

# **Mid-America Intergovernmental Audit Forum**



## **Selecting an External Auditor**

**Guide for Making a Sound Decision**

**May 2007**

## Foreword

The benefits of having a high-quality audit of a government's financial statements are both immediate and long-term. For example, high-quality audits can result in recommendations for immediate improvements in management operations. Furthermore, high-quality audits can result in increased accountability over government programs and long-term improvements in public confidence in government.

As a government official responsible for hiring an independent auditor, you can use this guide to help you obtain the benefits of an audit that complies with all relevant professional auditing standards. The guide offers a five-step process to help guide you to a quality audit.

Selecting a qualified auditor can be a very subjective process involving several factors. Government Auditing Standards issued by the Government Accountability Office (GAO), noted that a sound procurement practice when contracting for audit services should consider other factors besides the fee.

Further, an American Institute of Certified Public Accountants (AICPA) task force report also discusses the importance of an auditor's experience and degree of specialization. The report noted that an auditor who spent less than 25% of their time on federal award audits was three times more likely to obtain a substandard assessment of audit quality as a result of external peer review.

Finally, to comply with federal Office of Management and Budget (OMB) Circular A-133, which governs audits of expenditures of federal funds, a government entity must consider audit quality factors in addition to the price of the audit when choosing an external auditor.

We believe following this guide will help you meet your responsibilities, make a sound decision, and get your money's worth when hiring an independent auditor.

*Mid-America Intergovernmental Audit Forum*

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## Introduction

Regardless of the type or size of public entity you are affiliated with—from the smallest local unit of government to the largest state, from a neighborhood health clinic to a major hospital, from a grade school to a university—an effective audit can improve your operations and possibly yield significant dollar savings. Selecting a qualified auditor will help you achieve the benefits of an effective audit and help you avoid wasting resources on auditors that aren't likely to produce a quality audit. If your responsibilities include hiring an independent auditor, this guide can help you make a sound decision and get the most for your money.

Taking steps to ensure a quality audit is especially important in light of previous Government Accountability Office (GAO) and President's Council on Integrity and Efficiency (PCIE) reports that have identified audit quality problems with government audits conducted by independent auditors. This was especially true when auditors were selected without following effective audit procurement practices.

Public entities should select auditors only after considering the following five basic steps for an effective audit procurement process:

- Step 1: Planning—determining what needs to be done and when
- Step 2: Communicating Audit Requirements and Soliciting Proposals—writing a clear and direct solicitation document and disseminating it widely
- Step 3: Selecting a Qualified Auditor—authorizing a committee of knowledgeable persons to evaluate the ability of prospective auditors to effectively carry out the audit
- Step 4: Writing the Agreement: Documenting Expectations—documenting the expectations of both the entity and the auditor
- Step 5: Monitoring the Audit: Ensuring a Quality Audit—periodically reviewing the progress of the audit

This guide discusses these five steps of audit procurement. At the end of each section, the guide also addresses (1) the needs of small entities which normally do not have procurement systems that are as formal as those of states or large local governments and (2) special considerations when contracting for a Single Audit—required for many recipients of federal moneys. Finally, this guide includes a short bibliography of selected procurement guidelines

Keep in mind, however, that if any guidance provided conflicts with applicable laws or regulations or relevant grant conditions, the laws, regulations, or conditions are controlling.

## **Step 1: Planning the Audit and the Procurement**

Planning to procure a quality audit requires time and attention. Nevertheless, resources an entity spends on planning are likely to be rewarded by a smoother, more timely, higher quality, and often less expensive audit.

### ***Matters to Consider***

- *Defining the entity to be audited.*

Governments and other public organizations are often composed of numerous smaller, sometimes legally separate entities. You should decide which of these units to include in the scope of your audit, taking into account any legal requirements and generally accepted accounting principles.

- *Delineating the scope of the financial audit.*

For audits of financial statements, you need to determine whether you want the auditor to limit the examination to the general-purpose financial statements, the minimum allowable audit scope, or to extend the examination to cover additional statements, such as the combined, individual fund, or other supplementary schedules.

- *Determining the specific audit requirements.*

To determine your audit requirements—a sometimes difficult task—you may want to seek the assistance of knowledgeable persons. This assistance is ideally provided by an audit committee composed of people with backgrounds in accounting, auditing, finance, or management. Entities without audit committees may want to seek the assistance of other government personnel with specialized knowledge of accounting and auditing, the state auditor, or the state CPA society.

- *Deciding on the appropriate auditing standards*

While generally accepted auditing standards (GAAS) are typically used for both private and public sector audits, your organization may be subject to grant terms, state statutes, federal regulations, or "single audit" requirements. (Single audit requirements, applicable to many organizations receiving federal funding, can be found in federal Office of Management and Budget Circular A-133.)

If these additional conditions apply, you may be required to use government auditing standards (GAS). Commonly referred to as the "Yellow Book," these audit standards are issued by the Comptroller General of the United States. GAS build upon GAAS and involve additional auditor responsibilities, including special reporting on internal controls and on compliance with applicable laws and regulations, contracts and grants. You should determine and specify the appropriate standards for your auditor to follow.

- *Identifying the attributes necessary in an auditor.*

Personnel performing the audit should have experience with audits of similar entities and continuing professional education in governmental accounting and auditing. Moreover, they should comply with applicable requirements for peer review and continuing professional education.

- *Deciding how to evaluate prospective auditors.*

Developing a systematic procedure for evaluating prospective auditors' qualifications is essential. Although price is important, you should also consider:

- = Responsiveness of the bidder to the request for proposal
- = Past experience of the bidder, particularly auditing federal programs
- = Availability of bidder staff with professional qualifications and technical abilities
- = Results of the bidder's external quality control reviews

- *Reviewing legal requirements.*

You should review applicable laws, regulations, and grant conditions to ensure that both the procurement process and the audit itself will meet legal requirements.

- *Considering a multi-year agreement.*

The first year of an audit engagement usually involves significant start-up costs as auditors devote considerable time to learning about the entity and its internal control. Using this groundwork, the auditor may be able to perform the audit in less time and at less cost in the succeeding years. If authorized by law, a multi-year agreement—perhaps a 1-year agreement with the option to extend the agreement for up to 5 years—has two advantages:

- = It enables an auditor to propose a price that takes into account the savings to be realized in subsequent years.
  - = It saves the entity the costs associated with repeating the selection process.
- *Evaluating the auditor rotation option.*

Some people argue that changing auditors at the end of a multi-year contract infuses the audit process with fresh views and new perspectives. Others contend that these benefits can be achieved through internal rotation of audit staff and that maintaining a long-term, ongoing relationship with a particular auditor is more advantageous. A long-term relationship with an auditor, however, will not necessarily enable the entity to utilize appropriate competition to help ensure reasonably priced audits. It makes sense to carefully consider the advantages and disadvantages of auditor rotation as well as applicable legal requirements before setting a policy.

- *Establishing a work schedule.*

A schedule should be established and agreed to by both the entity and the selected auditor, which sets forth dates by which certain milestones in the audit process must be reached. The only way to ensure the timely preparation and issuance of financial statements and related reports is to develop and adhere to such a schedule.

### ***Additional Considerations for Small Entities***

All of the foregoing suggestions—especially creating and using an audit committee—can help a small entity achieve a quality audit. Even the smallest organization can appoint a two-person or three-person audit committee that understands what is to be audited and how the audit should be performed.

### ***Additional Considerations for Single Audits***

You will need to determine whether the Single Audit Act applies to your organization. The Single Audit Act, as implemented by OMB Circular A-133, establishes supplemental audit requirements in the areas of internal control and compliance. In addition, it sets the funding thresholds for organizations subject to its requirements and the ways in which Federal programs are selected for audit coverage ("risk based approach"). This could significantly impact the scope of the audit, including increasing the complexity of the audit bidding/procurement process due to changing audit coverage of Federal programs.

OMB Circular A-133 requires auditees to follow the procurement standards set forth in OMB Circulars A-102 (State and Local Governments) and A-110 (Institutions of Higher Education, Hospitals, and Non-Profit Organizations). In addition to other requirements, these Circulars require auditees to make positive efforts to use small businesses, minority-owned firms, and women's business enterprises. A good source for information concerning these requirements can be found at OMB's web page at:

<http://www.whitehouse.gov/OMB/>

OMB Circular A-133 allows the performance of a 'Program-Specific Audit' when an organization expends Federal awards under only one Federal program and no requirement exists for a 'financial statement audit' to be conducted. Otherwise, a Single Audit must be performed.

A good reference document to gain an understanding of the Single Audit requirements is the American Institute of Certified Public Accountants (AICPA) "Audit Guide" for Federal Award Programs.

## **Step 2: Communicating Audit Requirements and Soliciting Proposals**

Full and open competition is basic to government procurement. Encouraging as many qualified auditors as possible to submit proposals for auditing your organization increases the likelihood that you will receive a quality audit at a fair price. You must clearly communicate your audit needs to potential proposers. This is critical, because auditors who do not clearly understand exactly what services you want might not respond at all, or they may base their responses on invalid requirements.

### ***How to Solicit for an Audit***

There are many ways to solicit bids for your audit, but the most reliable method—and the one we suggest—is a written request for proposal, or RFP.

RFPs should be clearly written; set forth all terms, conditions, and evaluation criteria as well as the scope of the work required; and be sufficiently distributed and publicized to encourage full and open competition.

Using your audit committee to advise you when writing your RFP is a good idea. Committee members should have a clear understanding of both the audit function and what your organization requires of the audit.

You may want to consider compiling a list of potential auditors from general and professional directories and from your past experiences with audit firms. You should review the listing to see if it includes small businesses, minority-owned firms, and women's business enterprises so that they are made aware of any audit opportunities. Maintaining an updated list makes it easy to distribute your RFP to auditors that are most likely to be interested in performing your audit.

In addition to (or instead of) traditional mailing, you may want to post the RFP electronically on an official website so that prospective bidders can download the document. It may make sense (or even be a requirement) to publish a notice of the RFP in an official publication. Finally, you may wish to contact your state's CPA Society to have notice of your RFP published in its periodical.

### ***What to Include in Your RFP***

The prime consideration in preparing your RFP is that it contains enough information to provide auditors with a common basis by which to prepare proposals that address all your audit needs. It is also important, however, that you consult with your purchasing office and/or legal counsel to ensure that your RFP conforms with the laws, regulations, and grant terms applicable to your organization.

In developing this guide, we evaluated RFPs used by several states in soliciting audit proposals. Our review noted that 'audit fees' typically accounted for 25-30% of the evaluation ranking, while the auditors' qualifications, including the articulation of their ability to perform the audit, accounted for 70-75% of the evaluation ranking.

*At a minimum, your RFP should contain the following:*

- the name and address of your organization;
- the entity to be audited, scope of services to be provided, and specific reports, etc., to be delivered;
- the period to be audited (with explanation if the RFP calls for a multi-year procurement);

- the name and telephone number of a contact person at your organization;
- the format in which you want proposals to be prepared;
- the address to which proposals should be delivered or sent;
- the date and time proposals are due;
- the number of proposal copies to be submitted;
- whether electronic submissions are acceptable (if so, be sure that your procedures ensure that electronic documents received actually are from the firms they purport to be from);
- the criteria to be used in evaluating the bids and their relative importance to each other;
- the method and timing of payment; and
- any other important points, including the consequences if due dates are missed or work does not meet audit standards.

*Your chances of receiving high-quality proposals will be enhanced if you:*

- explain the work that your organization does;
- explain what is to be audited, e.g., general-purpose financial statements, specific funds, or both;
- describe in some detail your organization's accounting system, administrative controls, records, and procedures. The RFP should identify the availability of proposer access to staff and records upon request;
- identify the appropriate auditing standards;
- inform prospective proposers if data from prior years (audit reports, management letters, etc.) will be available, whether major audit findings remain open from prior years, and whether any audits of subrecipients—other entities receiving grants from or through your organization—are required;
- notify prospective proposers of requirements for work paper retention and making the work papers available to the entity as well as to governmental auditors, if they request them;

- describe expected audit products, the required format of the audit report, and the format of any required progress reports;
- explain any assistance that your organization will offer, such as staff support to assist the auditor (which could materially reduce your audit costs); and
- outline the expected schedule of work (completing field work, issuing reports, etc.).

*Finally, a well-prepared RFP will elicit certain information from prospective auditors. For example, it will ask prospective auditors to state:*

- how they would conduct the audit and, if it is a multi-year contract, how they would approach the work efforts of the subsequent year(s);
- their qualifications, those of their local office, if applicable, and those of the proposed audit staff, including their prior government auditing experience;
- whether they meet appropriate State licensing requirements in the State where the audit will be performed;
- their policies on notification of changes in key personnel;
- whether the proposed staff have received continuing professional education in governmental accounting and auditing during the last 2 years;
- whether they are independent, as defined by applicable auditing standards;
- that they have not been suspended or debarred from performing government audits, or from other government activity;
- whether they have received a positive peer review within the last 3 years;
- whether they have been the object of any disciplinary action during the past 3 years;
- whether they contract with small businesses, minority-owned firms, or women's business enterprises to assist in performing audit work;
- their audit fees.

### ***Holding a Proposers' Conference***

Although you will have been as thorough as possible in preparing your RFP, you may overlook some information that prospective proposers will find useful. One effective way of communicating additional information to prospective proposers is to invite them to a proposers' conference, where you can provide additional information and they can ask questions. Although these purposes could be served by letters and individual conversations, bringing all prospective proposers together at the same time to hear the same information is efficient and helps ensure that all proposers are treated fairly. This is especially important, since unsuccessful proposers may challenge the procurement if their competitors were given significantly different or more information.

Any notes or minutes from the proposers conference should be provided to all prospective proposers, whether in attendance at the conference or not.

In place of a proposer's conference, you may want to take questions from proposers for a specified period of time and post the answers electronically on a website. This option can save time and money for both the RFP issuer and potential proposers.

### ***Additional Considerations for Small Entities***

Obtaining an extensive list of prospective proposers may be difficult for small entities in rural areas. Soliciting lists from nearby, larger entities and from the CPA society in your region often is helpful.

Furthermore, preparing a detailed RFP for a small engagement may be economically impractical in many cases. Abbreviated RFPs, designed for small engagements and requiring only a little tailoring to meet individual needs, may be available through state and regional government organizations.

At a minimum, such RFPs should clearly define the work to be done, including the reports and opinions to be delivered.

### ***Additional Considerations for Single Audits***

You should inform prospective proposers whether the Single Audit Act applies to this audit. If so, you should provide them with information concerning: Federal funding; the cognizant federal audit agency; results of previous audits including the types of auditors' opinions rendered on the financial statements and compliance with Federal laws and regulations, contracts and grants; previous audit findings, etc. This information is necessary for prospective proposers to gain an understanding of whether your organization may qualify for 'low-risk

auditee' status, including a general understanding of the Federal programs that may need to be audited as major Federal programs.

You may also want to describe who will be responsible for completion of the various parts of the Data Collection Form required to be submitted to the Federal Audit Clearinghouse.

### **Step 3: Selecting a Qualified Auditor**

Once the due date for proposals has passed, you can begin evaluating the proposers' qualifications. The technical evaluation is important for two reasons:

- it provides a systematic framework for selecting an auditor on the basis of the entity's established RFP criteria, and
- it documents that the auditor was selected fairly.

Comparing your entity's requirements with the auditors' plans, skills, experience, and understanding of the audit requirements before reviewing their price proposals will help you select the auditor that can provide the best audit at the fairest price.

### ***Establishing an Evaluation Committee***

To limit errors in judgment and to bring varied perspectives to the technical evaluation of the proposals, you will probably want to establish an evaluation committee. The committee should be composed of people with experience in accounting, auditing, budgeting, or another specialty field pertinent to the required audit work. Your audit committee can also play an important advisory role in this process.

### ***Evaluating Qualifications Separately From Price***

We suggest separate evaluations of 1) office qualification, 2) staff qualifications, and 3) audit fees. The office and staff qualifications address the auditors' technical ability to perform the audit. Although the price for the work to be performed is a factor in the selection of a qualified auditor, you will be more likely to get a high-quality audit at a fair price if both price and technical ability are taken into account in selecting the successful proposer.

### ***Screening Bidders for Minimum Standards***

As a first step, you should require all proposers to meet certain minimum standards before evaluating either the technical qualifications or the price proposals. By doing so, you can spare your entity the needless and time-consuming technical evaluation of prospective auditors that do not meet your requirements. These minimum standards can be determined by the laws governing your entity, its general internal policies, and its policies regarding specific audit engagements. However you delineate them, your minimum standards should include that prospective auditors:

- meet state licensing requirements or other legal requirements enabling them to perform the audit,
- meet the applicable independence standard,
- have a record of responsible work, and
- comply with applicable requirements for peer review and continuing professional education.

### ***Evaluating Proposals Received***

The criteria set out in the RFP and used in the evaluation process can vary. At a minimum, however, the evaluation committee should be able to answer "yes" to the following questions:

#### Understanding the Audit Requirements

- Does the proposal (both in the statement of the audit requirements and elsewhere) demonstrate that the proposer has an understanding of the audit's objective(s), your organization's needs, and the final products to be delivered?
- Does the proposal show the proposer's intention to start the audit when required and complete the audit in a timely fashion?

#### Soundness of Technical Approach

- Does the proposal contain a sound technical plan and a realistic estimate of time required to complete the audit?
- Does the technical plan show a practical approach to meeting benchmarks and specific deadlines?
- Does the proposal indicate that the proposer will use (1) a systematic approach to examining systems and internal controls and (2) effective procedures, including consideration of risk and materiality, to determine the extent of audit testing and review necessary?

- Does the proposal indicate the proposer's willingness to use other auditors' work, to the extent possible, to avoid duplication of effort?

#### Qualifications of the Audit Organization

- Does the audit organization have experience in performing the required work for entities of your type and size? Evaluators should reserve the right to review supporting documentation for any experience claimed by the audit organization or its key personnel.
- Do prior clients have a positive opinion of the audit organization?
- Has the audit organization passed its latest peer review?

#### Qualifications of the Audit Team

- Does the proposal clearly show the collective experience of the team to be assigned to the audit?
- Does the proposal specify, in concrete language, that key personnel have education and experience in the type of work that the audit entails?
- Is the experience explained in terms of specific audit engagements?
- Is the continuing professional education of key personnel explained in detail?
- Does the proposal indicate the extent to which your entity's personnel would be expected to contribute to the work effort?
- Does the proposal specify that you must be notified in writing of changes in key personnel?
- If the proposal is for a multi-year contract, does it provide an approach for planning and conducting the work efforts of the subsequent year(s)?

### ***Selecting a Proposal***

Initial evaluations should be based on the proposers' proposals submitted. As you evaluate the proposals, make a list of strengths and weaknesses for each to support its technical rating. After you complete the technical evaluation and review the prices offered by the proposers, you may be prepared to select the proposal that is most advantageous to your entity.

If, however, you feel you need more information before selecting a proposal, you should hold individual discussions with proposers who have a reasonable chance of being selected to allow them to respond to your concerns and submit revised proposals by a specified date. Care should be taken during these discussions not to reveal proprietary information submitted by other proposers. You should then evaluate the revised proposals as described above and award the contract on the basis of both technical competence and reasonable price.

### ***Additional Considerations for Small Entities***

Using a committee to carry out the evaluation process is especially important for small entities with limited resources. A more comprehensive analysis of the proposals is likely to be achieved by having more people involved in the evaluation process.

### ***Additional Considerations for Single Audits***

When evaluating proposals, particular attention should be given to the proposers' descriptions of the methodology to be used in performing the 'risk-based' approach in determining major Federal programs. This will affect the Federal programs selected for review which could significantly impact proposed audit fees, etc. This is especially critical when comparing audit fees between proposers. Consideration should be given to contacting one of the Offices of Inspectors General (IG) within a Federal Agency if you have questions concerning the 'risk-based' approach or other single audit matters. A good source for identifying how to contact the various IG offices is the Inspectors General Network (IGnet) at:

<http://www.ignet.gov>

If a proposer for audit services also provides, or is being considered for providing, non-audit services to your organization, be aware that in many such cases government auditing standards prohibit a provider of non-audit services from also providing audit services because of impairments to auditor independence. For guidance in this area, you may consult *Government Auditing Standards*, Government Accountability Office.

### **Step 4: Writing the Agreement: Documenting Expectations**

The lack of a written agreement between the entity contracting for the audit and the auditor can contribute to problems. To foster sound and productive communication and to avoid misunderstandings, both parties should agree in writing on important audit-related matters. Make clear at the start—before prospective proposers spend time assessing the nature of the job and estimating its costs—that you expect to sign a formal document at the culmination of the proposal process. Auditors unwilling to commit themselves to signing such a document are better avoided.

A signed agreement represents a contract and is binding upon both parties. For that reason, when drafting the agreement, seek the advice of your purchasing office or legal counsel on the agreement's form and substance.

### ***What to Include in a Written Agreement***

When an RFP has been used, the written agreement should incorporate, by reference, the terms of the RFP and those of the successful proposer's last proposal. The agreement should be signed by the entity and the auditors and should clearly specify the:

- audit scope, objective, and purpose;
- deadlines for work to be performed;
- audit cost;
- report format;
- type and timing of support to be provided to the auditor by the entity; and
- professional auditing standards to be followed in performing the audit.

Furthermore, the agreement should make the following points about the auditor/entity relationship, changes in the kind or amount of work required, and access to and ownership of audit products:

- The relationship of the auditor to the entity is that of an independent contractor.
- At any time, the entity may, by written notice, make changes in or additions to work or services within the general scope of the agreement. If such changes are made, an equitable adjustment will be made in the cost of the audit using the rates specified in the agreement.
- If the auditor believes that a change in or addition to work is beyond the general scope of the agreement, the auditor must notify the entity in writing within a specified time and before beginning that work. The agreement should indicate where the final administrative authority rests in deciding disputes.
- Audit documentation prepared by the auditor during the audit is the auditor's own property. This documentation should be retained for a period to be designated in this agreement. Copies of audit documentation (if requested) are to be made available to the entity and governmental auditors or regulators.
- All reports rendered to the entity by the auditor are the exclusive property of the entity and subject to its use and control, according to applicable laws and regulations.

- If the auditor asks you to sign an engagement letter and you also have (or will have) a separate contract, make sure that there are no inconsistencies between the two documents.

### ***Additional Considerations for Small Entities***

In the absence of an RFP, many small engagements are documented only by an engagement letter prepared by the auditor that protects the auditor more than the entity being audited. If you decide to use an engagement letter as your written agreement, we advise including the information listed above and ensuring that the document is signed by both parties.

### ***Additional Considerations for Single Audits***

Information should be provided on who will be responsible for completion of the various parts of the Data Collection Form required to be submitted to the Federal Audit Clearinghouse.

### **Step 5: Monitoring the Audit: Ensuring a Quality Audit**

Monitoring the progress of the audit is the most effective way to ensure that your organization receives both the type and quality of audit services specified in the written agreement. Key elements that you may wish to consider to ensure proper monitoring include the following:

- Monitoring is a role that your audit committee can carry out most effectively. This group of experts can evaluate the audit while it is taking place, thereby addressing and resolving problems before the audit is completed. It can also review audit results and assist in post-audit quality evaluation. Thus, not only does the audit product improve, but working relationships between the audited entity and auditor are enhanced.
- Monitoring is especially beneficial during the first year of a new auditor's contract and during the audit of any unit or segment of an organization that is unique or complex. Furthermore, monitoring is beneficial throughout the term of a multi-year contract: it provides status reports and helps coordinate the auditor's activities with the audit's requirements. While auditors are responsible for ensuring the quality of the audit, monitoring work performed as a quality-assurance measure is critical.
- Monitoring can be accomplished by requiring periodic progress reports, as well as by holding regular meetings to discuss issues that need to be resolved. Furthermore, meeting after the completion of the audit to

discuss the draft report can help ensure a clear understanding of the report and its findings.

### ***Additional Considerations for Small Entities***

Few small entities have the resources to thoroughly monitor the work of an auditor. When audit committee members are unavailable within an organization, composing a committee from people outside the organization may be the answer.

### ***Additional Considerations for Single Audits***

Federal and State Agencies may perform quality review procedures for Single Audits for which they are the assigned Cognizant or specified Oversight Agency. Those procedures would include such things as reviewing the audit report and the supporting audit documentation.

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