



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: September 9, 2011

IBA Report Number: 11-52

Audit Committee Docket Date: September 12, 2011

Item Number: 3

Review of the Outside Auditor's Performance and Agreement

OVERVIEW

On June 2, 2009, the City Council authorized an Agreement with Macias Gini & O'Connell (MGO) to audit the City's financial statements for fiscal years 2009 through 2013. In approving the Agreement, the City Council directed the IBA to review and evaluate MGO's performance after the financial statement audits for fiscal years 2009 and 2010 had been completed. MGO completed the City's financial statement audit for FY 2010 on August 31, 2011.

In response to the City Council's direction, the IBA has evaluated MGO's performance in part by asking questions of different participants with knowledge of the City's financial statement audit process. These participants include management (City Comptroller staff), the Office of the City Auditor (who administers the current Agreement with MGO) and MGO representatives. The IBA has also reviewed and commented on certain criteria developed by audit experts to assist audit committees in evaluating the performance of outside auditors. Additionally, this report reviews commitments made by MGO in their 2009 proposal to the City which have been incorporated into the current Agreement.

FISCAL/POLICY DISCUSSION

Background

MGO performed the City's financial statement audits for fiscal years 2004 through 2008. Early in 2009, the Audit Committee requested the IBA work with the Purchasing and Contracting Department and the Office of the City Auditor to develop/issue a RFP for outside audit services for fiscal years 2009 through 2013. The RFP was issued and notifications were sent to 94 audit firms in February of 2009. Despite direct mailing to 94 audit firms and advertised notification, MGO was the only qualified respondent to the City's RFP.

In evaluating the limited response to the RFP, members of the Technical Evaluation Committee for the RFP (including the City Auditor) informed the IBA that it is not uncommon for large municipalities to receive a very limited number of bids. For example, the County of San Diego only received two qualified proposals to their outside auditor RFP in 2009 and the City of San Jose only received one (both agencies selected MGO). While there was no clear explanation for the limited response, the IBA identified the following factors in presenting the MGO contract for Council consideration in 2009:

- Very few audit firms are capable and willing to audit large public agencies. As noted in IBA Report #08-96 and MGO's proposal, MGO serves as the outside auditor for the cities of San Francisco, Sacramento, Oakland, San Jose, Fresno, and the counties of Los Angeles, San Diego, Alameda, San Mateo and Santa Clara.
- One qualified audit firm that might have submitted a proposal sent the City a letter indicating that due to their other contractual engagements they had insufficient auditor capacity to take on the City's audit.
- City's history of delinquent and challenging audits for fiscal years 2003 through 2008.
- Higher risks associated with the complexity of larger municipalities.
- More lead staff planning time required for the audit of larger municipalities.

The City's Technical Evaluation Committee found the MGO proposal to be responsive to the RFP and recommended them to the City's Audit Committee. In making their recommendation to the Audit Committee, they noted the following representations in MGO's proposal:

- In keeping with best practices, a new lead partner would be assigned for the financial statement audits for fiscal years 2009 through 2013.
- MGO's familiarity with the City's accounts and good sense of the City's internal control environment.
- Proposal to utilize a SAP system implementation specialist skilled at ascertaining where risks associated with new IT systems should be tested.
- MGO's commitment to regularly update the Audit Committee and promptly advise them of any audit related needs/challenges.
- A fee proposal that reduced the total cost of audit services in FY 2009 by 19% from the total cost of their FY 2008 audit work. The fees would then be further reduced by an additional 11% for both the FY 2010 audit and FY 2011 audits. Fees would then be increased by 5% for the FY 2012 and FY 2013 audits.

Based on the recommendation of the Technical Evaluation Committee and the Audit Committee, the City Council approved the MGO Agreement for fiscal years 2009 through 2013. Given the length of the Agreement and expected improvements in the timeliness of the City's financial statement audits, the City Council felt it would be prudent to direct the IBA to review MGO's performance after two years and report back to the Audit Committee.

Feedback from Participants with knowledge of the City's Financial Statement Audit Process

In discussing MGO's work on the financial statement audits for fiscal years 2009 and 2010 with City personnel, staff expressed satisfaction with their performance. City Comptroller staff has regular interaction with MGO during the course of an audit. Comptroller staff informed the IBA that they had a good working relationship with MGO. In particular, they noted good back and forth communication, experienced staff and MGO's ability to meet aggressive audit timelines.

The Office of the City Auditor is responsible for administration of the Agreement with MGO. City Auditor staff indicated MGO had been compliant with the terms of their Agreement to date. It should be noted that in April 2011, MGO requested additional compensation for 1) unanticipated risk assessment and audit testing attributable to the causes and corrections of City payroll expense allocation errors and 2) additional federally required program testing for the City's Single Audit. After reviewing the terms of their Agreement with the Office of the City Auditor and the IBA, MGO agreed to absorb these costs without requesting compensation above that specified in the Agreement.

For an external assessment of MGO's quality control systems for audits, the IBA requested a copy of MGO's most recent Peer Review. Government Auditing Standards require audit organizations to receive an external peer review at least once every three years. The objective of a peer review is to determine whether an audit organization's internal quality control system is in place and operating effectively. A peer review also provides assurance that established policies and procedures and applicable auditing standards are being followed.

MGO's last Peer Review was completed on May 14, 2009. The Peer Review was performed by the CPA firm of Davis, Monk & Company (Review Report is Attachment 1). The IBA was informed that the captain of the review team, Harold Monk, Jr., served as Chairman of the Auditing Standards Board and was a member of the GAO's Advisory Committee on Auditing Standards. Davis, Monk & Company found the system of quality control for the accounting and auditing practice of MGO to be "suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting with applicable professional standards in all material respects." MGO is scheduled to have another Peer Review during calendar year 2012.

Review Criteria developed by audit experts

The IBA evaluated auditor review criteria developed by professional accounting and audit organizations. A few of these criteria are listed below with our comments:

What is the audit firm's reputation? Are there any significant litigation cases of note against the firm? MGO is one of the State's leading local government audit firms and maintains good working relationships with the clients we contacted. The IBA asked if there was any significant recent or current litigation against MGO that they thought we should know of in assessing their audit performance to date. In response, MGO indicated they have never had a judgment against them related to audit services since the inception of the firm over 30 years ago.

Do the individuals assigned to the audit team have the requisite experience, including industry knowledge, to effectively audit the City? Have sufficient staff resources been allocated to the audits? The IBA has been informed that key members of MGO's audit engagement team for the City possess broad public industry sector experience, understand the major issues facing local government units and have experience auditing the City. Additionally, all key members of the City's engagement are reported to either be CPAs or working towards their CPA certification. MGO has been asked to work under aggressive audit timelines and allocated sufficient staff resources to meet those timelines in completing the City's financial statement audits.

Have the engagement partners and other senior personnel been sufficiently involved in the audit process? The IBA understands that the Engagement Partner for Fieldwork and/or Engagement Director (currently Kevin Starkey) works out of their downtown office and an office at the City Administration Building to oversee MGO's on-site audit staff during the audit. Anthony Neequaye, Linda Hurley or Kevin Starkey have been present at almost every Audit Committee meeting to provide audit updates or answer questions related to the audits in progress. Additionally, Concurring Partner Ken Macias has attended meetings of the Audit Committee and City Council for certain issues and/or trainings.

Did the auditor meet with the Audit Committee when requested? As noted above, the IBA has observed Anthony Neequaye, Linda Hurley or Kevin Starkey to be present at almost every Audit Committee meeting to provide updates or answer questions as to the status of the audits. It is our understanding that key MGO staff has otherwise been available to Audit Committee Members when needed.

Did the auditor inform the Audit Committee of any risks of which the Committee was not previously aware? The IBA believes this information is most typically made available to the Audit Committee in either the Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters (Yellow Book Report) or their Management Letter (SAS 114).

Does it appear that the independent auditors are reluctant or hesitant to raise issues that would reflect negatively on management? This is a difficult criterion to assess; however, the IBA did not observe this to be the case in Audit Committee meetings or during our conversations with MGO representatives.

Adherence to Representations in the MGO Agreement

MGO's 2009 proposal to the City was incorporated into the current Agreement. The IBA has reviewed the Agreement for MGO commitments and would note the following as measures of performance:

Communication: The IBA believes MGO has fostered good communication with management and the City's Audit Committee in the course of performing their audit work.

Staffing: As noted above, individuals assigned to the audit team possess the requisite experience, including industry knowledge, to effectively audit the City. MGO has assigned sufficient staff to complete the City's financial statement audits in a timely manner.

Training: MGO committed to provide annual audit training to the City at no cost. They have fulfilled this requirement by providing annual training for Comptroller staff on upcoming issues in auditing, accounting and reporting. Additionally, MGO provided Financial Statement Overview training to the City Council on January 25, 2010.

Cost: MGO has completed the financial statement audits for fiscal years 2009 and 2010 without exceeding the amount set forth in the Agreement.

Questions Related to What a Financial Statement Audit Should Catch

On July 14, 2011, a local news article suggested MGO's audits may have missed two alleged abuses of public funds. The cited abuses of public funds were for SDMSE (a public-private ambulance partnership) and the Southeastern Economic Development Corporation – SEDC (unauthorized bonuses). The article raised the question of what a financial statement audit should reasonably be expected to catch. On July 25, 2011, Audit Committee Members Carl DeMaio and Thomas Hebrank requested Audit Committee Chair Kevin Faulconer to docket an opportunity for the Audit Committee to publicly discuss MGO audit performance.

The question of what a financial statement audit can reasonably be expected to catch is not easily answered. In planning and performing their audit, auditors consider internal controls over financial reporting in order to determine their audit procedures for the purpose of expressing their opinions on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. However, in their limited review and testing of the City's internal control environment to develop the scope of their audit, audits typically do identify control deficiencies. Significant control deficiencies are reported to the City and other deficiencies help the auditor determine where they should perform their audit procedures.

In discussing what a financial statement audit should be expected to catch, MGO indicated that auditing standards do not require or contemplate financial statement audits catching everything as that would not be practical or feasible. MGO cited Statement of Auditing Standard No. 99 with respect to consideration of fraud in a financial statement audit. In keeping with that standard, MGO stated that audits are required to be planned and performed to obtain *reasonable, but not absolute, assurance* about whether the financial statements are free of material misstatements whether from errors, fraud, misappropriation of assets, or violations of law. The IBA understands that MGO partners and key staff plan to attend the September 12th meeting of the Audit Committee to provide additional information and answer questions Committee members may have.

CONCLUSION

In 2009, the City Council authorized an Agreement with Macias Gini & O'Connell (MGO) to audit the City's financial statements for fiscal years 2009 through 2013. In approving the Agreement, the City Council directed the IBA to review and evaluate MGO's performance after the financial statement audits for fiscal years 2009 and 2010 had been completed. This report is provided in response to that direction and to assist the Audit Committee in fulfilling their City Charter responsibility to monitor the engagement of the City's outside auditor.

The IBA evaluated MGO's performance under the current Agreement which covers the City's financial statement audits for fiscal years 2009 and 2010. Our evaluation included the following:

- A review of MGO's performance with staff from the 1) Office of the City Comptroller who produce the annual financial statements and frequently interact with MGO during the course of each audit and 2) Office of the City Auditor who administer the City's Agreement with MGO.

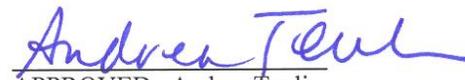
- A discussion with MGO that in part covered certain criteria developed by audit experts to assist audit committees in evaluating the performance of outside auditors.
- A review of commitments made by MGO in their 2009 proposal to the City which have been incorporated into the current Agreement.

Despite unanticipated City delays in the availability of the FY 2010 financial statements, MGO has been responsive and timely in performing audit work for the City. The City staff we interviewed favorably evaluated MGO's performance to date under the current Agreement. MGO passed their 2009 Peer Review which offers a professional external review of their quality control systems for audits. In evaluating MGO against auditor review criteria developed by professional accounting and audit organizations, the IBA did not find anything that would cause us significant concern.

We understand that a recent news story raised questions about what a financial statement audit should reasonably be expected to catch. After discussing this issue with other auditors and MGO, we acknowledge that this can be a difficult question to answer. Public expectations related to audits often exceed professional audit requirements; however, we believe these are reasonable questions to be addressed by the Audit Committee and MGO. Senior representatives of MGO will be present at the September 12th Audit Committee meeting to respond to questions.

In conclusion, the IBA believes MGO has performed well for the City to date. We commend their willingness to adjust to changing audit circumstances, meet aggressive timelines, make themselves available to the Audit Committee and provide training to City staff and City Council.


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Attachments: 1. MGO Peer Review Report 2009