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## FISCAL IMPACT REPORT

ORIGINAL DATE 02/11/15  
 SPONSOR Ivy-Soto & Hall LAST UPDATED 03/01/15 HB \_\_\_\_\_  
 SHORT TITLE Charter Schools & Public Audit Changes SB 257/aSEC  
 ANALYST Gudgel

### APPROPRIATION (dollars in thousands)

Appropriation		Recurring or Nonrecurring	Fund Affected
FY15	FY16		
	NFI		

(Parenthesis ( ) Indicate Expenditure Decreases)

### ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY15	FY16	FY17	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
<b>Total</b>		< \$65.0	< \$65.0	< \$130.0	Recurring	State Auditor's Office Operating Budget

(Parenthesis ( ) Indicate Expenditure Decreases)

### SOURCES OF INFORMATION

LFC Files

#### Responses Received From

Public Education Department (PED)

Office of the State Auditor (OSA)

### SUMMARY

#### Synopsis of SEC Amendment

Senate Education Committee Amendment to Senate Bill 257 requires the auditor for the primary government entity to accept the audit performed by the auditor selected by the component audit, consistent with the recommendation of the State Auditor. However, PED's analysis notes the amendment could create a significant conflict where auditors may be in violation of their professional standards and licensing if they are required to accept an audit that they believe does not meet audit standards. Also by accepting the audit as part of the primary government entity audit the auditor would assume responsibility if there are errors or omissions in the audit.

Synopsis of Bill

Senate Bill 257, endorsed by the Legislative Education Study Committee, amends the Audit Act to include “charter schools” in the definition of a “political subdivision” considered an “agency”, subjecting charter schools to all of the requirements of an agency under the Act. Additionally, the bill includes new language in the Act that allows a political subdivision of the state that is a component unit of a primary government entity in accordance with generally accepted accounting principles, to be audited separately from the primary government entity if the component unit chooses. If the component unit chooses to have a separate audit conducted, the component unit audit will still be included in the primary government entity’s audit but the component unit’s audit does not need to be conducted by the same auditor as that of the primary government entity. The provisions of the bill apply to the financial affairs of an agency in FY16 and subsequent fiscal years.

**FISCAL IMPLICATIONS**

The bill would allow any component unit of a primary government entity to be audited separately from the primary government entity. The state auditor’s office indicated they oversee approximately 700 primary government entities, of which 50 have component units. The bill would allow the component units of those 50 primary government entities to select and contract for the completion of separate audits annually. The SAO notes the number of component units shifts from year to year though the SAO does not track the number separately. SAO states component units exist at the state agency level, within municipalities, counties, school districts and other entities. For example, in FY14, the SAO reported 96 charter schools that were component units of the PED or another chartering authority and 23 component units within the higher department.

SAO indicated they could see a significant increase in workload related to processing additional audit contracts and resolving disputes between the primary governmental entity and the component unit. The SAO indicates it could result in the need to hire 1 additional FTE at an annual cost of \$65 thousand.

PED’s analysis states the bill may result in higher audit costs for charter schools that choose to have an independent audit.

PED’s annual audit contract for FY14 totaled \$970 thousand. Of this amount, \$175 thousand was for the department’s audit and \$75 thousand was for the Division of Vocational Rehabilitation which is administratively attached to the department. The remaining \$720 thousand was for 54 state-chartered charter schools. PED staff indicated the same cost is allocated to each state-chartered charter school – \$13,333 – regardless of school or budget size. PED stated the current auditor has been asked to look at this in future years and determine whether a specific cost for each individual charter school should be included in annual contracts, noting this could result in increased and decreased costs for individual charter schools. It is unclear if state-chartered charter schools are dissatisfied with the current arrangement, given that no state-chartered charter schools has elected to exercise existing statutory and regulatory provisions that allow them to be audited separately. See Significant Issues.

## SIGNIFICANT ISSUES

Current statute allows state-chartered charter schools to be audited by an independent auditor pursuant to Section 12-6-14 NMSA 1978, which states, "...The state auditor shall notify each agency designated for audit by an independent auditor, and the agency shall enter into a contract with an independent auditor of its choice in accordance with procedures prescribed by rules of the state auditor; provided, **however, that a state-chartered charter school subject to oversight by the public education department or an agency subject to oversight by the higher education department shall receive approval from its oversight agency prior to submitting a recommendation for an independent auditor of its choice...**

Regulations enacted by SAO further enumerates procedures for a component unit to request an exemption from the requirement to be audited by the same audit firm as the primary government entity (See NMAC 2.2.2.10):

- c) The state auditor requires the component unit(s) to be audited by the same audit firm that audits the primary government (except for public housing authority component units that are statutorily exempt from this requirement). **Requests for exemption from this requirement must be submitted in writing by the agency to the state auditor.** If the request to use a different auditor for the component unit is approved in writing by the state auditor, **the following requirements must be met: (i) the primary auditor must agree to use the information from the work of the component unit auditor; (ii) the component unit auditor selected must appear on the office of the state auditor list of eligible independent public accountants; (iii) the bid and auditor selection processes must comply with the requirements of this rule; (iv) the office of the state auditor standard contract form must be used; (v) all component unit findings must be disclosed in the primary government's audit report; and (vi) any separately issued component unit audit report must be submitted to the state auditor for the review process described in 2.2.2.13 NMAC.**

New Mexico statute and regulation already provide exemptions for component units to conduct their own independent audits. The SAO indicated it is very rare for a component unit to seek an exemption pursuant to these provisions. PED staff noted that no state-chartered charter school has requested a separate audit since at least FY10.

SAO noted the proposed bill does not require a primary government entity to consent in advance to reliance on the component unit auditor's work (as noted in the above regulation), which could lead to disputes between the primary government entity and the component unit. The State Auditor's historical experience indicates primary unit auditors are reluctant to rely on the work of component unit auditors. This problem is more acute when the component unit auditor is a smaller, lesser-known firm. However, it is precisely these smaller, lesser-known firms that are likely to bid on stand-alone component unit audits. As a result, OSA notes the bill could result in an increase in the number of such inter-accounting firm disputes that result in delays.

PED notes that state-chartered charter schools are considered to have their own board of finance, similar to school districts while locally chartered charter schools do not. Locally chartered charter schools operate under the board of finance of the district in which they are authorized. PED notes this is an important distinction, as locally chartered charter schools cannot operate independently from their local authorizer. Given this distinction, the State Auditor's Office has

agreed to revisit the question of whether a state-chartered charter school can be considered a primary government entity for the purpose of annual financial audits or whether they are considered component units pursuant to the Governmental Accounting Standards Board (GASB).

Additionally, PED notes that the bill allows component units of primary governmental entities to conduct separate audits. These audits have to be conducted in accordance with generally accepted accounting principles and would then be included in the primary government entity's audit. PED states this framework for conducting audits is problematic for a number of reasons:

- The contracted auditor of the primary government entity may not accept the audit of the component unit for inclusion in the primary government entity's audit. If the work of the subdivision's audit is not accepted, the primary government entity's auditor may have to conduct a separate audit of the political subdivision. Such a scenario would create considerable cost and duplication to the primary governmental entity and its political subdivision and likely result in delayed audit completion.
- While the auditor of the primary government entity and the political subdivision are bound by the same generally accepted accounting principles, there still may be inconsistencies in each of their audits. Inconsistencies between contracted auditors will create larger inconsistencies in the audit and create long term financial consequences for the primary government entity.

## **TECHNICAL ISSUES**

Provisions in the bill may be in conflict with Section 12-6-14 NMSA 1978, which requires a state-chartered charter school or an agency subject to the higher education department to receive approval from PED or HED respectively prior to submitting a recommendation for an independent auditor of its choice.

The State Auditor suggests the following addition to the bill's Section 2, at the end of the proposed new language in NMSA 12-6-3(F): "The primary unit auditor shall accept the audit performed by the auditor selected by the component unit." This will alleviate the issue related to disputes between the primary and component unit auditors.

## **ALTERNATIVES**

The Legislature may wish to require the collection of data related to concerns behind this bill, such as the number of exemptions applied for each fiscal year, the annual cost of component unit audits compared with the annual cost of similarly sized primary government entity audits to validate concerns.