, 2024, the Office of the State Auditor held a public hearing and commentary on rule changes.
- ❑ On July 16, 2024, the OSA announced the publication and implementation of the 2024 Audit Rule amendments.

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Under the New Rules (effective 7/16/24)

- ❑ Prior approval by OSA of District-Initiated Special Audits or Examinations is no longer required.

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Key Definitions

- ❑ "Special audit" means "a limited-scope examination of financial records and other information designed to investigate allegations of waste, fraud, abuse, theft, non-compliance, or misappropriation of funds, or to quantify the extent of such losses, including both attest engagements and non-attest engagements, performance audits, forensic accounting engagements, and any other engagement that is not part of the annual financial statement and compliance audit, depending on designation or scope." 2.2.2.7(S)(5) NMAC.
- ❑ "Special investigation" or "special examination" means "a limited-scope investigation into or examination of an agency's or local public body's financial records and other information designed to investigate allegations of waste, fraud, abuse, theft, non-compliance, or misappropriation of funds, or to quantify the extent of such losses." 2.2.2.7(S)(5) NMAC.

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Waste Defined

- ❑ "'Waste' includes, but is not limited to, the act of using or expending resources carelessly, extravagantly, or to no purpose. Importantly, waste can include activities that do not include abuse. Rather waste relates primarily to mismanagement, inappropriate actions, and inadequate oversight. Waste does not necessarily involve fraud or illegal acts. However, waste may be an indication of internal control weakness, non-compliance, fraud, or illegal acts." 2.2.2.7(W) NMAC.

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Fraud Defined

- ❑ "Fraud" means "obtaining something of value through willful misrepresentations. This includes, but is not limited to, fraudulent financial reporting, misappropriation of assets, corruption, and use of public funds for activities prohibited by the constitution or laws of the state of New Mexico. Fraudulent financial reporting means intentional misstatements or omissions of amounts or disclosures in the financial statements to deceive financial statement users, which may include intentional alteration of accounting records, misrepresentation of transactions, or intentional misapplication of accounting principles. Misappropriation of assets means theft of an agency's or LPB's assets, including theft of property, embezzlement of receipts, or fraudulent payments. Corruption means bribery and other illegal acts." 2.2.2.7(F)(3) NMAC.

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Abuse Defined

- ❑ "'Abuse' includes, but is not limited to, behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances but excludes fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements. Abuse also includes misuse of authority or position for personal interests or for the benefit of another or those of an immediate or close family member or business associate." 2.2.2.7(A)(3) NMAC.

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Misappropriation of Funds Defined

- ❑ OSA rules do not define misappropriation of funds. However, misappropriation of assets is defined as a type of fraud.
- ❑ "Misappropriation of assets means theft of an agency's or LPB's assets, including theft of property, embezzlement of receipts, or fraudulent payments." 2.2.2.7(F)(3) NMAC.

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Notice to Office of the State Auditor

- ❑ "Any agency, local public body, IPA or other professional
 - ❑ that enters into a professional services contract for a **special audit or examination** of the financial affairs and transactions of an agency or local public body
 - ❑ that was not designated by the state auditor for the engagement must notify the OSA"
- ❑ 2.2.2.15(C)(2) NMAC.

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Entrance and Exit Conferences

- ❑ New OSA rules do not require entrance and exit conferences for district-initiated special audits.
- ❑ However, NMSA § 22-8-12.3(D)(3), specific to school districts, requires the audit committee to “attend the entrance and exit conferences for annual and special audits.”



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Confidentiality of Sources

- ❑ “The identity of a person making a report to the OSA alleging financial fraud, waste, or abuse in government is confidential audit information and may not be disclosed, except as required by Section 12-6-6 NMSA 1978.” 2.2.2.15(A)(2) NMAC.



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Confidentiality of Files

- ❑ "Confidentiality of files: A report alleging financial fraud, waste, or abuse in government that is made to the OSA and any resulting special audit, performance audit, attestation engagement or forensic accounting or other non-attest engagement files are confidential audit documentation and may not be disclosed by the OSA or the agency, except to an independent auditor, performance audit team or forensic accounting team in connection with a special audit, performance audit, attestation engagement, forensic accounting engagement, nonattest engagement, or other existing or potential engagement regarding the financial affairs or transactions of an agency." 2.2.2.15(A)(3) NMAC.

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Confidentiality of Files

- ❑ "Any records that result in, or are part of, any subsequent or resulting special audit, performance audit, attestation engagement or forensic accounting or other non-attest engagement will be audit workpapers and therefore confidential. Records that result from, or are part of OSA, special investigations that do not result in a subsequent special audit, performance audit, attestation engagement or forensic accounting or other nonattest engagement may be disclosed, with personal identifier information redacted, once the examination or investigation is closed." 2.2.2.15(A)(3)(a) NMAC.

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Confidentiality of Files

- ❑ "Any information related to a report alleging financial fraud, waste, or abuse in government provided to an independent auditor, performance audit team or forensic accounting team, is considered to be confidential audit or engagement documentation and is subject to confidentiality requirements, including but not limited to requirements under Subsections E and M of 2.2.2.10 NMAC, the Public Accountancy Act, and the AICPA Code of Professional Conduct." 2.2.2.15(A)(3)(b) NMAC.

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Report Format

- ❑ "Communicating findings: All finding reference numbers shall follow a consistent format.
- ❑ Findings required by Section 12-6-5 NMSA 1978 shall be presented in a separate schedule of findings and placed at the end of the report.
 - (1) Section 12-6-5 NMSA 1978 requires that for every special audit and examination made "each report set out in detail, in a separate section, any violation of law or good accounting practices found by the audit or examination."

2.2.2.15(D)(1) NMAC.

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Report Content

- Each finding shall specifically state and describe the following:
 - (a) Condition (provides a description of a situation that exists and includes the extent of the condition and an accurate perspective, the number of instances found, the dollar amounts involved, if specific amounts were identified);
 - (b) Criteria (identifies the required or desired state or what is expected from the program or operation; cites the specific section of law, regulation, ordinance, contract, or grant agreement if applicable);
 - (c) Effect (the logical link to establish the impact or potential impact of the difference between the situation that exists (condition) and the required or desired state (criteria); demonstrates the need for corrective action in response to identified problems or relevant risks);
 - (d) Cause (identifies the reason or explanation for the condition or the factors responsible for the difference between what the auditors found and what is required or expected; the cause serves as a basis for the recommendation);
 - (e) Recommendation addressing each condition and cause; and
 - (f) Agency response (the agency's response shall include specific planned corrective actions with a timeline and designation of what employee position(s) are responsible for meeting the deadlines in the timeline).

2.2.2.15(D)(2) NMAC.



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Final Report to be Sent to OSA

- "Any agency, local public body, IPA or other professional that enters into a professional services contract for a special audit or examination of the financial affairs and transactions of an agency or local public body that was not designated by the state auditor for the engagement must ... provide a copy of any resulting report or any resulting findings of violations of law or good accounting practices to the OSA." 2.2.2.15(D)(2) NMAC.



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Findings to be Reported to be Sent to OSA

- “Any agency, local public body, IPA or other professional that enters into a professional services contract for a special audit or examination of the financial affairs and transactions of an agency or local public body that was not designated by the state auditor for the engagement must ... provide a copy of any resulting report or any resulting findings of violations of law or good accounting practices to the OSA.” 2.2.2.15(D)(2) NMAC.



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State Statute Has Not Changed ... but It Is Not Clear Whether It Now Only Applies to OSA Initiated Special Audits

- A. The state auditor shall cause a complete written report to be made of each annual or special audit and examination made. Each report shall set out in detail, in a separate section, any violation of law or good accounting practices found by the audit or examination. Each report of a state agency shall include a list of individual deposit accounts and investment accounts held by each state agency audited. A copy of the report shall be sent to the agency audited or examined; five days later, or earlier if the agency waives the five-day period, the report shall become a public record, at which time copies shall be sent to:
 - (1) the secretary of finance and administration; and
 - (2) the legislative finance committee.
- B. The state auditor shall send a copy of reports of state agencies to the department of finance and administration.
- C. Within thirty days after receipt of the report, the agency audited may notify the state auditor of any errors in the report. If the state auditor is satisfied from data or documents at hand, or by an additional investigation, that the report is erroneous, the state auditor shall correct the report and furnish copies of the corrected report to all parties receiving the original report.

NMSA 1978, § 12-6-5.



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Findings to be Reported to Regular IPA

- ❑ Per OSA, school districts “are required to inform their annual financial and compliance IPA of such agency-initiated special audits and findings to allow the IPA to consider including findings from an agency-initiated special audit in the annual financial and compliance audit report in accordance with 2.2.2.10(L)(2)(a) NMAC.” See letter dated 10/30/24.

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Audit Committee to Track Progress on Findings and Advise Board

- ❑ NMSA § 22-8-12.3(D)(6), specific to school districts, requires the audit committee to “track and report progress on the status of the most recent audit findings and advise the local school board on policy changes needed to address audit findings.”

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Implications

- ❑ If the District enters into a professional services agreement or otherwise engages a professional investigate allegations of waste, fraud, abuse, theft, non-compliance, or misappropriation of funds, or to quantify the extent of such losses, that triggers obligations under the OSA rules:
 - ❑ Notice to the Office of the State Auditor
 - ❑ Audit Committee (Entrance and Exist Conference)
 - ❑ Confidentiality
 - ❑ Report Format
 - ❑ Final Report to be Provided to the Office of the State Auditor
 - ❑ Final Report to be Provided to Regular IPA
 - ❑ Audit Committee to Track Progress on Findings and Advise Board

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What is the Finance Subcommittee's Role regarding Waste, Fraud, Abuse?

- ❑ NMSA § 22-8-12.3(C), specific to school districts, requires the finance subcommittee to:
 - (1) make recommendations to the local school board in the following areas:
 - (a) financial planning, including reviews of the school district's revenue and expenditure projections;
 - (b) review of financial statements and periodic monitoring of revenues and expenses;
 - (c) annual budget preparation and oversight; and
 - (d) procurement; and
 - (2) serve as an external monitoring committee on budget and other financial matters.

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What is the Board's Role?

- ❑ 6.29.1.9(A)(11), specific to school districts, lists among the duties and powers of the local board of education that the board shall "be responsible for oversight of revenue and expenditures within the district or charter school budget."
- ❑ With respect to entering into a professional services contract for a special audit or examination, NMSA 1978, § 22-5-4(J), specific to school districts, lists among the duties and powers of the local board of education that the board shall "except for expenditures for salaries, contract for the expenditure of money according to the provisions of the Procurement Code."

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