

Selecting an Auditor

Illinois Government Finance Officer's Association



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Chapter I – Reporting Entity

In order to ensure your government obtains the audit services it needs/desires, the government must determine the nature of the entity to be audited (“reporting entity”) and communicate this information to the various audit firms. The various reporting entities are discussed below.

Primary Government - Only

The primary government is the City/Municipality/District/County etc. requesting the audit services and includes all of its funds, capital assets, and long-term obligations.

Primary Government and All Component Units

This would include the primary government, as discussed above, and all of its blended and discretely presented component units as defined by GASB Statements No. 14 and 39.

GASB Statement No. 14 defines a component unit as a separate legal entity which includes (a) organizations for which the primary government is financially accountable, and (c) other organizations for which the nature and significance of their relationship with the primary government are such that exclusion would cause the reporting entity's financial statements to be misleading or incomplete.

GASB Statement No. 39 is an amendment to GASB statement No. 14. Generally, it requires reporting as a component unit, an organization that raises and holds economic resources for the direct benefit of a governmental unit, if material.

Primary Government and Certain Component Units

Often times, one or more component units of a governmental reporting entity will separately contract for its own audit services. As such, it would typically be excluded from the scope of audit services contracted by the primary government. The auditors of the primary government would exclude these component units from the scope of their audit, and refer to the report of the component unit auditors in the primary government audit report (auditor's opinion).

Component unit(s)

As discussed above, a government that is a component unit of another government may request its own audit.

Single Fund

It may be necessary or desirable to obtain an audit of a single fund. This may be necessary for any of the following reasons:

- Public interest
- Separate board has requested a separate report (i.e. Public Library Fund or Police or Fire Pension Fund)
- Legal requirements (to provide information to revenue bondholders, etc.)

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Other

For purposes of complying with various State statutes, grant agreements, or other legal requirements, the government may need an audit, performance of "agreed upon procedures", or other attest functions limited to an assertion or subject matter. This does not constitute an audit of the governmental entity; it is much more limited in its nature. Common examples include:

- Tax Increment Financing Audit (TIF)
- Agreed upon procedures relating to a grant award
- Agreed upon procedures relating to an outside subject matter (hotel/motel tax verification)

Chapter II - Audit Subject Matter and Scope of the Audit

In addition to carefully defining the entity to be audited, the government should carefully consider the subject matter of the audit. Identification of the subject matter clarifies the level of detail at which the audit will be conducted. The various options are discussed below.

Audit of basic financial statements only

This is the most common option selected by governments in the State of Illinois. An audit of the basic financial statements requires the auditor to perform the amount of work necessary to determine if the basic financial statements are fairly stated, in all material respects.

The audit is conducted in accordance with auditing standards generally accepted in the United States of America (GAAS). Those standards require that the auditor plan and perform the audit to obtain reasonable rather than absolute, assurance about whether the financial statements are free of material misstatement whether caused by error, fraudulent financial reporting, or misappropriation of assets. Accordingly, a material misstatement, whether caused by error, fraudulent financial reporting, or misappropriation of assets, may remain undetected. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. As a result, an audit is not designed to detect errors or fraud that are immaterial to the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Materiality, for the purpose of designing audit tests, would be based on the basic financial statements and would include, at a minimum, separate materiality calculations as follows:

- All governmental activities entity wide
- All business-type activities entity wide
- All discretely presented component units combined
- Each major fund
- All remaining fund information combined (includes Nonmajor governmental and enterprise funds, internal service funds, investment trust funds, pension trust funds, agency funds and private purpose trust funds)

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In addition to the audit opinion expressed on the basic financial statements, the auditor would express an "in relation to" opinion on any supplementary information included in the financial section of the report such as combining and individual fund statements and schedules. The opinion would state that such information has been subjected to the auditing procedures applied in the audit of the basic financial statements.

Audit of basic financial statements and other data such as individual fund financial statements

For this audit, the auditor will express an opinion on the basic financial statements, as addressed above, as well as the combining and individual fund's financial statements. In addition to the materiality calculations done above, a separate calculation will be done for each individual fund. These materiality levels will typically be much lower than the materiality levels for the basic financial statements. As a result, the auditor will need to do a greater amount of procedures to assure themselves that the financial statements are not materially misstated. Because the auditor will be required to do more procedures, the cost of expanded individual fund audit will be greater than an audit of the basic financial statements alone.

Government Auditing Standards (Yellow Book Audit)

In planning any audit, the auditor's objective is to obtain an understanding of the policies and procedures established by the government to provide reasonable assurance that (1) operations will be conducted and resources will be used in accordance with management's authorizations and that such authorizations will be consistent with laws, regulations, contracts and policies; and that (2) financial data will be recorded, processed, summarized and reported in a manner consistent with management's assertions embodied in the financial statements. Those policies and procedures are collectively referred to as the entity's internal control.

When the audit is to be performed in accordance with Government Auditing Standards (GAS), and the Single Audit Act, the auditor is required to make assessments of control risk and test whether internal controls are functioning in accordance with prescribed procedures. The auditor is not required under GAAS to evaluate the effectiveness of design and operation of internal control policies, procedures and records to plan the audit unless he intends to assess control risk below the maximum.

Single Audit

If your government is a recipient of federal awards and funding, you may be required to have a "single audit". A single audit is an audit performed in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. A single audit is required for any fiscal year in which the government expends \$500,000 or more in federal monies, on an accrual basis. As with the audit discussed above, the scope of this audit is greater than that of an audit of just the basic financial statements and requires the auditor to perform additional tests and procedures and issue additional reports.

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A single audit engagement is performed in accordance with the requirements of GAAS and GAS as well as OMB Circular No. A-133. GAAS and GAS require the auditor to obtain an understanding of internal controls material to the financial statements sufficient to plan the audit, while A-133 requires the auditor to perform procedures to obtain an understanding of internal control over federal programs sufficient to plan the audit to support a "low assessed level of control risk for major programs."

For purposes of performing a single audit, the auditor must identify all material financial applications or classes of transactions (e.g., revenues and receipts; procurement, payables, expenditures and disbursements; financial reporting; etc.), as well as applicable compliance requirements, for every major federal program, document an understanding of the five elements of internal control, and make a preliminary assessment of control risk based on the design of internal control. Some understanding of internal control may need to be obtained for every significant federal program.

Other Engagements (attestation engagements)

Attestation engagements refer to engagements in which an independent accountant(s) is engaged to issue an examination, a review, or an agreed-upon procedures report on a subject matter, or an assertion about the subject matter, that is the responsibility of another party. Examples of attestation engagements are as follows:

- Reporting on subject matter or an assertion;
- Agreed-upon procedures engagements;
- Reporting on financial forecasts and projections;
- Reporting on pro forma financial information;
- Reporting on an entity's internal control over financial reporting; and
- Compliance attestations

These engagements are outside the scope of a regular financial audit, and if required, should be separately addressed in the request for proposal. Many firms will require a separate arrangement letter for this type of engagement.

Chapter III Evaluative Criteria

After the subject matter and scope of audit services to be requested has been determined, the government should determine the criteria to be used in evaluating the responsive auditors, as well as the team that will do the evaluation. Criteria should be weighted and would typically include:

- A. *Required Items (independence, licensed, etc.)* The auditor should be licensed in the state in which the government resides and should be independent of the government. This means that the auditor should not be providing other non-audit services for the government. Independence rules for an audit performed in accordance with Government Auditing Standards (GAS) are stricter than a non GAS audit.

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The Government Accountability Office (GAO) revised the Government Auditing Standards (GAS) in 2003. This revision addresses auditor independence. The most significant changes and the primary topic of this section relate to the auditor's independence when certain non-audit or consulting services are provided to a current or prospective GAS auditee

The independence standards include a principles-based approach to addressing independence supplemented with certain safeguards. The two overarching principles addressed in the standards are:

1. "Auditors should not perform management functions or make management decisions; and"
 2. "Auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant/material to the subject matter of the audit."
- B. *Qualifications of the firm.* The auditor (firm) should be able to demonstrate they have experience in performing similar engagements and are qualified to perform the services requested in the RFP. The RFP should request a listing of engagements performed by the auditor that are similar in nature to the services that are the subject of the RFP. The government should consider requesting this information for current existing clients as well as past clients of the audit firm.
- C. *Qualifications of the personnel assigned.* In addition to qualifications of the audit firm, the RFP should request information on the individuals that would be assigned to conduct the engagement should the firm be awarded the audit. Typically this information should be provided for the senior/in-charge, manager and partner. It is also a good idea to ask for the firm's policy on continuity of personnel to determine how replacements are handled in the event that one of the staff assigned can not perform the engagement.
- D. *References.* The RFP should request information on current and former clients. The information should include, at a minimum, the name and phone number of a contact person. Typically, a request of five to ten references would be appropriate.
- E. *Audit process, involvement of senior staff.* The RFP should ask the firm to describe its audit process. This would include such information as: what is done during the planning stage, the use of sampling during the audit process, communication with management and the Board and/or audit committee, reports to be issued etc. In addition, the firm should provide details on the level of involvement of its senior personnel (seniors, managers and partners). It may be useful to ask the firm for a breakdown of the percentage of hours each level anticipates be assigned to the engagement.

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- F. *Price.* The RFP should request information on the price for conducting the audit. The RFP may request a total all inclusive price only, or can ask for the information to be broken down by level, such as follows:

Personnel	Hours	Total
Partner	-	\$ -
Director	-	-
Supervisor	-	-
Staff	-	-
Clerical	-	-
Total Personnel	-	-
Other Costs - printing, travel, etc.		-
Total all-inclusive maximum fee		\$ -

OR:

	FY 200X	FY 200X	FY 200X	Total
Audit	\$	\$	\$	\$
GASB #34	\$	\$	\$	\$
SAS #99	\$	\$	\$	\$
Single Audit	\$	\$	\$	\$
Total	\$	\$	\$	\$

The RFP also might request a price breakdown that would facilitate allocation of audit charges to various funds.

- G. *Other Specifications.* The RFP should specify other important items such as timing of fieldwork, key deliverable dates, attendance at Board meetings etc.

Chapter IV Creating the RFP

Based on information in I through III above, create a "Request for Proposal" (RFP)

- A. The entity and subject matter of the audit should be outlined in the RFP in detail. For further information, see chapters I and II above (some of this information might be available in the most recent management representation letter).
- B. The scope of the audit should be outlined in the RFP in detail (GAAS, Generally Accepted Government Auditing Standards (GAGAS) etc.). For further information see chapter II above.
- C. Reports to be issued should be detailed in the RFP. Be very specific as to what the expectation is. Specify if the services are to include preparation of the State Comptroller' Report, the Illinois Department of Insurance Reports, a report on compliance for a TIF District etc. Also, if separate fund reporting is needed, such as

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for a pension fund or a Library Fund, it should be specified. Specify the number of copies required for each report.

- D. The RFP should provide background information on the government's operations, financial situation, fund structure, key personnel etc. This would include any information that would be useful to an outsider in assessing the size of the government, the financial health of the government, and technical competence of the government's staff. Assistance to be provided by management should be specified in the RFP. Ideally, financial statements and all supporting documentation should be prepared by the government. Many larger governments have sufficient staff on hand to prepare the financial statements, create and post all year end adjustments, as well as assisting the auditors by typing confirmation letters, pulling invoices etc. Other governments, however, need more assistance, including preparation of the financial statements and schedules. Be very specific in the RFP as to what assistance will be provided, and what nonaudit services, such as preparation of the financial statements, are requested of the audit firm. Include a time table of work and report due dates.
- E. The criteria against which the auditors will be evaluated should be specified in the RFP. See chapter III above for more information.
- F. Requirements and deadlines for submitting the proposal should be included. Be sure to provide a sufficient amount of time for the auditors to prepare a proposal. The time allowed should be sufficient for the auditors to do some background research on your government, review prior year financial statements and management letters, ask questions of the government, etc. Three to five weeks is a good range to adhere to.
- G. Years to be audited should be specified (for multi-year contracts) in the RFP.
- H. Non-audit services to be included should be specified (preparation of financial statements, preparation of Comptrollers Report, IDOI Filing, etc).

Additionally, the government should determine if the cost portion of the proposal should be submitted in a sealed package separated from the rest of the proposal. This is commonly done when the government wants to first evaluate, and narrow, the proposals based on technical expertise, without being influenced by the fee quoted.

Chapter V Distributing the RFP

Determine which firms will be given the RFP. This can be exclusive, or all inclusive depending on the amount of time and resources available to review responses. If there is a short time frame in which to select the auditor, the government may choose to distribute its RFP to a select group of firms in order to minimize the number of responses which must be reviewed. Conversely, if the government has sufficient time and resources to evaluate numerous responses, the RFP can be posted on a website with an invitation to any firm to respond. Information on auditors in your vicinity can be obtained from the following sources:

- A. Vendor listing on IGFOA website
- B. Referrals from neighboring communities
- C. Other website listings

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Chapter VI Bidders Conference

A bidder's conference will provide an opportunity for interested firms to meet with key government staff and ask questions about the government and the RFP. All reports issued during the prior year's audit should be made available for review. Holding a conference such as this ensures that all interested firms are able to hear the questions asked by other firms as well as the answers provided. This helps ensure that all interested firms obtain the same understanding of the scope of the work and other relevant information.

If there are any questions asked that the government is not able to answer during the meeting, the answer should later be provided to all firms in attendance at the meeting, via fax, phone or e-mail.

In addition to the bidder's conference, you may schedule individual meetings with interested firms to provide the firms the opportunity to be creative in their audit approach.

Chapter VII Evaluating the Proposals

The proposals received should be evaluated based on the criteria previously established. Commonly, governments will use a numerical scoring system and rate the proposals submitted, from best to worst, for each category determined in section III above such as price, technical expertise, experience of staff assigned, etc. If there are several qualified firms, the decision as to which is best for your government can be a difficult one. At this stage, it is often useful to conduct short interviews with each of the qualified firms. This gives the government the opportunity to ask more detailed questions about information contained in the proposal. It also gives the government's staff the opportunity to meet the staff and partner that will be assigned to the engagements. Based on the scoring and interview process, the government should determine the firm best suited to meet the government's needs.

Chapter VIII Making a Recommendation

Most governments require formal Board approval of the firm to be selected. The Finance Director, selection committee, or other key individuals will typically make a recommendation to the Board, Finance Committee, Audit Committee or other responsible party, based on the evaluation criteria. Have the Board approve the selection of the auditor.

Chapter IX Audit Committees

If your government has an audit committee, they should be actively involved in the selection of the evaluation criteria, evaluation of the proposals submitted, and interviews with qualified firms. They typically will also be responsible for the award decision.