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## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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**Date Issued:** September 5, 2008

**IBA Report Number:** 08-96

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# Compensation for Outside Auditors

## OVERVIEW

On July 7, 2008, the IBA provided the Audit Committee with key component parts of a contemplated sole source agreement with Macias Gini & O'Connell LLP (MGO) for the FY 08 financial statement audit. The proposed Schedule of Fees for multi-faceted audit work was \$1,260,505, of which approximately \$812,000 was for the FY 08 financial statement audit. In directing the IBA to work with the Purchasing Department to finalize the draft sole source agreement for City Council consideration, the Audit Committee requested that the IBA research and report back on outside audit costs that other comparable public agencies incur for their financial statement audits. This report provides information on financial statement audits costs at other agencies and feedback from MGO related to their fee proposal.

## FISCAL/POLICY DISCUSSION

### Financial Statement Audit Costs at Comparable Public Agencies

The IBA reviewed the cost of financial statement audits at comparable California public agencies for FY 08. In order to compare similar audit costs, we have extracted financial statement audit costs (shown in the third column below entitled CAFR Audit Cost) from the total contract amount (thereby excluding costs for single audits and other miscellaneous audit work). It should be noted that MGO has been contracted to perform the audit work for all but one of the public agencies cited below:

Public Agency	Firm	FY 07/08 CAFR Audit Cost	FY 07/08 Single Audit Cost	Other costs (e.g. other agencies, etc)	FY 07/08 Total Contract
City of Oakland	MGO	\$424,600	\$89,590	\$180,085	\$694,275
City of San Jose	MGO	\$246,136	\$97,063	\$519,871	\$863,070
City/County of San Francisco	MGO	\$361,400	\$284,800	\$263,980	\$910,180
City of Los Angeles	Simpson & Simpson	\$338,030	\$84,150	\$247,820- \$357,820-	\$670,000- \$780,000
County of Los Angeles	MGO	\$439,480	\$243,430	\$352,294	\$1,121,688
County of San Diego	MGO	\$145,110	\$73,898	\$78186	\$297,194
<b>City of San Diego</b>	<b>MGO</b>	<b>\$811,790</b>	<b>\$183,165</b>	<b>\$265,550</b>	<b>\$1,260,505</b>

Additionally, we have provided information on the annual percentage change in total audit costs for other major cities between FY 07 and FY 08. This information is presented in the table below:

City	FY 06/07 Audit Fee	FY 07/08 Audit Fee	% Increase
Phoenix, AZ	\$393,738	\$460,000	16.8%
Portland, OR	\$485,865	\$517,400	6.5%
Oklahoma City, OK	\$548,148	\$592,000	8.0%
Austin, TX	\$516,556	\$600,891	16.3%
Kansas City, MO	\$585,000	\$602,550	3.0%
Oakland, CA	\$659,161	\$694,275	5.3%
San Antonio, TX	\$800,000	\$750,000	-6.3%
Atlanta, GA	\$855,000	\$900,000	5.3%
Long Beach, CA	\$1,105,000	\$1,149,000	4.0%
City/County Denver, CO	\$1,000,275	\$1,196,000	19.6%
<b>San Diego</b>	<b>\$1,159,710*</b>	<b>\$1,260,505</b>	<b>8.7%</b>

(\*) – Initial Contract Amount

Source: City of Phoenix - Office of the City Auditor

### Considerations Related to the Cost of Outside Audits for Public Agencies

The IBA discussed the development of audit fee proposals with Jim Godsey and Anthony Neequaye of MGO to better understand significant differences in outside audit costs between comparable public agencies. Auditing standards require auditors to perform an assessment of the risk that material misstatement (caused by fraud or error) may occur in the financial statements and not be detected by the entity's system of internal controls. Based on this assessment, the outside auditor designs appropriate audit procedures to

reduce that risk to a low level. That assessment and the resulting procedures determine the level of effort required to perform the audit and serve as the basis for preparing an estimate of cost. Some of the key factors considered by MGO in bidding their public audit work include:

- A local government's control environment including:
  - Integrity and ethical values
  - Governance
  - Management philosophies and operating style
  - Financial reporting competencies
  - Authority and responsibility
  - Human resources
- The effectiveness of a local government's system of internal controls over financial reporting.
- Expectations and needs of the users of the financial statements including:
  - Investors
  - City Council
  - Management
  - Regulatory agencies and
  - Citizens
- The City's own evaluation and response to its risk
- Non routine transactions and adjustments
- The amount of anticipated testing of financial information that must be performed by the outside auditor to ensure reliability
- Size and complexity of local government (number of funds, stand-alone financial statements to be evaluated, number of audit deliverables required, etc.)
- Anticipated responsiveness of the local government's staff based upon their knowledge and experience
- Sophistication of the automated CAFR preparation process
- IT general and application controls

Other factors (not mentioned by MGO) that may influence the development of a bid for public audit work include: profit margins; a desire to enter a new market niche; targeting a new client; location of needed staff; or other considerations that may not directly relate to the anticipated workload for a particular engagement.

In discussing the relatively higher fee proposal for the City of San Diego's financial statement audit, MGO cited the following City circumstances that factored into their fee proposal:

- **Lack of internal controls requiring that an inefficient substantive audit approach be taken.**
- Anticipated testing sample sizes that are significantly larger than comparable local governments.

- Potential legal challenges that have been raised that will require investigation.
- Numerous “manual” post-close entries that needed to be reviewed.
- Complexity of capital asset accounting function making it more time consuming to audit.
- Substantive testwork to be performed on City’s payroll and City’s vendor procurement process. (Detailed review of payroll to employees and review of procurement process for majority of city vendors).
- Additional audit considerations as a result of implementing the suite of new risk-based audit standards (SAS #104-111, 114)
- Additional audit testwork as a result of implementing new accounting pronouncements; such as GASB 45, GASB 48.
- Expectation that the financial statements will be used as part of official statements for financing of debt.
- With respect to the City’s Single Audit, material weaknesses that carry forward require more stringent testing (CDBG, HUD, etc.).

## CONCLUSION

In response to the Audit Committee’s request, the IBA has provided comparative outside audit cost information in this report to be considered in evaluating the proposed Schedule of Fees for the FY 08 audit of the City’s financial statements. We have also listed several factors audit firms consider in developing fee proposals for public audit work. Additionally, we have provided some of the rationale MGO utilized in developing their fee proposal for the City’s FY 08 financial statement audit.

The IBA recommends that the Audit Committee review this information with the MGO audit team who will be present at the meeting and ask any questions they might have related to the fee proposal for FY 08. We will incorporate any additional direction the Audit Committee may have with respect to the proposed sole source agreement with MGO before forwarding it to the City Council for consideration. It is important that the City Council quickly consider the proposed agreement in order for the FY 08 audit work to begin.

**[SIGNED]**

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