



## Report to the City of San Diego Audit Committee

### Best Practices, Analysis and Recommendations for:

- Audit Committee Process for Reviewing Annual Financial Statements (CAFR)
- Outside Auditor – Selection, Communications and Evaluation

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# EXECUTIVE SUMMARY

## Background

The City Council Audit Committee is mandated by the Audit Committee's Charter to perform the following key responsibilities:

- 1) the appointment of the outside auditor
- 2) disclosure controls and procedures
- 3) accounting policies
- 4) pre-approval of all audit services
- 5) annual audit
- 6) financial reporting procedures
- 7) securities law compliance
- 8) coordination and reporting

- Appointment of outside auditor – Appoint, compensate, retain, provide oversight, and, if necessary, replace the City's outside auditor for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the City.
- Disclosure controls and procedures – Review periodically with the Disclosure Practices Working Group (DPWG) and the Mayor the City's disclosure controls and procedures, and review and evaluate the annual report on the City's disclosure controls and practices.
- Accounting policies – Review periodically with the Mayor and outside auditor the quality, as well as the acceptability, of the city's accounting policies, etc.
- Pre-approval, of all audit services and permitted non-audit services – Approve, or establish procedures for representatives of the committee to approve, in advance, all audit services and all permitted non-audit services to be provided to the City by the outside auditor in order to ensure the outside auditor's independence.
- Annual Audit – Perform and/or oversee the following:
  - Request from the outside auditor a formal written statement delineating all relationships between the outside auditor and the City consistent with Independence Standards Board Standard No. 1.
  - Recommend to the City Council, after appropriate consultation with the Mayor, the selection and terms of the engagement of the outside auditor.
  - Review with the Mayor and the outside auditor the audited financial statements to be included in the City's Comprehensive Annual Financial Report (CAFR), and provide to the Mayor any comments or recommendations it may have, and review and consider the outside auditor the matters required to be discussed by SAS No. 61 (Superseded by SAS No. 114 effective December, 2006).
  - Perform the procedures set forth below in "Financial Reporting Procedures" with respect to the annual financial statements to be reported.
  - Review with the Mayor and the outside auditor the City's critical accounting policies and practices.
  - Recommend to the Council whether, based on the reviews and discussions referred to above, the annual financial statements should be issued by the City.

- Financial reporting procedures – Perform the following:
  - Discuss with the outside auditor, to the extent appropriate, whether all material correcting adjustments identified by the outside auditor in accordance with GAAP are reflected in the City’s financial statements.
  - Review with the outside auditor all material communications between the outside auditor and the Mayor, such as any letter or schedule of unadjusted differences.
  - Review with the Mayor and the outside auditor any material financial or other arrangements of the City which do not appear on the City’s financial statements and any transactions or courses of dealing with third parties that are significant in size or involve terms or other aspects that differ from those that would likely be negotiated with independent parties, and which arrangements or transactions are relevant to an understanding of the City’s financial statements.
  - Resolve any disagreements between the Mayor and the outside auditor regarding financial reporting.
  
- Securities Law Compliance – Review and evaluate the City’s compliance with its obligations under federal and state securities laws with respect to securities issued by the City and by the “related entities,” as defined in San Diego Municipal Code section 22.1702, and provide to the DPWG, the Mayor, and the City Council any comments or recommends it might have.
  
- Coordination and Reporting – Work to assure maximum coordination between the work of the internal auditor, the Council as a legislative body, and the outside auditor. The Audit Committee shall report to the City Council at least quarterly, and more frequently as needed.

**Objective**

- To review best practices, comparable government entities’ practices, and current City of San Diego practices related to the Audit Committee’s review of the City of San Diego’s CAFR.
- To review the Ad-hoc Advisory Committee’s Report Memo dated April 14, 2008, on the City’s financial processes, internal control function, and the Audit Committee’s CAFR review questions.
- To review best practices, comparable government entities’ practices, and current City of San Diego’s practices related to the selection of, communication with and evaluation of the outside auditor.

**Scope**

Present a written report to the Audit Committee regarding the following:

- 1) Critical process and attributes for an Audit Committee’s review of the City’s financial statements:
  - Description of best practices surrounding the review of financial statements utilizing the American Institute of Certified Public Accountants (AICPA), the Government Finance Officers Association (GFOA), the Generally Accepted Auditing Standards (GAAS), the Institute of Internal Auditors (IIA) Standards, and the Association of Local Government Auditors (ALGA).
  - Comparison of the Audit Committee’s financial statement review practices to both the standards and to the practices of other municipalities.
  
- 2) Review and comment on the Ad-hoc Advisory Committee’s Report as it relates to the Audit Committee’s CAFR review questions.

3) Critical processes and attributes for an Audit Committee's selection of, communication with, and evaluation of an outside auditor:

- Description of best practices surrounding the selection and evaluation of an outside auditor utilizing the American Institute of Certified Public Accountants (AICPA), the Government Finance Officers Association (GFOA), the Generally Accepted Auditing Standards (GAAS), the Generally Accepted Government Auditing Standards (GAGAS), the Institute of Internal Auditors (IIA) Standards, and the Association of Local government Auditors (ALGA).
- Comparison of the Audit Committee's selection and evaluation of an outside auditor to both the standards and to the practices of other municipalities.
- Describe best practices surrounding communication with an outside auditor utilizing the American Institute of Certified Public Accountants (AICPA), the Government Finance Officers Association (GFOA), the Generally Accepted Auditing Standards (GAAS), the Generally Accepted Government Auditing Standards (GAGAS), the Institute of Internal Auditors (IIA) Standards, and the Association of Local government Auditors (ALGA).
- Comparison of the Audit Committee's communication with the outside auditor as compared to both the standards and the practices of other municipalities.

### **Approach**

In order to complete the above objective and provide the Audit Committee with recommendations based on best practices regarding how the Audit committee can best be involved in 1) the review and approval of the City's Comprehensive Annual Financial Report (CAFR), 2) the Audit Committee's Ad-hoc Advisory Committee's Report and 3) retain and evaluate the outside audit, as well as perform adequate communication, we performed the following:

- Reviewed the current Audit Committee Charter and the Audit Committee's current practices for its CAFR review process.
- Reviewed the best practices for CAFR review within the AICPA, IIA, GAO, GAAS, GAGAS and ALGA standards and guidance.
- Reviewed and had conversation with other cities regarding their CAFR review processes.
- Reviewed the Audit Committee's Ad-hoc Advisory Committee's Report and compared it with the above literature and standards.
- Reviewed the Audit Committee's current practices for the selection and evaluation of its outside auditor.
- Reviewed the best practices for selection and evaluation of an outside auditor within the AICPA, IIA, GAO, GAAS, GAGAS and ALGA standards and guidance.
- Reviewed and had conversation with other municipalities regarding their outside auditor selection and evaluation practices.
- Reviewed the Audit Committee's current practices for communication with its outside auditor.
- Reviewed the best practices for communication with the outside auditor within the AICPA, IIA, GAO, GAAS, GAGAS and ALGA standards and guidance.
- Reviewed and had conversation with other municipalities regarding their communication practices with their outside auditors.

## **Recommendations**

### **Recommendation 1 – Signed documentation of CAFR related questions should be considered as an addition to the CAFR review process and not a replacement for a strong, vigorous Audit Committee discussion.**

#### **Basis for Recommendation**

It has been recommended by the Ad Hoc Committee that the thirty CAFR related questions asked of the outside auditor, management and the Audit Committee be documented. Each respondent should complete and sign a document prior to the meeting, answering the applicable questions. Any negative responses should be documented in detail including a “get well” plan, if appropriate. We agree with this recommendation. Also, it is important to note that the Ad Hoc Committee did not suggest that the documentation of the questions replace the verbal discussion in the Audit Committee. The purpose of this recommendation is to emphasize that while having an advance considered, signed document is a valuable addition, it should only be considered as a addition to the process and not a replacement for a strong, vigorous audit discussion, such as evidenced at the City’s Audit Committee’s April 18, 2006 CAFR approval meeting with the outside auditor.

In light of the City’s recent financial report-process concerns, transparency surrounding the City’s financial statement reporting is extremely important. “Open forum” discussions, sunshine laws, and public-versus-private meetings are relevant in today’s government environment.

#### **Recommendation**

The Audit Committee should continue its practice of obtaining verbal responses, in an open-forum format, to the Audit Committee’s CAFR reporting-process related questions.

#### **Resource Impact**

Additional time, 1 hour of preparation and questioning time per financial statement reviewed by the Audit Committee.

### **Recommendation 2 – The City of San Diego’s Audit Committee’s CAFR formal questioning during the CAFR review process should also include questions to the City’s Internal Auditor.**

#### **Basis for Recommendation**

The “AICPA Audit Committee Toolkit: Government Organizations” recommends a listing of questions for the Internal Auditor entitled, “Internal Audit – A Tool for the Audit Committee.” The questions are modeled on those found in the COSO report, “Internal Control – Integrated Framework.” The questions are detailed in the Financial Statement Review – Ad Hoc Advisory Committee Recommendations section of this report.

The AICPA suggests the questions should be discussed in an open forum. The questions address issues such as “tone at the top,” integrity and ethical values, competence, etc.

#### **Recommendation**

The Audit Committee should include the City’s Internal Auditor in the CAFR Review Question list to be more encompassing in its final review of the CAFR.

## Resource Impact

Additional time, 1 hour of preparation, would be required before the Audit Committee meeting to familiarize the Internal Auditor with the questions he/she would be asked.

### **Recommendation 3 – Communications with the Outside Auditor should be increased to become compliant with the new auditor communication’s standard (SAS No. 114 – The Auditor’s Communication with Those Charged with Governance, superseding SAS No. 61 – Communication with Audit Committee).**

#### **Basis for Recommendation**

In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed by the auditor for matters under GAAS. It is also important for the audit committee to understand that an audit conducted in accordance with GAAS is designed to obtain *reasonable*, rather than absolute, assurance about the fair presentation of the financial statements.

Under the new Statement on Auditing Standards No. 114 – *The Auditor’s Communication with Those Charged with Governance*, specific matters are to be communicated, many of which are generally consistent with the old standard, SAS No. 61. However the new SAS includes certain additional matters to be communicated and provides additional guidance on the communication process. In particular, the SAS states:

- Describes the principal purposes of communication with those charged with governance and stresses the importance of effective two-way communication.
- Requires the auditor to determine the appropriate person(s) in the entity’s governance structure with whom to communicate particular matters. That person may vary depending on the nature of the matter to be communicated.
- Recognizes the diversity in governance structures among entities (including the existence of audit committees or other subgroups charged with governance) and encourages the use of professional judgment in deciding with whom to communicate particular matters.
- Recognizes the unique considerations for communicating with those charged with governance when all of those charged with governance are involved in managing the entity, which may be the case with some small entities.
- Additional requirements to communicate:
  - An overview of the planned scope and timing of the audit.
  - Representations the auditor is requesting from management.
- Provides additional guidance on the communication process, including the forms and timing of communication. Significant findings from the audit should be in writing when, in the auditor’s professional judgment, oral communication would not be adequate. Other communications may be oral or in writing.
- Requires the auditor to evaluate the adequacy of the two-way communication between the auditor and those charged with governance.
- Establishes a requirement to document required communications with those charged with governance.

#### **Recommendation**

Communications both pre-audit and post-audit should be increased between the Audit Committee and the outside auditor to be in compliance with SAS No. 114.

## **Resource Impact**

Additional time, 10+ hours would be needed on the part of the Audit Committee Members to full comply with the new SAS No. 114.

## **Recommendation 4 – The City of San Diego’s Audit Committee should conduct a formal annual evaluation of its outside auditor.**

### **Basis for Recommendation**

The AICPA recommends that audit committees formally evaluate its outside auditor on an annual basis thereby providing a formal document to discuss performance with the outside auditor.

Most municipalities currently evaluate their outside auditor informally with discussions amongst themselves. However, municipalities that do formally evaluate their outside auditor find it much easier to justify reappointing or releasing an outside auditor. If a municipality finds the need to release and/or not rehire its current auditor, a formal evaluation provides the audit committee with a listing of grievances.

If a formal evaluation is done, the chair of the Audit Committee should meet in person with the outside auditors to discuss the results. This will give an opportunity for the committee to provide constructive feedback and openly express concerns or opportunities for further improvement. However, it is also an opportunity for the outside auditor to respond to such items and share any concerns they may have. Open and candid discussion is key to strengthening this relationship and improving the audit process.

### **Recommendation**

The City of San Diego’s Audit Committee should conduct an annual formal evaluation of its outside auditor thereby providing a mechanism for the Audit Committee to give the outside auditor its assessment of the audit firm’s performance and a way for the Audit Committee to obtain feedback on improvement opportunities.

### **Resource Impact**

Additional time, 10+ hours per year will be needed on the part of the Audit Committee Members to participate in and communicate an annual performance evaluation of the outside auditor.

# Financial Statement Review – Best Governmental Practices

One of the primary duties of a municipality's audit committee is to oversee the integrity of the annual issuance of a municipality's Comprehensive Annual Financial Report (CAFR). A key element in the audit committee's oversight of the integrity of the financial statements and the financial-reporting process is the review and discussion of the CAFR with the external auditors and management. This process helps determine whether the financial statements are complete and consistent with acceptable accounting standards and practices. The audit committee is also responsible for assessing the quality, not just the reliability, of the statements.

Therefore, in addition to a general review of the CAFR, the audit committee should understand the following financial reporting concepts:

- Independence of the external auditor
- Auditor's responsibility under Generally Accepted Government Auditing Standards (GAGAS), Generally Accepted Auditing Standards (GAAS), and the American Institute of Certified Public Accountants (AICPA) standards
- Materiality and material misstatement
- New accounting principles
- Significant accounting policies and any changes in those accounting policies
- Significant and/or unusual accounting adjustments, estimates, reserves, and accruals
- Significant audit adjustments
- Fraud, violation of laws and abuse
- Illegal acts
- Transparency of footnotes and disclosures
- Other information contained in the audited financial statements, e.g. MD&A or Narratives
- Description of audit procedures performed
- Auditor recommendations
- Difficulties encountered in performing the audit
- Disagreements with management
- Correspondence/communication between auditor and management
- Quality of accounting/internal controls/competency of staff
- Consultation with other accountants (legal advice or regulatory bodies)
- Internal controls
- Material Weaknesses

Below is an explanation of each of the above financial reporting concepts:

## **Independence of the external auditor**

Under the Independence Standards Board Standard (ISB) 1, *Independence Discussions with Audit Committees*, the external auditor of an SEC engagement, at least annually, to: 1) disclose, in writing, independence issues to the audit committee, 2) confirm to the committee, in writing, that the external audit firm is independent, and 3) discuss with the committee the external auditor's independence.

Additionally, both the Generally Accepted Auditing Standards (GAAS) the Generally Accepted Government Auditing Standards (GAGAS) have extensive independence standards. GAAS in its Auditor's Responsibilities and Functions section (AU230.03) states that to be independent, the auditor must be intellectually honest; and to be recognized as independent, he or she must

be free of any obligation to or interest in the client, its management, or its owners. GAGAS Standard 3.02 – *Independence* states that an audit organization and the individual auditor must be free from personal, external, and organizational impairments to independence, and must avoid the appearance of such impairments of independence.

For the City of San Diego, the independence standard is met by addressing “independence” within the written engagement contract. The standard is also met by requesting from the outside auditor a formal written statement delineating all relationships between the outside auditor and the City consistent with Independence Standards Board Standard No. 1. Additionally, the Audit Committee satisfies the need for independence criteria by asking the external auditors (in conjunction with each audit performed) the following questions: “*Explain the process your firm goes through to assure that all of your engagement personnel are independent and objective with respect to the audit. Do any non-audit services performed for the City or its related entities affect the work that you do or the manner in which the engagement team or others are compensated.*”

### **Auditor’s responsibility under Generally Accepted Government Auditing Standards (GAGAS), Generally Accepted Auditing Standards (GAAS), and the American Institute of Certified Public Accountants (AICPA) standards**

In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed by the auditor for matters under GAAS. It is also important for the audit committee to understand that an audit conducted in accordance with GAAS is designed to obtain *reasonable*, rather than absolute, assurance about the fair presentation of the financial statements.

Under the new Statement on Auditing Standards No. 114 – *The Auditor’s Communication with Those Charged with Governance*, the auditor’s responsibility under GAAS includes:

- The auditor’s responsibility for forming and expressing an opinion on whether the financial statements that have been prepared by management with the oversight of those charged with governance are presented fairly, in all material respects, in conformity with Generally Accepted Accounting Principles (GAAP).
- The audit does not relieve management or those charged with governance of their responsibilities.

Note: “*Those charged with governance*” refers to the person or persons responsible for the strategic direction of the entity and the obligations relative to the accountability of such entity, including oversight of the financial reporting process. For entities with audit committees, “those charged with governance” encompasses the audit committee.

Note: The SAS defines “*management*” as the person or person(s) responsible for achieving the objectives of the entity, with the authority to establish policies and make decisions by which those objectives are to be pursued, and who are responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

Additional areas required to be communicated are:

- Planned scope and timing of the audit.
- Significant findings from the audit (must be communicated in writing).

Under GAGAS standards, AICPA standards are utilized along with additional GAGAS standards:

AICPA Field Work Standards include:

- The auditor must have reason to believe that the subject matter is capable of evaluation against criteria that are suitable and available to the users. (6.03)
- The auditor must adequately plan the work and must properly supervise any assistants. (6.04)
- The auditor must obtain sufficient evidence to provide a reasonable basis for the conclusion that is expressed in the report. (6.04)
- 

Additional GAGAS Field Work Standards include:

- Additional auditor communication during planning – Further understanding of services to be performed by auditor and by client, with nature, timing and extent of planned testing/reporting, level of assurance and potential restrictions, plus, if early termination, details will be documented. (6.06-6.08)
- Previous audits and attestation engagements - Auditor should evaluate whether the audited entity has taken appropriate corrective action to address findings and recommendations from previous engagement that could have a material effect on the subject matter. (6.9)
- Internal control – Auditor should obtain a sufficient understanding of internal control that is material to the subject matter in order to plan the engagement and design procedures to achieve the objectives of the engagement. (6.10-6.12)
- Fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that could have a material effect on the subject matter – Auditors should design the engagement to provide reasonable assurance of detecting fraud, illegal acts, or violations of provisions of contracts or grant agreements that could have a material effect on the engagement. Additionally, if during the course of the engagement, auditors become aware of abuse that could be quantitatively or qualitatively material, auditors should apply procedures specifically directed to ascertain the potential effect on the subject matter or other data significant to the engagement objectives. Abuse involves 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. Abuse also includes misuse of authority or position for personal financial interests or those of any immediate or close family member or business associate. Abuse does not necessarily involve fraud, violation of laws, regulations, or provisions of a contract or grant agreement. (6.13-6.14)
- Developing elements of a finding – Audit findings may involve deficiencies in internal control, fraud, illegal acts, violations of provisions of contract or grant agreements, and abuse. The elements needed for a *finding* depend entirely on the engagement objectives. Thus a *finding* or *set of findings* is complete to the extent that the engagement objectives are satisfied.(6.15-6.19)
- Documentation – Documentation must be of sufficient detail to provide a clear understanding of the work and results of the work. (6.20-6.26)
- Materiality – Due to the engagement objectives and public accountability of GAAGAS engagements, there may be additional considerations. See next Section for a description of Materiality. (6.28)
- Ongoing investigations of legal proceedings – Avoiding interference with investigations or legal proceedings is important. Laws, regulations, or policies might require auditors to report indications of certain types of fraud, etc. before performing additional procedures. It might be appropriate for the auditors to withdraw. (6.29)

AICPA Reporting Standards include:

- The auditor must identify the subject matter or the assertion being reported on and state the character of the engagement in the report. (6.30)

- The auditor must state the auditor's conclusion about the subject matter or the assertion in relation to the criteria against which the subject matter was evaluated in the report. (6.30)
- The auditor must state all of the auditor's significant reservations about the engagement, the subject matter, and, if applicable, the assertion related thereto in the report. (6.30)
- The auditor must state in the report that the report is intended for use by specified parties, i.e. limited number of parties or only specified parties. (6.30)

Additional GAGAS *Reporting* Standards include:

- State the reporting auditors' compliance with GAGAS. (6.31)
- Report deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse (6.33 – 6.43)
- Present findings sufficient clear to assist management or oversight officials in understanding the need for taking corrective action. If the auditors are able to sufficiently develop the elements of a finding, they may provide recommendations for corrective action. (6.42)
- If the auditor's report discloses deficiencies, the auditor should obtain and report the views of responsible officials concerning the findings, conclusions, and recommendations, as well as planned corrective actions. (6.43)
- Providing a draft report with findings for review and comment by responsible officials of the audited entity and other helps the auditors develop a report that is fair, complete, and objective. Including the views of responsible officials results in a report that presents not only the auditors; findings, conclusions, and recommendations, but also the perceptions of the responsible officials of the audited entity and the corrective actions they plan to take. Obtaining the comments in writing is preferred, but oral comments are acceptable.

### **Materiality and Material Misstatement**

Materiality is more than just a *quantitative* concept, and significant judgment is involved in its evaluation. A *quantitative* threshold, such as a materiality percentage, is a useful basis for preliminarily assessing whether an item is likely to be material.

Per Statement of Auditing Standards (SAS) 107 – *Audit Risk and Materiality in Conducting an Audit*, states that planning materiality is a matter of *professional judgment*. Typically, auditors apply a percentage to an appropriate basis such as:

- A percentage of total assets
- A percentage of total revenues

In the United States, the SEC recognizes that a 5% threshold often is used as a rule of thumb.

However, depending on the situation, significantly lower percentages could be deemed material. Management and the auditors need to assess all relevant facts and circumstances around an item – including both *quantitative* and *qualitative* measures – before an area can be deemed immaterial. The question needs to be asked, “How would a *qualitative* factor influence the chances of a misstatement, regardless of total dollar amount? *Qualitative* factors can lead to just as large a misstatement as a *quantitative* factor. If the *qualitative* factors are sufficiently pervasive, an auditor will reduce the materiality level to reduce the degree of risk of misstatement of the financials.

SAS 107 gives some examples of qualitative measures:

- What are the possible effects of the misstatement on profitability or other trends, or compliance with loan covenants, other contractual agreements, and regulatory provisions?
- Does the misstatement change a loss into income (or vice versa)?
- What is the effect of the misstatement on segment information or the effect of a misclassification (e.g. a misclassification between operating and non-operating income)?
- Are there statutory or regulatory requirements that affect materiality thresholds?
- How sensitive are the circumstances of the misstatements (e.g. a misstatement that involves a fraud or illegal act)?
- How significant is the financial statement element impacted by the misstatement or the significance of misstatement or disclosures as they relate to the needs of the users?
- What is the character of the misstatement (e.g. an error in an objectively determinable amount versus an error in an estimate, which by its nature involves a degree of subjectivity)?
- What is management's motivation?
- Do individually significant but different misstatements have offsetting effects?
- What is the likelihood that a currently immaterial misstatement may become material?
- What is the cost of correcting the misstatement?
- How great is the risk that there are possible additional undetected misstatements that might impact the auditor's evaluation?

In essence, something is material if a reasonable person would consider it important.

### **New accounting principles**

General Accepted Accounting Principles (GAAP) encompasses the conventions, rules, and procedures necessary to definite accepted accounting practices at a particular time in the United States. Accounting principles govern the accounting rules for assets, liabilities, revenue recognition, depreciation, etc. These principles underlie the preparation of financial statements on a consistent basis. They include concepts such as:

Business entity	Going concern
Accounting period	Matching revenue and expenses
Revenue recognition	Allocation of costs
Adequate disclosure	Consistency

As the world changes, there is an ever-evolving need for accounting rules (principles) to govern these changes in business and government. Therefore, new rules are issued for the U.S. business and governmental communities to follow. Management of finance departments need to continually update their accounting and audit knowledge to encompass the new laws. Adherence to current accounting rules ensures properly stated financial statements. The auditor's opinion will state that the financial statements are in *accordance with GAAP*.

If an entity has changed the application of an accounting principle, the audit committee should inquire as to the appropriateness of the change and whether the alternative methodology is equally sound.

An audit committee should inquire if the principles adopted by management are consistent with those adopted by management in other similar municipalities.

### **Significant accounting policies and any changes in those accounting policies**

Audit committees should understand the significant accounting policies of the municipality and whether they are reasonable and appropriate. With the number and complexity of standards,

audit committees should devote sufficient time to updating their knowledge of current and emerging accounting standards that can effect the municipality's accounting policies.

The auditor should inform the audit committee about the selection of and changes in significant accounting policies or their application. The audit committee should expect the auditors to communicate the following:

- All the significant accounting policies used by the municipality, including those that became applicable that year.
- How those accounting policies apply to the municipality.

The auditor should also inform the audit committee about the methods used to account for unusual transactions and the effect on significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

### **Significant and/or unusual accounting adjustments, e.g. estimates, reserves, and accruals**

Accounting estimates and reserves are an integral part of financial statement preparation. Estimates and reserves are based on management's judgment (from informed knowledge). Examples of accounting estimates and reserves are estimates for judgments, claims, self-insurance liabilities, allowance for doubtful accounts, pensions, etc.

Estimates can also be created or adjusted for changing trends or patterns. Below are some examples of estimates that are commonly required in governmental accounting:

1. Likely uncollectible accounts receivables.
2. Pension and other post employment benefit obligations.
3. Loan loss reserves.
4. Litigation reserves.
5. Other commitments and contingencies.

The Audit Committee should be aware of the ramifications of mismanaged estimates and reserves. A training session regarding the complex subject of accounting estimates and reserves can be very beneficial to an audit committee.

Accruals are routinely used to match revenue and expenses in the proper reporting period. However, if there is a significant accrual booked near year-end the auditors should discuss the change with the audit committee.

The auditors should discuss the following issues with the audit committee:

- The process used by management in formulating sensitive accounting estimates.
- The auditor's conclusion regarding the reasonableness of those estimates.

### **Significant audit adjustments**

The auditor should inform the audit committee about all audit adjustments arising from the audit that could have a significant effect on the municipality's financial statements. A list of audit adjustments are routinely discussed with management before the audit is closed. Management will evaluate the proposed adjustments and determine whether each adjustment should be booked. Failure to book audit adjustments can lead to a qualified opinion.

Per GAAS and GAGAS, the auditor should inform the audit committee about adjustments arising from the audit that could individually, or in the aggregate, have a significant effect on the organization's financial reporting process.

The audit committee should be additionally informed as to whether the adjustments were recorded, and if the adjustments could have gone undetected by the organization's own internal control system.

## **Fraud, violation of laws and abuse**

SAS No. 99 – *Consideration of Fraud in a Financial Statement* requires the auditor to bring any evidence of fraud to the attention of the appropriate level of management, even in the case of inconsequential fraud. The auditor should reach an understanding with the audit committee regarding when (nature and scope) an inconsequential fraud conducted by a low-level employee should be brought to the attention of the audit committee. However, the auditor must report any fraud involving senior management, and any fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements.

Areas most susceptible to fraud include:

- Expense Classification
  - Improperly capitalizing/deferring expenses
  - Failing to record expenses
  - Overstating ending inventory values
  - Improperly using restructuring and other liability reserves
  - Understating reserves for bad debts and loan losses
  - Failing to record asset impairments
  
- Revenue Recognition
  - Improperly recording the timing of sales
  - Recording fictitious revenue
  - Improperly valuing revenue

## **Illegal Acts**

SAS No. 54 – *Illegal Acts by Clients* defines an illegal act as violations of laws or government regulations attributable to the government organization, or acts by management or employees on behalf of the organization. Illegal acts do not include personal misconduct by the organization's personnel unrelated to the government's business activities. In addition, GAAS Chapter 5, Section 5.12 – *Auditor Communication* and OMB Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements* requires auditors to report noncompliance with laws and regulations disclosed by the audit, except for those instances of noncompliance that are clearly inconsequential. The auditor should report all instances of fraud and illegal acts unless clearly inconsequential and significant violations of provisions of contracts or grant agreements and abuse. In some circumstances, auditors are required to report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to the associated organizations/parties external to the audited organization.

The auditor has the responsibility to adequately inform the audit committee about illegal acts (that are of consequence) that come to the auditor's attention.

## **Transparency of footnotes and disclosures**

Every effort should be made to ensure transparency of the financial statements and footnotes/disclosures. Information should be complete, clear, candid, and understandable. Important information should be prominently stated. Accounting subjects such as commitments, contingencies and subsequent events should be complete and transparent.

## **Other information contained in the audited financial statements, e.g. MD&A or Narratives**

Although the footnotes to the financial statement are an integral part of the financial statements and are, therefore, included in the scope of the auditing procedures, *other information prepared by management that generally accompanies financial statements* is not necessarily included in the scope of the auditing procedures. An example of *other information*

is the “Management’s Discussion and Analysis of the Financial Condition and Results of Operations,” commonly known as MD&A.

Information stated in the MD&A section should be complete, clear, candid, and understandable. However, it should not be a simple repeat of the information contained in the footnotes/disclosures.

The auditor should discuss the responsibility, if any, that he or she has for *other information in documents contained in audited financial statements*, any procedures performed, and the results.

Assessing whether the information in narrative reports is accurate is only part of the audit committee’s obligation. It should also consider whether the information is complete. If the audit committee identifies a subject area that was not disclosed, it should challenge management regarding the reason it was not included. If the audit committee continues to feel a subject area should be included, the audit committee can demand it be included.

### **Description of audit procedures performed**

The auditor should give a brief presentation of the audit procedures performed in the course of the audit. This presentation assists the audit committee in understand the audit process and thereby be more effective in its oversight function.

### **Auditor recommendations**

Per GAGAS Standards, audit findings may involve deficiencies in internal control, fraud, violations of provisions of contract or grant agreements, abuse and illegal acts. The elements needed for a *finding* depend entirely on the engagement objectives. Thus a *finding* or *set of findings* is complete to the extent that the engagement objectives are satisfied. (6.15-6.19). Documentation must be of sufficient detail to provide a clear understanding of the work and results of the work. (6.20-6.26) A report regarding findings and the auditor’s recommendations regarding findings should be given to the audit committee with management’s responses to the findings.

### **Difficulties encountered in performing the audit**

The audit committee should be informed by the auditor of any serious difficulties encountered in working with management during the audit. Some common issues are:

- Unavailability of personnel.
- Unreasonable delays by management regarding the start of the engagement.
- Failure of management or staff to complete client-prepared schedules on a timely basis.
- Unreasonable delays or refusals to provide needed information.
- Unreasonable timetable set by management for the conduct of the audit.

### **Disagreements with management**

Disagreements can occur between management and the auditor regarding the application of accounting principles to specific transactions and events. Disagreements can also occur over the basis for management’s judgments about accounting estimates, the scope of the audit and/or the disclosures to be made in the financial statements or footnotes. These disagreements are usually resolved as more facts emerge surrounding the various subject areas.

However, the auditors should discuss any disagreements with the audit committee, whether or not resolved, that either individually or in the aggregate could be of significance to the financial statements or the auditor’s report.

### **Quality of accounting/internal controls/competency of staff**

The auditor's judgments about the quality, not just the acceptability of the municipality's accounting principles as applied in its financial statements, including disclosures, should be discussed. The discussion should include topics such as:

- Completeness of the financial statements and related disclosures.
- Consistency of the organization's accounting principles and their application.
- Clarity of the financial statements and related disclosures.
- Any changes in accounting policies and the selection of new accounting policies.
- Quality of judgments regarding estimates, significant accruals, judgments, reserves, uncertainties, etc.
- How unusual transactions were addressed.
- Adherence to the matching principle concept of matching revenues with related expenses.
- The department's treatment of industry-specific accounting practices.

The auditor should also evaluate and communicate to the audit committee his/her assessment of the competency of the staff. The auditor should address such issues as:

- Is the finance department over dependence on one or two key individuals?
- Is there an adequate support system to allow financial management to continually improve the quality of the financial reporting process in a timely manner, or are projects routinely put on hold while critical issues are addresses?
- Are financial managers setting an appropriate tone for the finance department?
- Is the accounting department staffed adequately?
- Are closings and reconciliations done in a timely manner?
- Is the accounting staff committed to effective internal controls?
- How would you assess the accounting and reporting staff?

### **Consultation with other accounting/auditing firms**

Sometimes management of the government agency may consult with other accountants about accounting and auditing matters. If the auditor is aware that such consultation has occurred, the auditor should discuss his/her view with the audit committee about significant matters that were the subject of the consultation. The audit committee may wish to ask management whether they have consulted with other accountants/auditors about accounting and auditing matters.

### **Internal controls**

SAS No. 60 – *Communication of Internal Control Related Matters Notes in an Audit* requires the auditor to communicate matters relating to the organization's internal controls where there were significant deficiencies in the design or operation of the internal control system observed by the auditor in the conduct of the financial statement audit. A significant deficiency in the design or operation of the internal control system can adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

The auditor should also assess the quality and depth of the internal audit department.

- What is the overall quality of the department?
- Do the internal auditors have enough experience?
- How is the internal audit department viewed by management and others in the organization?
- Is senior management setting the appropriate tone at the top?
- Are middle managers encouraged to bring control issues to senior management without fear of reprisal?
- Is senior management committed to bringing significant control issues to the audit committee?

- Are the control systems in place adequate given the size and complexity of the entity's operations?

**Material Weaknesses**

A material weakness is the reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected on a timely basis. If a material weakness is determined, the audit must bring the information regarding the material weakness and its effect to the audit committee. Management should inform the audit committee of its remediation efforts to remedy the material weakness.

## Financial Statement Review – Audit Committee’s Review Process compared to Standards, Charter Requirements and Other Guidance

The Audit Committee’s Charter gives the Audit Committee criteria for reviewing the CAFR. Additionally, the Audit Committee asked the City Attorney’s office to generate a listing of questions for use in the review of the CAFR. Additionally, the City’s SEC Independent Consultant generated a listing of CAFR review questions.

Utilizing the above Charter responsibilities plus the two guidance listing of questions, the Audit Committee completed its own listing of review questions that are used as a basis for asking CAFR review questions of both the City’s financial management group and the external auditor at the close of each audit.

Below is a comparative columnar grid that compares the Audit Committee’s CAFR Review Questions list (used at the conclusion of each City of San Diego audit) to the following:

- The Government Accounting Office’s (GAO) Generally Accepted Government Auditing Standards (GAGAS) for financial statement review of governmental entities.
- The Generally Accepted Auditing Standards (GAAS) for financial statement review.
- The Audit Committee Charter responsibilities
- The Independent Consultants CAFR Review Questions guidance listing
- The City Attorney’s CAFR Review Questions guidance listing.

As evidenced by the comparative grid, the Audit Committee’s CAFR Review Questions list is very inclusive of both the GAGAS/GAAS standards for financial statement review and the two guidance lists.

The City of San Diego’s Audit Committee is following best practices in its review of the CAFR.

<b>REVIEW OF FINANCIAL STATEMENTS - CAFR</b>						
<b>Best Practice Attributes</b>	<b>GAO/ GAGAS</b>	<b>AICPA/ GAAS/ GAAP</b>	<b>San Diego Audit Committee Charter</b>	<b>San Diego CAFR Review Questions</b>	<b>Independ- ent Consult- ant</b>	<b>SD City Attorney Recom- mendation</b>
<b>Audit Criteria</b>						
Independence of external auditor	X	X	X	X		X
In Accordance with GAGAS/GAAS/GAAP	X	X	X	X	X	X
Materiality and Material Misstatement	X	X	X	X	X	X
New Accounting Principles	X	X	X	X		X
Present and Change in Accounting Policies	X	X	X	X		X
Significant Accounting Adjustments, Estimates, Reserves, Accruals	X	X	X	X	X	X
Subsequent Events (See Footnotes/Disclosures)	X	X			X (& Kroll Status Rpt 1/28/08)	
Significant Audit Adjustments	X	X	X			X
Fraud/Violation/Abuse	X	X	X	X	X	
Illegal Acts	X	X	X	X	X	
Transparency of Footnotes/Disclosures	X	X	X	X	X	X
Narrative Reporting (MD&A)	X	X		X	X	X
Description of Audit Procedures Performed	X	X	X			X
Auditor Recommendations	X	X	X	X	X	X
<b>Qualitative Factors:</b>						
Difficulties encountered in performing the audit	X	X		X	X	X
Disagreements with Management	X	X		X		X
Quality of accounting/internal controls/competency of staff	X	X		X	X	X
Consultation with other accounting/audit firms?	X	X		X		X
<b>Internal Controls</b>						
Internal Controls	X	X	X	X	X	X
Material Weaknesses	X	X	X	X	X	X
GAO - U.S. Government Accountability Office GAGAS - Generally Accepted Government Auditing Standards (By the US Comptroller General) AICPA - American Institute of Certified Public Accountants GAAS - Generally Accounting Auditing Standards						

# Financial Statement Review - Ad Hoc Advisory Committee Recommendations

The Audit Committee Ad Hoc Advisory Committee issued a report (memo dated April 14, 2008) presenting policy and procedures recommendations for the Audit Committee. The subject areas covered were 1) financial processes, 2) the internal audit function, and 3) CAFR review questions. Comments in this report will be confined to the third item on the report, CAFR review questions.

The CAFR review questions section of the Ah Hoc Advisory Committee report includes suggestions for the Audit Committee regarding their "CAFR Review Questions" memo which includes a series of seven questions of the City's CFO and Director of Financial Reporting (Management), nineteen questions of the outside auditor and four questions of the Audit Committee members themselves. All of the questions relate to the issuance of the City's Annual CAFR. The listing is read to the appropriate person each time an annual CAFR and/or a component audit report comes before the Audit Committee. The intent is to offer "open forum" or public assurance that the information surrounding the CAFR is reasonable and correct.

The Ad Hoc Committee recommended that the thirty questions asked of the above-mentioned people during actual Audit Committee meetings should be documented. Each respondent should complete and sign a document prior to the meeting, answering the applicable questions. Any negative responses should be documented in detail including a "get well" plan, if appropriate.

We agree with this recommendation. Also, it is important to note that the Ad Hoc Committee did not suggest that the documentation of the questions replace the verbal discussion in the Audit Committee. However, we feel that it is important to emphasize here that while having an advance considered, signed document is a valuable addition, it should only be considered as a addition to the process and not a replacement for a strong, vigorous audit discussion, such as evidenced at the City's Audit Committee's April 18, 2006 CAFR approval meeting with the outside auditor. When the CAFR questions are asked and discussed in open forum, it provides increased transparency to the review process. In light of the City's past financial reporting difficulties, continuation of this transparency it is important.

The Committee's second recommendation was to remove Question II.2 from the list of questions for Management and move it to a list for the Internal Auditor. Question II.2 states, "Was the audit performed in accordance with generally accepted auditing standards (GAAS standards) or generally accepted government auditing standards (GAGAS standards)? If not, why?" The same question is also asked of the outside auditor. The suggestion is a valid one as Management is responsible for preparing the CAFR in accordance with Generally Accepted Accounting Principles (GAAP). The auditors are responsible for reviewing the CAFR in accordance with GAGAS and GAAS Auditing Standards.

The Committee's third recommendation regarding Question III.2, a "conflict of interest," independence question of the outside auditors is that the question should be answered in detail as part of the engagement contract. The original question states, "Explain the process your firm goes through to assure that all of your engagement personnel are independent and objective with respect to our audit. Do any non-audit services performed for the City or its related entities affect the work that you do or the manner in which the engagement team or others are compensated?" The Committee recommended that a better question might be, "Have you reviewed personnel assignments and city contracts for any potential conflict of interest and was any remediation action taken." Per the Audit Committee's Charter, the outside auditor must sign a formal written statement delineating all relationships between the outside auditor and the City consistent with Independence Standards Board

Standard No. 1. However, even with the above written assurance, a publicly-asked independence-related question lends continued transparency to the heavily-relied-upon topic of “independence.”

The Committee’s fourth recommendation states that a question should be added to the CAFR Review Questions list for the outside auditor – “Has the firm been engaged to provide any services besides the independent audit of which the audit committee is not already aware?” The question is a valid one and should be added to the CAFR Review Question list.

The Committee’s last suggestion regarding the CAFR Review Questions list states, “The Committee suggests that questions be asked of the Internal Auditor.” The Committee then recommends that a series of questions additionally be asked of the Internal Auditor. The ten questions are:

- Was the independent audit performed in accordance with generally accepted accounting principles (GAAP) or generally accepted government accounting standards (GAAS)? If not, why?
- Overall, is management cooperating with the internal audit team? Does management have a positive attitude in responding to findings and recommendations, or is it insecure and defensive of findings?
- Are you aware of any disagreements between management and the internal auditors?
- Has management set an appropriate “tone at the top” with respect to the importance of and compliance with the internal control system around financial reporting?
- Are you aware of any current or past occurrence of any type of fraud in the organization? Do you know of any situations where fraud could occur?
- Do you have the freedom to conduct audits as necessary throughout the organization?
- Were you restricted or denied access to requested information?
- Have you been pressured to change findings, or minimize the language in those findings so as to not reflect badly on another member of management? Are the findings and recommendations given the level of discussion needed to properly satisfy any issues raised, to your satisfaction?
- Do you feel comfortable raising issues without fear of retribution?
- Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of sound government?

The AICPA in its “Audit Committee Toolkit: Government Organizations” suggests that the Internal Auditor answer questions of the above subject areas in open forum.

**Recommendation 1 – Signed documentation of CAFR related questions should be considered as an addition to the CAFR review process and not a replacement for a strong, vigorous Audit Committee discussion.**

**Recommendation 2 – The City of San Diego’s Audit Committee’s CAFR formal questioning review should also include questions to the City’s Internal Auditor in addition to the questions asked of both the outside auditors and management.**

# Financial Statement Review - Comparable Municipalities

Jefferson Wells conducted an extensive internet search of comparable-sized municipalities that potentially had audit committees and reviewed their processes for accepting, reviewing and approving their annual CAFR. Each of the municipalities was also telephone to “flesh out” basic information gleaned from the internet.

Additionally, where possible, some additional California municipalities that had Audit Committees were chosen to be included in the survey.

Each municipality was asked the following questions:

- What is the composition of your Audit Committee?
- During what part of the CAFR issuance process do they receive the CAFR for review?
- Do they utilize any additional committees, working groups, etc. to provide them with additional assurance that the CAFR is reasonable and accurate?
- What review process does their Audit Committee use?
- Who formally presents the CAFR to the Audit Committee?
- Do they have a formalized listing of questions they ask of the Outside Auditor, Management, and/or the Internal Auditor?
- If they do not have a formalized listing of questions, do they conduct a question and answer period with the Outside Auditor, Management and/or the Internal Auditor?
- After they formally accept and approve the CAFR, does the CAFR go to another governing body for review and approval, or is it immediately released to the public and/or filed.
- What governing body is the final recipient and filer of the annual CAFR?

Many municipalities receive the CAFR, review it with little questioning, approve the document and pass it on to the next level, usually the City Council for acceptance and issuance.

In San Diego the CAFR process is:

- Management completes the CAFR.
- The outside auditor audits the CAFR.
- During the above process, the CAFR and its footnotes/disclosures move to the Disclosure Practices Work Group (DPWG) where the CAFR and its accompanying footnotes/disclosures are reviewed for accuracy, completeness and clarity.
- After the auditor and the DPWG are finished with their reviews, the CAFR is presented to the City's Audit Committee. Both the auditor and management are present for full presentations and conclusions.
- The City's Audit Committee continues its review of the CAFR with additional sessions, as needed, with management and the outside auditor to satisfy all members of the City's Audit Committee that the CAFR is reasonably accurate, complete and has clarity and transparency.
- After extensive review, the City's Audit Committee approves the CAFR and recommends it be forwarded to the City Council for acceptance and filing.
- The City Council accepts and files the CAFR and it is published. It will be additionally published on the Investor portion of the City's website as soon as that website page is available.

San Diego's Audit Committee has formalized the process of asking questions regarding areas such as independence, accounting principles, policies and procedures, and auditing practices as they relate to the CAFR. They formally ask the *qualitative* questions as well.

Over the course of the information-gathering process, it became apparent that the City of San Diego's CAFR review process is indeed on the "cutting edge" of fulfilling the requirements of both GAGAS and GAAS standards.

A grid of the municipalities researched and interviewed follows.

## Municipality Audit Committee Review of the CAFR

City	Name and Composition of Audit Committee	Who receives CAFR first	How is the CAFR reviewed and processed	Who is final recipient & filer
Austin	Audit Committee is a sub-committee of the City Council Sub-Committee: 4 Council Members selected by Council (Mayor Pro Tem currently serves as chair. All 4 are council members reaffirmed annually in Oct. The Mayor Pro Tem was a Fin Director and 2 of the CM's are CPAs.	A&FC	CFO conducts an extensive review with the external auditors (KPMG). After the review and finalization of the financial statements, the CAFR is presented to the A&FC with extensive explanation. After management's presentation, KPMG additionally conducts an extensive presentation. After the presentations and further review by the A&FC, the A&FC approves the CAFR to be forwarded to City Counsel. FY2006 CAFR - unqualified opinion, no material misstatements, no disagreements with management, difficulties encountered in performing the audit or major issues discussed prior to retention. No audit adjustments were recorded which would indicate deficiencies. No material weaknesses. Did make recommendations, new and future GASB statements, policies for estimating, reconciliations. City Council received the CAFR and accepted the recommendation to approve. The CAFR was then published to the public.	The City Council receives the CAFR, accepts the recommendation to approve and then has the CAFR published and filed at City Hall.
Chicago	Audit Committee - 3 Members - Budget Director, Comptroller and Corporate Counsel	??	Dept. of Finance, on behalf of the City, issues the CAFR after finalization by Independent Auditor. (Note: Chicago's Audit Committee only reviews and approves Internal Audit reports, not the CAFR. The Dept. of Finance is responsible for the review and release of the CAFR.)	Dept. of Finance copies the Mayor and the Council with copies available for the general public

Dallas	Finance, Audit and Accountability Committee - 7 Council members (knowledgeable in acct & audit) (Appointed by the Mayor - also chair and vice chair)	AC	AC meets with External for an audit de-brief and with Management for responses to findings. Approves and sends to Council, mayor, finance, and public	Finalized copies sent by AC to mayor, manager of finance, city attorney, city council and the public (via a newspaper)
Denver	Audit Committee - City Auditor (Chair) + 6 appointed members (no city employees) (all with education/experience in acct, audit, fin mgmt) (Currently all 7 are council members)	AC (for review/comment b/f finalized)	Auditor issues a final report to AC. The AC reviews and comments before it is approved. The AC then provides copies of the report to the mayor, manager of finance, city attorney, city council and the public	Finalized copies sent by AC to mayor, manager of finance, city attorney, city council and the public (via a newspaper)
Fort Worth	Audit and Finance Committee - 4 council members, 2 citizens with accounting/finance background, Mayor pro tem, City Manager and CFO	AC	External Auditor presents the findings/comments regarding the CAFR. Management is present for comments. AC reviews, approves and submits the CAFR to the City Council.	Copy to each member of council and city manager. City Council approves the CAFR.
Fresno	City Council Financial Audit Committee - 3 Council Members	AC	Reviews CAFR and submits to City Council for acceptance and approval	City Council
Indianapolis	City-County Internal Audit Committee - 7 members (council members)	AC	Reviews CAFR and submits to City Council for acceptance and approval	City Council
Jacksonville	Audit Committee on Finance - 6 council members	AC	Reviews CAFR and submits to City Council for acceptance and approval	Copy to Mayor, Management of areas audited, permanent record of Council Auditor's Office
Orange County	Advisory Committee to the Board of Supervisors - Chair Bd of Suprs, V-Ch Bd of Suprs, Auditor-Controller, County Executive Officer, Public Member and Treasurer Tax-Collector (Grand Jury recommending 2 more o/s people w/vested interest)	Audit Oversight Comm	AOC reviews CAFR and receives the External Auditor's Management Recommendations. Elected Auditor-Controller releases the CAFR.	Elected Auditor-Controller

Phoenix	Audit Committee - 9 Members: 3 Council Members appoint by the Mayor, 3 public members engaged in field of public or private finances/audits appointed by Mayor, the City Manager (chair), the Finance Director, and the Budget/Research Director	AC oversees the CAFR	AC and External Auditor has 3 sessions - Beginning, Status, and Final. Auditor conducts a formal communication with the Audit Committee presentation	Sent to City Council for final approval and filing
San Antonio	Audit Committee - 2 Members - Both Council Members	AC	Finance Department to AC for review and approval. Then forwarded to City Council.	Accepted by Council and published immediately
St. Louis County	Metro Pension, Finance & Audit Committee - 10 Members - all Metro Commissioners - 5 MO and 5 IL	AC	AC reviews and approves CAFR after presentation from external auditor. Forwards to the Board of Commissioners.	Board of Commissioners
Stockton	Audit Committee - 4 Council Members	AC	AC reviews and approves CAFR after presentation from external auditor	Council receives and approves

# Outside Auditor – Best Practices for Selection, Communication and Evaluation

## Selection of an outside auditor

It is a best practice for Audit Committees to select, or reappoint, the outside auditors, and their charters usually specify their responsibilities in this area.

Some factors in selecting or reappointing an outside auditor are:

- The outside audit firm's reputation for reliability and knowledge. References should be checked with other clients of the firm.
- The outside audit firm's knowledge and experience in governmental auditing.
- The engagement team's education, training, and experience.
- The engagement team's overall knowledge in governmental accounting and auditing.
- The availability of sufficient resources to perform the work in the time frame as specified by the audit committee.
- The lead partner's overall knowledge and experience in governmental accounting and auditing.
- The auditor's ability to clearly, candidly, and effectively communicate issues and concerns to the committee – both in private and public meetings.
- The auditors' ability to work cooperatively with management and non-financial management while maintaining objectivity.
- The auditors' ability to meet deadlines in providing service and respond to issues in a timely way.
- The outside audit firm's quality control procedures.
- Significant findings from recent firm inspections, peer reviews, or other governmental oversight reviews, if available.
- The auditors' independence, and the systems employed to ensure independence.
- The audit firm's proposed fee structure.

## Communication with the outside auditor

### **Pre-Audit Meeting**

Many governmental entities do not have formal pre-audit meetings with the Audit Committee whereby they indicate their independent relationship and discuss audit topics such as scope and materiality. However, effective December, 2006, SAS No. 114 – *The Auditor's Communication with Those Charged with Governance* became effective. One of the criteria of that standard is that the outside auditor is now required to hold a pre-audit meeting. See below for more details regarding the new standard.

### **SAS No. 114 – The Auditor's Communication with Those Charged with Governance**

In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed by the auditor for matters under GAAS. It is also important for the audit committee to understand that an audit conducted in accordance with GAAS is designed to obtain *reasonable*, rather than absolute, assurance about the fair presentation of the financial statements.

Under the new Statement on Auditing Standards No. 114 – *The Auditor's Communication with Those Charged with Governance*, the auditor's responsibility under GAAS includes:

- The auditor’s responsibility for forming and expressing an opinion on whether the financial statements that have been prepared by management with the oversight of those charged with governance are presented fairly, in all material respects, in conformity with Generally Accepted Accounting Principles (GAAP).
- The audit does not relieve management or those charged with governance of their responsibilities.

Note: “*Those charged with governance*” refers to the person or persons responsible for the strategic direction of the entity and the obligations relative to the accountability of such entity, including oversight of the financial reporting process. For entities with Audit Committees, “those charged with governance” encompasses the audit committee.

Note: The SAS defines “*management*” as the person or person(s) responsible for achieving the objectives of the entity, with the authority to establish policies and make decisions by which those objectives are to be pursued, and who are responsible for the financial statements, including designing, implementing, and maintaining effective internal control over financial reporting.

- **Planned scope and timing of the audit**  
The auditor should communicate an overview of the planned scope and timing of the audit, without compromising the effectiveness of the audit by, for example, communicating the nature and timing of detailed audit procedures.  
  
This communication may, but is not required to, include how the auditor proposed to address significant risks of material misstatement, approach to internal controls relevant to the audit, the concept of materiality and the extent to which the auditor will use the work of the entity’s internal audit department, if any.
- **Significant findings from the audit (must be communicated in writing).** See the first section of this report – Financial Statement Review – Best Governmental Practices for a listing of the subject areas the auditor should convey during, as applicable, status update meetings, and the post-audit presentation/meetings.

As SAS No. 114 indicates, it primarily focuses on communications from the auditor to those charged with governance. However, it recognizes the importance of effective *two-way* communication between those charged with governance and the auditor. Those charged with governance can assist the auditor in understanding the entity and its environment, etc.

### **Status Update Meetings**

Some audit committees have a monthly update from their outside auditor. Some committees meet with the auditor once or twice for a status update. The update should, preferably, be in writing and formally presented.

### **Post-Audit Meeting**

See the first section of this report – Financial Statement Review – Best Governmental Practices for best practices post-audit meeting criteria.

### **Evaluation of the outside auditor**

Most municipalities currently evaluate their outside auditor informally with discussions amongst themselves. However, municipalities that do formally evaluate their outside auditor find it much easier to justify reappointing them and/or releasing them. If a municipality finds the need to release and/or not rehire its current auditor, the formal evaluation provides the audit committee with a listing of grievances.

If a formal evaluation is done, the chair of the Audit Committee should meet in person with the outside auditors to discuss the results. This will give an opportunity for the committee to provide constructive feedback and openly express concerns or opportunities for further improvement. However, it is also an opportunity for the outside auditor to respond to such items and share any concerns they may have. Open and candid discussion is key to strengthening this relationship and improving the audit process.

*The AICPA Audit Committee Toolkit: Government Organizations* lists the following questions during the evaluation of the outside auditor:

- Did the auditor meet with the audit committee when requested?
- Did the auditor address issues of “tone at the top,” and antifraud programs and controls in place in the government organization?
- Did the auditor inform the audit committee of any risks of which the committee was not previously aware?
- Did the auditor adequately discuss issues of the quality of financial reporting, including the applicability of new and significant accounting principles? Did the auditor adequately discuss issues relating to the government’s conformance with local laws, regulations, and oversight requirements?
- Did the auditor communicate issues freely with the audit committee, or did they seem protective of management?
- Does it appear that management exercises undue influence on the independent auditors?
- Does it appear that the outside auditors are reluctant or hesitant to raise issues that would reflect negatively on management?
- Is the audit committee satisfied with the planning and conduct of the audit, including the financial statements and internal control over financial reporting (as applicable)?
- Review all audit-related and nonaudit services conducted by the independent auditor in the prior year. Are you satisfied that the independent auditor remains independent and objective both in fact and appearance?
- Is the audit committee satisfied with its relationship with the auditor? In making this determination, the audit committee should consider a) whether the partner-in-charge of the audit participated in audit committee meetings, b) whether the auditor was frank and complete in the required discussions with the audit committee, c) whether the auditor was frank and complete during executive sessions with the audit committee, d) whether the auditor was on time in delivery of services to the government.
- Was the audit fee fair and reasonable in relation to what the audit committee knows about fees charged to other government organizations, and in line with fee benchmarking data the audit committee might have available?
- Did the independent auditor provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization’s internal control system over financial reporting? How constructive are the key issues communicated in the management letter and other disclosures on audit findings and recommendations?

The AICPA additionally recommends that the audit committee also talk with the City’s Internal Auditor, the CFO and Controller to gather their assessments of the outside auditor’s work.

It is noted that the City of San Diego does not conduct a formal evaluation for their outside auditor.

**Recommendation 3 - Communications with the outside auditor should be increased to become compliant with the new auditor communication's standard (SAS No. 114 – The Auditor's Communication with Those Charged with Governance, superseding SAS No. 61 – Communication with Audit Committee).**

**Recommendation 4 - The City of San Diego's Audit Committee should conduct an annual formal evaluation of its outside auditor.**

## Outside Auditor – Comparable Municipalities’ Selection, Communication and Evaluation Practices

Below are the results of the outside auditor survey for various municipalities. The majority of the municipalities did not conduct any pre-audit scoping meetings. Only one municipality conducted a formal evaluation of the outside auditor. However, effective with this year, auditors will be required to conduct a formal pre-audit engagement scoping meeting under SAS No. 114 – *The Auditor’s Communication with Those Charged with Governance* and all municipalities should be participating in pre-audit meetings going forward.

<b>Outside Auditor Retention, Communication &amp; Evaluation</b>				
<b>City</b>	<b>Selects/ Approves</b>	<b>Reports to</b>	<b>Pre-Audit</b>	<b>Evaluation</b>
Austin	CFO recommends to Audit & Finance Comm (A&FC). A&FC recommends to full council. Council approves.	To the A&FC - a sub-committee of City Council	Has been done privately between CFO/External. Will be done publicly starting in 2008 due to new SAS 114 Standard	Informal – Staff relays concerns to CFO & Controller. Not forwarded to A&FC unless severe.
Dallas	City Council selects	City Council thru AC	Started with this year	Yes - If overruns
Denver	AC using RFP or request for qualifications procedures) (simple majority vote)	Thru AC (to the City Council)	No	Yes - Auditor is engaged on an annual basis.
Fort Worth	Selected by Council	Responsible to Council	No	Informally
Fresno	City Council selects	AC and City Council	No	Informally
Indianapolis	City Council selects	AC and City Council	No	Informally
Jacksonville	Appointed by council (Council Auditor does contract negotiations & mgmt of auditor)	Committee on Finance on behalf of City Council	No	Informally
Orange County	AOC (Sub-Comm selects & brings recommendation to Bd of Suprs. Bd of Suprs approves the contract.)	Elected Auditor-Controller	No	No
Phoenix	City Auditor does initial selection & recommends to AC (AC advises Council regarding status of contract.)	AC	Will start next year due to new SAS 114 Standard	Formally evaluated in 1st 2 years of a 5 year contract
Stockton	City Council	City Council	No	Informally