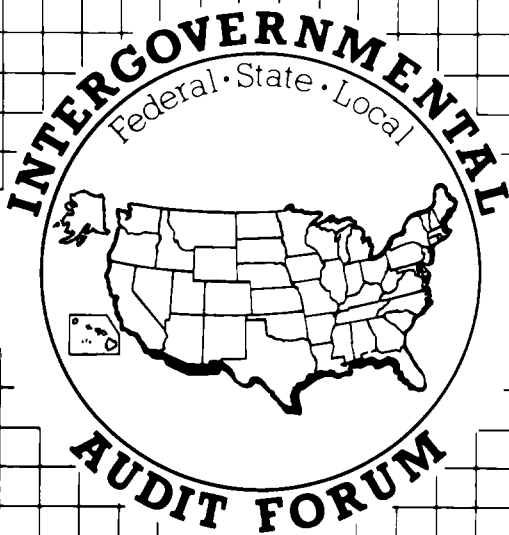


**How to Avoid
a Substandard Audit:
Suggestions for
Procuring an Audit**



National Intergovernmental Audit Forum

Executive Committee

Charles A. Bowsher	Chairman, Comptroller General of the United States
Frederick D. Wolf	GAO Representative, Director, Accounting and Financial Management Division, U.S. General Accounting Office
Anthony Piccirilli	Vice-Chairman and State Representative, Auditor General, Rhode Island
Gerald R. Riso	OMB Representative, Associate Director for Management, Office of Management and Budget
Richard P. Kusserow	Federal Representative, Inspector General, U.S. Department of Health and Human Services
Daniel Paul	Local Representative, City Auditor, Dallas, Texas
Edward Renfrow	Chairperson Representative for Regional Forums, State Auditor, North Carolina

NIAF Executive Director

Joseph D. Comtois	U.S. General Accounting Office
-------------------	--------------------------------

Procurement Handbook Task Force

John J. Cronin, Jr.	Task Force Director, U.S. General Accounting Office
Sefton Boyars	Regional Inspector General, U.S. Department of Education
John Crossley	Legislative Auditor, State of Nevada
Harvey Eckert	Deputy Secretary for Comptroller Operations, Commonwealth of Pennsylvania
Alan Erickson	Finance Director, City of Brooklyn Park, Minnesota
Ken Foster	Audit Manager, U.S. General Accounting Office
Roland Malan	Assistant Deputy Comptroller, State of New York
Dick Mangione	Office of Inspector General, U.S. Department of Health and Human Services
Terry Milrany	Audit Supervisor, Office of the City Auditor, Dallas, Texas
Hal Steinberg	Peat Marwick Main & Company
Nancy Crothers, Editor	Manager, Writing Resources Branch, U.S. General Accounting Office

Foreword

In recent years, much attention has been focused on the quality of audits of entities that receive federal assistance. This has been particularly true since the passage of the Single Audit Act of 1984, which requires a single, comprehensive financial and compliance audit of many entities receiving federal funds. The Congress, the General Accounting Office, federal inspectors general, state and local governments, and the accounting profession itself have all expressed concern about the quality of these audits. These groups have undertaken a number of significant actions during the past year to address these concerns.

This handbook was prepared by the National Intergovernmental Audit Forum to help public entities that are planning an external audit ensure that they engage a qualified auditor and receive a quality audit. Because we believe that approaching procurement systematically is the best way to ensure a quality audit, regardless of the size or complexity of the entity, this handbook suggests such an approach. While the guidance this

Foreword

handbook presents is in no way mandatory, we hope that using it will enable you to receive the best audit possible.

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Contents

Foreword	
Introduction	1
Planning: An Essential First Step	4
Competition and Solicitation: Communicating Audit Requirements	8
Technical Evaluation: Selecting a Qualified Auditor	14
The Written Agreement: Documenting Expectations	19
Audit Monitoring: Ensuring a Quality Audit	22
Bibliography	24

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
CPA	certified public accountant
GAAS	generally accepted auditing standards
GAGAS	generally accepted government auditing standards
GAO	General Accounting Office
NIAF	National Intergovernmental Audit Forum
OMB	Office of Management and Budget
RFP	request for proposal

Introduction

Regardless of the type or size of public entity you are affiliated with—from the smallest town or local entity to the largest state or federal agency, from a neighborhood health clinic to a major hospital, from a grade school to a university—an effective audit can improve management operations and yield significant dollar savings. It can also help you avoid wasting your entity's resources on a substandard audit. If your responsibilities include hiring a certified public accountant (CPA) or any other independent auditor, this handbook can help you get the most for your money.

Taking steps to ensure a quality audit is especially important in light of a General Accounting Office (GAO) report¹ that identified 34 percent of CPA audits it reviewed as substandard. Another GAO report² disclosed that entities with ineffective procurement systems stood a 46-percent chance of receiving a substandard audit; that figure dropped dramatically to 17 percent for entities that followed systematic audit procurement practices.

Public entities should never select auditors without considering five

¹CPA Audit Quality: Many Governmental Audits Do Not Comply With Professional Standards (GAO/AFMD-86-33, Mar. 19, 1986).

²CPA Audit Quality: A Framework for Procuring Audit Services (GAO/AFMD-86-34, Aug. 18, 1987).

basic elements of an effective audit procurement process:

- planning (determining what needs to be done and when),
- fostering competition by soliciting proposals (writing a clear and direct solicitation document and disseminating it widely),
- technically evaluating proposals and qualifications (authorizing a committee of knowledgeable persons to evaluate the ability of prospective auditors to effectively carry out the audit),
- preparing a written agreement (documenting the expectations of both the entity and the auditor), and
- monitoring the auditor's performance (periodically reviewing the progress of that performance).

This handbook discusses these five elements of audit procurement. It also addresses the use of audit committees—independent committees composed of persons with knowledge of accounting, auditing, finance, or management—which, among other things, can assist entities in procuring audit services and overseeing the audit process. In addition, because many small entities—in this context, those that contract for audits costing less than \$10,000—do not have procurement systems that are as formal as those of large states or local governments, we present information at the end of each section on how the critical elements of a procurement system can be applied to the special needs of small entities.

Finally, we have included a short bibliography of procurement guidelines. Keep in mind, however, that if the guidance that this handbook provides conflicts with applicable laws or regulations or relevant grant conditions, the laws, regulations, or conditions are controlling.

Planning: An Essential First Step

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

Matters to Consider

- Defining the entity to be audited. Governments and other public organizations are often composed of numerous smaller, sometimes legally separate entities. You should decide which of these units to include in the scope of your audit, taking into account any legal requirements and generally accepted accounting principles.
- Delineating the scope of the financial audit. For audits of financial statements, you need to determine whether you want the auditor to limit the examination to the general-purpose financial statements, the minimum allowable audit scope, or to extend the examination to cover additional statements, such as the combined, individual fund, and account-group financial statements.
- Determining the specific audit requirements. To determine your audit requirements—a sometimes difficult task—you may want to seek the assistance of knowledgeable persons. This assistance is ideally provided by an audit committee composed of people with backgrounds in accounting, auditing, finance, or management. Entities without audit committees may want to seek the assistance of other

- government personnel with specialized knowledge of accounting and auditing.
- Deciding on the appropriate auditing standards. While generally accepted auditing standards (GAAS) are typically used for both private and public sector audits, your organization may be subject to grant terms, state statutes, federal regulations, or the Single Audit Act and thus may be required to use generally accepted government auditing standards (GAGAS), which are issued by the Comptroller General of the United States. GAGAS incorporate GAAS but involve additional auditor responsibilities, including special reporting on internal controls and on compliance with applicable laws and regulations. You will need to determine and specify the appropriate standards for your auditor to follow.
 - Determining whether the Single Audit Act applies to your organization. The Single Audit Act of 1984 established supplemental audit requirements in the areas of internal control and compliance reviews. You should find out if your organization is affected by this legislation. A good reference document is the American Institute of Certified Public Accountants' (AICPA) guide for audits of state and local governmental units.³
 - Identifying the attributes necessary in an auditor. We suggest that the personnel performing the audit have

³ Audit and Accounting Guide: Audits of State and Local Governmental Units, revised edition (AICPA, Jan. 1986).

experience with audits of similar entities as well as continuing professional education in governmental accounting and auditing. Moreover, they should comply with applicable requirements for peer review and continuing professional education.

- Deciding how to evaluate prospective audit firms. Developing a systematic procedure for evaluating firms' qualifications is essential. Although price is important, technical qualifications should be a critical criterion in selecting an auditor.
- Reviewing legal requirements. You should review applicable laws, regulations, and grant conditions to ensure that both the procurement process and the audit itself will meet legal requirements.
- Considering a multiyear agreement. The first year of an audit engagement usually involves significant start-up costs as auditors devote considerable time to learning about the entity and its internal control systems. Having completed this groundwork, the auditor usually is able to work at less cost in the succeeding years. If authorized by law, a multiyear agreement—perhaps a 1-year agreement with the option to extend the agreement for up to 5 years—has a dual advantage: It enables an auditor to propose a price that takes into account the savings to be realized in subsequent years and saves the entity the costs associated with repeating the selection process.

- Evaluating the auditor rotation option. Some people argue that changing auditors at the end of a multiyear contract infuses the audit process with fresh views and new perspectives. Others contend that these benefits can be achieved through internal rotation of audit staff and that maintaining a long-term, ongoing relationship with a particular auditor is more advantageous. A long-term relationship with a firm, however, will not necessarily enable the entity to seek out and take advantage of lower priced audits. It makes sense to carefully consider the advantages and disadvantages of auditor rotation as well as applicable legal requirements before setting a policy.
- Establishing a work schedule. You should develop a schedule both for yourself and for the auditor you eventually select that sets forth dates by which certain milestones in the audit process must be reached. The only way to ensure the timely preparation and issuance of financial statements and related reports is to develop and adhere to such a schedule.

Small Entities

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

Competition and Solicitation: Communicating Audit Requirements

Full and open competition is basic to government procurement. Encouraging as many qualified audit firms as possible to submit their proposals for auditing your organization increases the likelihood that you will receive a quality audit at a fair price. The next step, then, is to communicate your audit needs to potential bidders.⁴ This step is critical, because bidders who do not clearly understand exactly what services you want might not respond.

How to Solicit an Audit

There are many ways to solicit bids for your audit, but the most reliable method—and the one we suggest—is a written request for proposal, or RFP. RFPs should be clearly written; set forth all terms, conditions, and evaluation criteria as well as the scope of the work required; and be sufficiently well distributed and publicized to ensure full and open competition.

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

You may want to consider compiling a list of potential auditors from general and professional directories and from your past experiences with audit firms. Maintaining an updated list

⁴This handbook uses the term “bidder” to mean “proposer” or “offeror.”

makes it easy to distribute your RFP to the firms that are most likely to be interested in bidding on your audit.

What to Include in Your RFP

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

- the name and address of your organization;
- the entity to be audited, scope of services to be provided, and specific reports, etc., to be delivered;
- the period to be audited (with an explanation if the RFP calls for a multi-year procurement);
- the name and telephone number of a contact person at your organization;
- the format in which you want proposals to be prepared;
- the address to which proposals should be delivered or sent;
- the date and time proposals are due;
- the number of proposal copies to be submitted;
- the criteria to be used in evaluating the bid and their relative importance to each other;

**Competition and
Solicitation:
Communicating
Audit Requirements**

- the method and timing of payment; and
- any other important points, including the consequences if due dates are missed or work does not meet audit standards.

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

- explain the work that your organization does;
- explain what is to be audited, e.g., general-purpose financial statements, specific funds, or both;
- describe in some detail your organization's accounting system, administrative controls, records, and procedures;
- inform prospective bidders whether the Single Audit Act applies to this audit;
- identify the appropriate auditing standards;
- inform prospective bidders if data from prior years (audit reports, management letters, etc.) will be available, whether major audit findings remain open from prior years, and whether any audits of subrecipients are required;
- notify prospective bidders of requirements for workpaper retention and for making the workpapers available to the entity as well as governmental auditors if they request them;
- describe expected audit products, the required format of the audit report, and the format of any required progress reports;

**Competition and
Solicitation:
Communicating
Audit Requirements**

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

Finally, a well-prepared RFP will elicit certain information from prospective bidders. For example, it will ask bidding firms to state

- how they would conduct the audit and, if it were a multiyear contract, how they would approach the work efforts of the subsequent year(s);
- their qualifications, those of their local office, if applicable, and those of the proposed audit staff, including their prior government auditing experience;
- their policies on notification of changes in key personnel;
- whether the proposed staff have received continuing professional education in governmental accounting and auditing during the last 2 years;
- whether they are independent, as defined by applicable auditing standards;
- whether they have received a positive peer review within the last 3 years;
- whether they have been the object of any disciplinary action during the past 3 years; and
- their fee.

**Bidders'
Conference**

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

Small Entities

Obtaining an extensive list of potential bidders may be difficult for small entities in rural areas. Soliciting lists from nearby, larger entities and from CPAS in your region that have experience with governmental audits often is helpful.

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

**Competition and
Solicitation:
Communicating
Audit Requirements**

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

Technical Evaluation: Selecting a Qualified Auditor

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

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

By comparing your entity's requirements with the auditors' plans, skills, experience, commitment, and understanding of the audit requirements and then reviewing bidders' price proposals, you will be able to select the firm that can provide the best audit at the fairest price.

The Role of Committees

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

The Evaluation Process

We suggest separate evaluations of technical ability and price. The technical evaluation addresses the firms' technical qualifications and ability to

**Technical Evaluation:
Selecting a
Qualified Auditor**

perform the audit. Although the price for the work to be performed is a significant factor in the selection of a qualified audit firm, you will be more likely to get a high quality audit at a fair price if both price and technical ability are taken into account in selecting the successful bidder.

**Requiring
Minimum
Standards**

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

- meet the appropriate state licensing requirements,
- meet the applicable independence standard,
- have a record of responsible work, and
- comply with applicable requirements for peer review and continuing professional education.

Technical Criteria

The technical criteria set out in the RFP and used in the evaluation process can vary. At a minimum, however, the evaluation committee should be able to

**Technical Evaluation:
Selecting a
Qualified Auditor**

answer “yes” to the following questions.

**Understanding
the Audit
Requirements**

- Does the proposal, both in the statement of the audit requirements and elsewhere, demonstrate that the firm has an understanding of the audit’s objective(s), your organization’s needs, and the final products to be delivered?

**Soundness of
Technical Approach**

- Does the proposal contain a sound technical plan and a realistic estimate of time required to complete the audit?
- Does the proposal show the bidder’s intention to start the audit when required and complete the audit in a timely fashion?
- Does the technical plan show a practical approach to meeting benchmarks and specific deadlines?
- Does the proposal indicate that the firm will use (1) a systematic approach to examining systems and internal controls and (2) effective procedures, including consideration of risk and materiality, to determine the extent of audit testing and review necessary?
- Does the proposal indicate the bidder’s willingness to use other auditors’ work, to the extent possible, to avoid duplication of effort?

**Qualifications of the
Audit Firm**

- Does the firm have experience in performing the required work for entities of your type and size?

**Technical Evaluation:
Selecting a
Qualified Auditor**

**Qualifications of the
Audit Team**

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

**Rating the
Proposals**

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

**Technical Evaluation:
Selecting a
Qualified Auditor**

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

Small Entities

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

The Written Agreement: Documenting Expectations

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

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

What to Include in a Written Agreement

When an RFP has been used, the written agreement should incorporate by reference the terms of the RFP and those of the successful bidder's last proposal. The letter should be signed by the entity and the audit firm. The written agreement will then clearly specify the

- audit scope, objective, and purpose;
- deadlines for work to be performed;
- audit cost;
- report format;

**The Written Agreement:
Documenting Expectations**

- type and timing of support to be provided to the auditor by the entity; and
- professional auditing standards to be followed in performing the audit.

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

- The relationship of the auditing firm to the entity is that of an independent contractor.
- At any time, the entity may, by written notice, make changes in or additions to work or services within the general scope of the agreement. If such changes are made, an equitable adjustment will be made in the cost of the audit using the rates specified in the agreement.
- If the contractor believes that a change in or addition to work is beyond the general scope of the agreement, it must notify the entity in writing within a specified time and before beginning that work. The agreement should indicate where the final administrative authority rests in deciding disputes.
- The workpapers prepared by the contracting auditor during the audit are its own property. These documents should be retained for a period to be designated in this agreement and made available to the entity and governmental auditors upon request.

**The Written Agreement:
Documenting Expectations**

-
- All reports rendered to the entity by the contracting auditor are the exclusive property of the entity and subject to its use and control, according to applicable laws and regulations.

Small Entities

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

Audit Monitoring: Ensuring a Quality Audit

Monitoring the progress of the audit is the most effective way to ensure that your organization receives both the type and quality of audit services specified in the written agreement. This is a role that your audit committee can carry out most effectively. This group of experts can evaluate the audit while it is taking place, thereby addressing and resolving problems before the audit is completed. It can also review audit results and assist in post-audit quality evaluation. Thus, not only does the audit product improve but working relationships between the audited entity and auditor are enhanced.

Monitoring is especially beneficial during the first year of a new auditor's contract and during the audit of a particular unit or segment(s) of an organization that is unique or complex. Furthermore, monitoring is beneficial throughout the term of a multiyear contract: It provides status reports and helps coordinate the auditing firm's activities with the audit's requirements. While the responsibility for a quality audit rests ultimately with the auditor, monitoring the work being performed as a quality assurance measure is a good idea.

Monitoring can be accomplished by requiring periodic progress reports as well as by holding regular meetings to discuss issues that need to be resolved. Furthermore, meeting after the completion of the audit to discuss the

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

Small Entities

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

Bibliography

Audit and Accounting Guide: Audits of State and Local Governmental Units, revised edition. AICPA. January 1986.

A Finance Officers' Guide to the Audit Selection Process. Government Finance Officers Association. Special Bulletin 1982b. November 1982.

Buying Professional and General Services—A Guide. The Council of State Governments. 1986.

CPA Audit Quality—A Framework for Procuring Audit Services. GAO/AFMD-87-34. August 1987.

Guidelines for Preparation of Requests for Audit Proposals. Western Intergovernmental Audit Forum. April 1988.

Study of Professional Services Contracting. Office of Federal Procurement Policy. January 1985.

Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments. (24 Federal Agency Common Rule). March 11, 1988.

For further information, write the National Intergovernmental Audit Forum, 441 G Street, N.W., Washington, D.C. 20548.

Requests for copies of this pamphlet
should be sent to:

U.S. General Accounting Office
Post Office Box 6015
Gaithersburg, Maryland 20877

Telephone 202-275-6241

The first copy of each pamphlet
is free. Additional copies are \$2.00
each.

There is a 25% discount on orders for
100 or more copies mailed to the same
address.

Orders must be prepaid by cash or by
check or money order made out to the
Superintendent of Documents.
