

GAO

Report to the Chairman, Legislation and
National Security Subcommittee, House
Committee on Government Operations,
House of Representatives

August 1987

CPA AUDIT QUALITY

A Framework for Procuring Audit Services



Released

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United States
General Accounting Office
Washington, D.C. 20548

Comptroller General
of the United States

B-219869

August 18, 1987

The Honorable Jack Brooks
Chairman, Legislation and National
Security Subcommittee
Committee on Government Operations
House of Representatives

Dear Mr. Chairman:

In response to your April 21, 1986, letter, this report describes the results of the third phase of our review of the quality of audits performed by certified public accountants (CPAs). In this phase, we determined whether there was a relationship between the procurement process used by state and local entities—defined as governmental units or programs that receive federal funds—to obtain audit services and the quality of the audits that resulted.

Our review showed that entities are almost three times as likely to receive an audit that meets professional standards when they have an effective procurement process compared to when they do not. We also found that entities are much more likely to have an effective procurement process if financial officials—people with specialized knowledge of governmental accounting and auditing techniques—are involved in planning and implementing the procurement process.

This report sets out a framework that entities can use to effectively procure audit services. This framework includes four critical attributes that, to the extent legally possible, should be present in any procurement, regardless of size. These attributes are

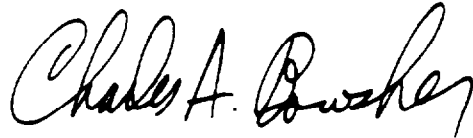
- competition,
- solicitation,
- technical evaluation, and
- written agreement.

This report recommends that entities (1) carefully assess their procurement practices and take actions, consistent with their own state and local laws and regulations, to utilize the procurement framework we outlined, (2) use qualified technical people, specifically those knowledgeable in governmental accounting and auditing, in the procurement process, and (3) use audit committees in the audit process.

B-219869

As agreed with your office, unless you publicly announce the contents of this report earlier we will not distribute it until 30 days from the date of this report. At that time, we will send copies of the report to the Director of the Office of Management and Budget, interested congressional committees, and other interested parties. We will also make copies available to others upon request.

Sincerely yours,

A handwritten signature in cursive script that reads "Charles A. Bowsher". The signature is written in black ink and is positioned above the typed name and title.

Charles A. Bowsher
Comptroller General
of the United States

Executive Summary

Purpose

The federal government administers domestic assistance programs with outlays exceeding \$100 billion per year through state and local governments. The recipients of these funds are required to be audited and often contract directly with nonfederal auditors—mostly certified public accountants (CPAs)—for audits. These audits help ensure that federal funds are used for intended purposes and that recipients administer their programs in compliance with all applicable laws and regulations. Each year, these federal fund recipients pay CPAs between \$100 and \$200 million to perform these audits, and this amount will increase with full implementation of the Single Audit Act of 1984, which will increase the number of entities required to obtain audits of their federal funds.

In April 1986, Representative Jack Brooks, Chairman, Legislation and National Security Subcommittee, House Committee on Government Operations, asked GAO to evaluate the procedures used by state and local officials to obtain the services of public accounting firms. Mr. Brooks' request resulted from earlier hearings on CPA audit quality, which revealed significant problems with such audits. Specifically, Mr. Brooks asked GAO to assess whether a relationship exists between the way these officials procure audit services and the quality of audits that result. He also requested that GAO make recommendations for correcting any weaknesses in current procurement procedures and for ensuring healthy price competition among firms interested in performing governmental audits.

Background

Since 1985, both GAO and the American Institute of Certified Public Accountants (AICPA) have cited concerns about the quality of audits of governmental units and factors that adversely affect audit quality. Over the last 2 years, GAO has issued two reports¹ addressing CPA audit quality, which indicated that CPAs did not satisfactorily comply with professional auditing standards in many cases. A recent AICPA task force report confirmed GAO's concerns with audit quality and concluded that procurement was one of several contributing factors and recommended that a study be undertaken of the procurement of audit services and the way in which that process influences audit quality.

In this review, GAO determined whether an identifiable relationship exists between the process used to procure audit services from CPAs and

¹CPA Audit Quality: Inspectors General Find Significant Problems (GAO AFMD-86-32, December 1985) and CPA Audit Quality: Many Governmental Audits Do Not Comply With Professional Standards (GAO AFMD-86-33, March 19, 1986).

the eventual quality of the audit. Because no criteria existed to evaluate the effectiveness of an audit procurement process, GAO first convened a panel of experts who helped identify four "critical attributes" that should be present when procuring audit services. GAO was able to compare these attributes against previously established criteria for evaluating audit quality developed in its March 1986 report on audit quality and was then able to determine if a relationship existed. This was done by analyzing the responses to a questionnaire GAO sent to a sample of state and local officials asking them to describe the procedures they use for procuring audit services and by reviewing a sample of audits.

Results in Brief

Experts in the fields of accounting, auditing, and contracting helped GAO develop a framework for procuring audit services that, if followed, should substantially improve the quality of audits of state and local governmental units. This framework includes four "critical attributes" for an audit procurement process—competition, solicitation, technical evaluation, and written agreement.

GAO analyzed the responses to its procurement questionnaire and found that state and local governmental units were almost three times as likely to receive an acceptable quality audit when their procurement processes met the criteria for all four attributes than when they did not. These findings are projectable to a universe of an estimated 5,800 audits that were received by seven federal agencies and reviewed for audit quality from October 1, 1984, to April 30, 1986.

Principal Findings

GAO found that 58 percent of the entities in its universe used a procurement process for engaging their auditors that did not meet the criteria for all four attributes. While some entities may have met one or more of the criteria, it was necessary to meet all four of the attributes to be considered to have an effective procurement for purposes of GAO's analyses. GAO defines entity as any governmental unit or program required by law or regulation to obtain an audit of its federal funds. GAO found that these entities received unacceptable quality audits from their CPAS 46 percent of the time. However, the incidence of unacceptable quality audits fell to 17 percent when entities met the criteria for all four attributes. (See chapter 2.)

In addition to determining whether entities met the criteria for all four attributes, GAO analyzed the extent to which entities met the criteria for each attribute. The analyses of the questionnaire responses indicated

that 33 percent of the entities did not have an effective system for obtaining competition, 29 percent did not have an effective solicitation process, 43 percent did not have an effective technical evaluation process, and 46 percent did not prepare an effective written agreement. GAO considered the entity to have an effective process for an attribute if it met the criteria for that attribute. (See chapter 2.)

In addition, GAO found that some entities engaged in multiyear agreements. These agreements normally provided for annual contract renewal at the entity's option—usually contingent upon the audit firm performing acceptable quality work. Although there was some disagreement as to the ideal length of a multiyear agreement, most of the experts GAO spoke with indicated a range of from 3 to 5 years. GAO agrees that entities should consider using multiyear agreements, preferably of a 5-year duration, due to the potential long-term cost savings and benefits. (See chapter 2.)

GAO's analyses also showed that personnel with financial backgrounds—preferably specific knowledge of governmental accounting and auditing—make a major contribution in helping the entity meet the criteria for the four critical attributes. (See chapter 3.)

GAO also found that audit committees, in addition to overseeing entities' financial operations, can play an important role in helping entities plan and implement their procurement processes. (See chapter 3.)

Finally, GAO found that entities currently have very little guidance and employ a wide variety of procurement techniques. As a result, GAO believes that a detailed procurement handbook, incorporating the principles discussed in this report, could provide entities, to the extent allowed by state or local law or regulation, with the means to more effectively procure audits. (See chapter 4.)

Recommendations

GAO recommends, among other things, that entities that procure CPA services carefully assess their procurement practices and incorporate the four critical attributes of an effective procurement process. Specifically, GAO recommends that entities

- obtain competition by ensuring that at least two audit firms are considered when selecting a qualified auditor,
- prepare solicitations that are comprehensive and convey all audit requirements to interested audit firms.

- use specific technical factors in selecting a qualified audit firm.
- prepare written agreements which hold both the entity and the audit firm accountable.
- consider using multiyear agreements, preferably of a 5-year duration.
- obtain financial officials—qualified personnel with specialized knowledge of governmental accounting and auditing—to assist in planning and implementing their procurement processes, and
- consider the benefits of using audit committees both to help plan and to oversee entities' procurement processes. (See chapters 2 and 3.)

In addition, GAO endorses the formulation of detailed procurement guidance as an important vehicle to improving audit quality. The results of GAO's work should be useful in this effort. GAO believes the guidance can be best accomplished by all interested organizations working together under the auspices of an intergovernmental organization facilitating the project or by GAO leading the project with the assistance of an advisory committee. (See chapter 4.)

Agency Comments

During the review, the views of experts in the fields of accounting, auditing, and contracting were sought, and are incorporated in the report where appropriate. However, as agreed with the requester's office, GAO did not obtain formal comments from federal agency inspectors general, contracting entities, or the public accounting profession on this report.

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Abbreviations

AICPA	American Institute of Certified Public Accountants
CPA	certified public accountant
DOL	Department of Labor
DOT	Department of Transportation
EPA	Environmental Protection Agency
GAO	General Accounting Office
HHS	Department of Health and Human Services
HUD	Department of Housing and Urban Development
IFB	invitation for bid
IG	inspector general
OMB	Office of Management and Budget
RFP	request for proposal
RIG	regional inspector general
USDA	U.S. Department of Agriculture

Introduction

The federal government administers domestic assistance programs with outlays exceeding \$100 billion per year through state and local governments. These programs include financial assistance to universities, colleges, and proprietary schools; block grants and housing assistance to cities and counties; and social service and economic assistance to community organizations. The recipients of these funds are required to be audited and often contract directly with nonfederal auditors—mostly certified public accountants (CPAs)—for these audits. The federal government also administers a number of guaranteed and insured loan programs that require program participants to have annual audits by CPAs. These audits help ensure that federal funds are used for intended purposes and that recipients administer their programs in compliance with all applicable laws and regulations. Each year, recipients of federal assistance pay CPAs between \$100 and \$200 million to perform these audits.

In April 1986, Representative Jack Brooks, Chairman, Legislation and National Security Subcommittee, House Committee on Government Operations, asked us to evaluate the procedures state and local officials use to procure the services of public accounting firms. Mr. Brooks' request resulted from earlier hearings on CPA audit quality, which revealed a significant problem with the quality of CPA audits of federal grant funds. Specifically, Mr. Brooks asked us to determine whether an identifiable relationship exists between the procurement process and the quality of audits. He also requested that we make recommendations for correcting any weaknesses in current procurement procedures and for ensuring healthy price competition among firms bidding for audit contracts.

Procurement of CPA Audits Is a Long-Standing Problem

Deficiencies in the way entities procure audit services is not a new concern. For the purposes of our study, we define an "entity" as any governmental unit or program that is required by law or regulation to obtain an audit of its federal funds. In recognition of the fact that many audits did not comply with professional standards, GAO and the American Institute of Certified Public Accountants (AICPA) jointly sponsored a colloquium in Cherry Hill, New Jersey, in 1980, to explore ways to improve audit quality.

One major area of discussion at the colloquium was the problems associated with procurement practices. The colloquium members concluded that there were an adequate number of procurement methods for obtaining CPA services. However, they expressed much concern about

the lack of guidance below the federal level about how to properly apply these procurement methods.

In their report, colloquium members stated that entities' lack of guidance for procuring audit services was further compounded by a misunderstanding of the scope and limitations of services provided by CPAs. As a result, they concluded that on many occasions the quality of an audit decreased because all parties to the contract did not agree in the beginning on the nature of the services that would be provided, the audit period, or all price provisions. This was due, in the members' opinions, to the complexity of the request and proposal process.

Since 1984, GAO and the AICPA have become very concerned about the quality of audits of governmental units. In the last 2 years, we issued two reports addressing CPA audit quality.² In our March 1986 report on audit quality, we stated that CPAs did not satisfactorily comply with professional auditing standards in 34 percent of the governmental audits they performed. During this study, we spoke with many local government officials and program managers who contract for audit services, federal officials who oversee audit quality, and CPAs to find out why many audits did not comply with professional standards. We often heard that where some of these audits were not in compliance with professional standards, the CPA and the entity had not adequately communicated and agreed on the scope and focus of the audit engagement before the work was completed.

Further, in July 1985, the AICPA established a task force with one of its objectives to "determine the factors that adversely affect the quality of nonfederal auditors' financial and compliance audits of governmental units and funds, and recommend ways to correct these conditions." The recently issued "Report of the Task Force on the Quality of Audits of Governmental Units" (dated March 1987) concluded that procurement was a problem and included a recommendation that "a comprehensive study...be undertaken of the procurement of audit services and the way in which that process influences audit quality." The task force report makes reference to our current study, which focuses on the relationship between audit quality and the procurement of audit services, and supports it as being responsive to the recommendation.

²CPA Audit Quality: Inspectors General Find Significant Problems (GAO, AFMD-86-20, December 5, 1985) and CPA Audit Quality: Many Governmental Audits Do Not Comply With Professional Standards (GAO, AFMD-86-33, March 19, 1986).

Last, as we reported in March 1986, it is ultimately the CPA's responsibility to perform a quality audit, regardless of the process used for procuring audit services. Therefore, in cases where the entity's procurement process does not communicate the necessary requirements of the engagement, or this guidance is vague, the CPA must obtain this information by researching the law, consulting with program or technical officials, or contacting the entity, before the final audit report is submitted.

As previously discussed, problems with audit quality and their relation to the procurement process are the focus of this report. The following sections describe these terms in detail, as used in the context of this report.

Defining Audit Quality

In the context of our work, we define "audit quality" as compliance with the professional standards and contractual terms set out for the particular type of audit being conducted. To help ensure consistency in the scope and quality of audit work and in the preparation of professional and meaningful reports, both the AICPA and GAO have issued standards that auditors must follow in performing governmental audits. GAO standards (commonly referred to as "generally accepted government auditing standards") are broader in scope than those established by the AICPA ("generally accepted auditing standards").

Compliance with standards helps assure users of audit reports that the auditor has adequately performed the audit and therefore increases the probability that the audit report can be relied upon. Federal program managers rely on these reports to ensure that the audited entity is managing its programs in compliance with federal laws and regulations and that material instances of noncompliance are identified. When auditors do not comply with professional auditing standards, doubt is cast on the credibility of the audit and, thus, the usefulness of the audit report may be reduced.

Defining the Procurement Process

The process of procuring audit services is an ongoing one. It begins with an entity's recognition that an audit is required, continues with the entity actually procuring the audit, and ends with the final acceptance of the audit report. The responsibility of procuring audit services is usually assigned to the program manager or other program administrator, or to the finance director of a municipality.

In addition to state and local laws and regulations, entities receiving many types of federal assistance should follow attachment O, "Procurement Standards," of either OMB circular A-102,³ or OMB circular A-110,⁴ in procuring audit services. These guidelines discuss basic procurement principles, such as obtaining competition, and the appropriateness of various procurement methods. In applying the standards contained in the circulars, some entities have considerable latitude which allows them to employ a variety of techniques to obtain audit services. These techniques are discussed in chapters 2 and 3 of this report.

Traditionally, entities have procured audit services through formal advertising and competitive negotiation. In formal advertising, the entity issues precise, tailored specifications and awards the contract to the lowest responsive bidder. This method is only viable when the services are so well-defined that selection of an audit firm can appropriately be made on the basis of price alone. The complexity of most audits, however, usually requires that solicitation methods using factors other than cost be considered.

Competitive negotiation has therefore been the preferred method for obtaining audit services because it is flexible enough to take price into account but permits the entity to make informed choices given the marketplace. Competitive negotiation allows an entity to trade off features of experience, quality, qualifications, and value and to take advantage of unique talents and proposals that might be offered and tailored precisely to the entity's needs. The framework for procuring audit services addressed in this report is consistent with this method of procurement.

Objectives, Scope, and Methodology

Our objectives in this review were to (1) determine whether an identifiable relationship exists between the process entities use to procure audit services from CPAS and the resulting quality of the audit, (2) make recommendations to correct any weaknesses in current procurement procedures and to ensure healthy price competition among firms bidding for audit contracts, and (3) develop a framework that specifies criteria for an effective procurement process. This framework is used in this study to make the comparison in the first objective and to identify weaknesses in current procurement procedures, as noted in the second objective.

³"Uniform Requirements for Assistance to State and Local Governments" (January 1, 1981).

⁴"Grants and Agreements With Institutions of Higher Education, Hospitals, and Other Non-profit Organizations" (July 1, 1976).

To accomplish our objectives, we performed work in five areas. First, we defined the scope of our work by identifying the universe of entities that contracted for audits of their federal assistance funds. Next, we applied criteria for evaluating the quality of audits being procured by these entities. Third, we developed criteria to evaluate the effectiveness of these entities' procurement processes. Fourth, we developed a detailed questionnaire to obtain data on the manner in which entities procured their particular audits and sent it to a statistical sample of 210 entities in the universe. Finally, we analyzed the procurement questionnaire by matching the responses with audit quality data that were independently applied to these same audits to determine whether there was a relationship between procurement and audit quality. Entities' responses to the questionnaire, and the corresponding audit quality data, form the basis for all of our analyses and observations presented in chapters 2 and 3 of this report.

Developing Our Universe

The scope of our work covered entities that received federal assistance funds and contracted with CPAS to audit these funds. These entities sent their completed audits to their appropriate regional inspectors general (RIG) where a quality control review was performed. A quality control review includes a review of the auditor's working papers to ensure that the audit conforms with all applicable professional standards. To be included in our universe, the entity's audit had to be quality control reviewed by the RIGs during the period October 1, 1984, through April 30, 1986.

Our findings and observations are based on data provided by a statistically valid sample of 148 of these entities that responded to our questionnaire. This total represents a 70-percent response rate based upon the 210 entities receiving copies of our questionnaire. Although all entities in our sample had their audits quality control reviewed, we performed statistical tests to determine that these audits were representative of all audits sent to the RIGs during our time frame. Therefore, we can project our results to 5,800 entities nationwide. See appendix I for demographic data about the entities in our sample.

Because inspectors general (IGs) decentralize the audit quality review process to their regional offices, we identified the universe of contracting entities at the regional level. However, we did not visit every regional office; instead, we concentrated our work in the locations that coincided with six GAO regional offices. (See appendix I.) We performed our work at the regional offices of the following agency IGs:

-
- the Department of Agriculture (USDA),
 - the Department of Education,
 - the Department of Health and Human Services (HHS),
 - the Department of Housing and Urban Development (HUD),
 - the Department of Labor (DOL),
 - the Department of Transportation (DOT), and
 - the Environmental Protection Agency (EPA).

We chose these agencies for our study because they administered programs accounting for 95 percent of all domestic federal assistance in fiscal year 1985.

Obtaining Data on Audit Quality

In our March 1986 report, we established criteria to measure audit quality, which were accepted by the various sectors of the accounting and auditing community. In our current study, we applied that criteria to audits of entities in our universe. This information was entered into a data base that was later combined with procurement data provided by entities responding to our questionnaire.

The audit quality criteria focused on auditors' compliance with professional standards for fieldwork and reporting—generally accepted auditing standards and generally accepted government auditing standards—and judged whether or not auditors satisfactorily adhered to audit standards as a whole. Fieldwork standards consist of evidence, internal control study and evaluations, and documentation, while reporting standards include financial, internal control, and compliance reporting. According to the criteria, auditors performed an unacceptable quality audit when they did not perform or document substantially all of the required fieldwork in any segment of the audit (compliance with laws and regulations, internal control review, and financial statements) or when they failed to report material internal control weaknesses or non-compliance with laws or regulations that they had discovered. Nonadherence solely to a general standard, however, did not preclude the audit from satisfactorily adhering to audit standards as a whole, and would have been judged of acceptable quality.

We asked each RIG to review the results of its quality control reviews and, for each audit in the universe, to determine the quality of the audit in accordance with the criteria established in our March 1986 report. Although RIGs made this determination in most cases, there were a few instances where they did not have the resources to perform this task. Consequently, at some RIG locations, we had to determine the quality of

audits ourselves. To ensure consistency among all RIGs, we subsequently visited many of them and verified their application of the criteria and the resulting quality determinations of 90 percent of the audits in our universe. This information formed the audit quality data base we used to determine whether audit quality is in fact related to entities' procurement practices.

Developing Criteria for an Effective Procurement Process

At the time of our review, criteria to evaluate the effectiveness of an entity's procurement process did not exist. Therefore, to accomplish our reporting objectives, we had to determine what elements should be present to help ensure an effective procurement process. Because the crucial elements of an effective procurement process are subject to different judgments, we wanted the criteria for evaluating an entity's procurement process to be widely accepted and considered minimally acceptable to ensuring an effective procurement. Accordingly, we selected a panel of over 20 experts in the fields of accounting, auditing and contracting, who assisted us in developing a conceptual framework for procuring audit services.

The experts who assisted us in our study represent the following professional organizations, business schools, CPA firms, and contracting entities:

- Government Finance Officers Association;
- National Association of State Auditors, Comptrollers and Treasurers;
- National State Auditors Association;
- National Intergovernmental Audit Forum;
- National Association of State Purchasing Officials;
- National Institute for Governmental Purchasing;
- President's Council on Integrity and Efficiency;
- AICPA State and Local Government Committee;
- AICPA Members in Government Committee;
- AICPA Task Force on the Quality of Audits of Governmental Units;
- Harvard Business School;
- Ashby, Armstrong and Co., CPAS;
- Clifton, Gunderson and Co., CPAS;
- Coopers and Lybrand, CPAS;
- Kerber, Eck and Braeckel, CPAS;
- Purchase Bureau, State of New Jersey;
- Human Resources Administration, New York, New York;
- Fairfax County Government, Fairfax, Virginia; and

- Department of Economic and Community Development, St. Mary's County, Maryland.

Our experts assisted us in two ways. First, they advised us in formulating a framework for procuring audit services that included four critical attributes—competition, solicitation, technical evaluation, and written agreement. The formulation of the framework began with a roundtable meeting in Washington, D.C., where our experts were invited to discuss the attributes they believed an effective procurement process should include. Once the attributes were identified, we obtained a consensus among our panel of experts that they supported the framework. These experts believed that to maximize the possibility of obtaining a high-quality audit, all four attributes should be present when obtaining the services of CPAS.

Secondly, we asked the experts to help us develop detailed criteria to determine if an entity effectively met each of the four attributes when it procured its audit. These detailed criteria were developed by asking experts to identify the specific questionnaire responses that should be present for an entity to effectively meet each attribute. The experts' consensus on which questionnaire responses should be present became the criteria against which each questionnaire was compared to see if the entity had an effective procurement process.

Questionnaire Development and Use

Early in our review, we developed a detailed questionnaire to identify the procurement procedures entities used to obtain audit services for the audits in our sample and to elicit various demographic data about these entities. The questionnaire was an essential part of our analysis because it provided us with data to evaluate the effectiveness of entities' procurement processes—the factor we compared with audit quality to assess whether a relationship exists.

We developed our questionnaire over a period of 3 months, based upon discussions with over 50 contracting entities and assistance from technical experts within GAO. The questionnaire was designed to be comprehensive and to cover most contracting methods entities might use. It was pretested at eight contracting entities and subsequently revised to clarify substantive and format questions. Finally, we sent the questionnaire to all 210 entities in our sample with instructions that they complete it for the specific audit they obtained during our time frame. A follow-up letter was subsequently sent to entities not responding to our questionnaire.

Questionnaire Analyses

Our sample of entity responses to the questionnaire was statistically weighted, and as mentioned previously, is projectable to an estimated universe of about 5,800 audits. (The associated sampling errors are included in appendix II.) This projection is lower than the estimated 9,000 audits in the universe nationwide because we did not do work in the northeastern, midwestern, and Pacific northwestern United States, and it is based on a 70-percent response rate from the entities in our sample.

In addition to the statistical analyses developed and reported in chapters 2 and 3, which are projectable to our universe, we also report information from questionnaire responses on various methods and techniques entities use in their procurement processes. In these situations, we only report the responses of entities in our sample and do not project to the universe. The title of each figure indicates whether it is descriptive of the sample or applicable to the universe.

We edited the questionnaires for logic and consistency but we did not verify each entity's responses to our questionnaire. All responses were then keypunched to create a procurement process data base, which was then merged with the audit quality data base established earlier in the review. We then applied the procurement criteria to the data base to determine whether an identifiable relationship exists between procurement and audit quality. These results are presented in chapters 2 and 3 of the report.

To make recommendations on how to improve entities' procurement practices, which was our second objective, we relied heavily on the entities' responses to the questionnaire; however, we also considered the views of our panel of experts and the discussions we had with over 50 contracting entities in the planning stages of our review. Most of our recommendations related to the procurement attributes resulted from questionnaire responses.

Our recommendations for correcting weaknesses in entities' procurement procedures are not intended to supersede state or local law or regulation. Instead, our recommendations are intended to assist entities where legally and administratively appropriate.

We conducted our review between March 1986 and March 1987 in accordance with generally accepted government auditing standards, except, as requested, we did not obtain comments from federal agency IGS, contracting entities, or the public accounting profession on this report.

However, as described here, the views of experts were sought in conjunction with our work and are incorporated in the report where appropriate.

Procurement Practices Relate to Audit Quality

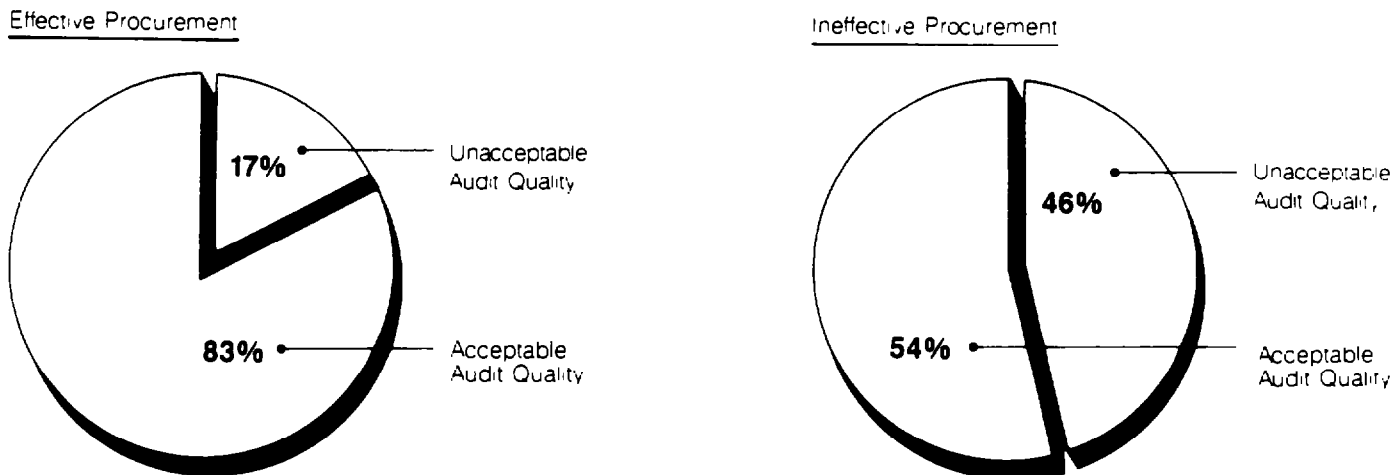
Based upon our review results, we found that the process an entity follows to engage its auditor significantly relates to the quality of the audit and the final report. Thus, entities need to use a procurement process that strives for a quality audit at a reasonable cost. Through our ongoing process of discussions and validations with experts, we have identified four critical attributes that comprise the framework of a procurement process. They are

- competition,
- solicitation,
- technical evaluation, and
- written agreement.

These four attributes provide a framework that, if followed, should substantially improve the procedures entities use to obtain audit services at a reasonable cost and ultimately improve the quality of their auditors' work. The detailed criteria we developed to evaluate whether entities used these attributes to procure their audits are discussed in detail later in this chapter.

The entities' responses to our questionnaire, when compared against the procurement criteria, showed that 58 percent of the entities in our universe did not meet the criteria for all four attributes. While some entities may have met one or more of the criteria, it was necessary to meet all four attributes to be considered to have an effective procurement for purposes of our analyses. Our data also showed that these entities received unacceptable quality audits from their CPAs in 46 percent of their engagements. On the other hand, for entities which met the procurement criteria based on their questionnaire responses, the likelihood of receiving an unacceptable audit decreased to 17 percent. Figure 2.1 illustrates these results. Throughout this chapter, we use the terms "effective" and "ineffective" to indicate when an entity did or did not meet our criteria.

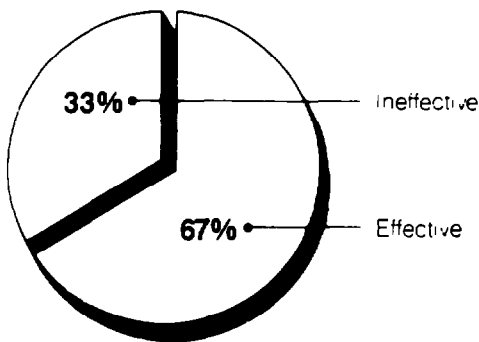
Figure 2.1: Effective and Ineffective Procurement Processes and Related Audit Quality



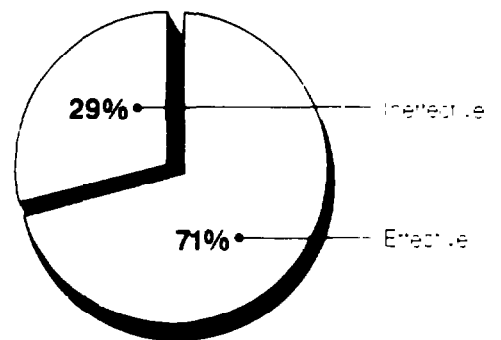
Our analysis acknowledges that none of the four critical attributes can be considered totally independent of the others. However, based on our procurement criteria, our data further indicated that 33 percent of the entities did not effectively obtain competition, 29 percent did not have an effective solicitation process, 43 percent did not have an effective technical evaluation of proposals, and 46 percent did not have an effective written agreement. These findings are projectable to a universe of an estimated 5,800 audits that were received by the seven agencies and reviewed for audit quality during our time frame (from October 1, 1984, through April 30, 1986). Figure 2.2 illustrates these results.

Figure 2.2: Percent of Time Procurement Criteria Were Met for Each Attribute

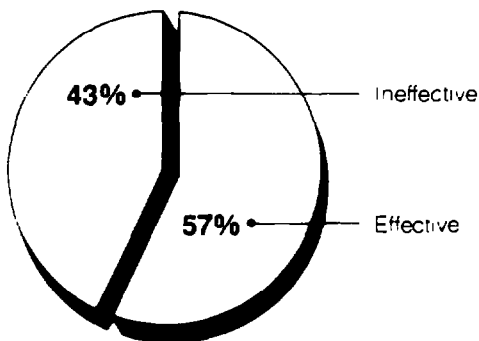
Competition



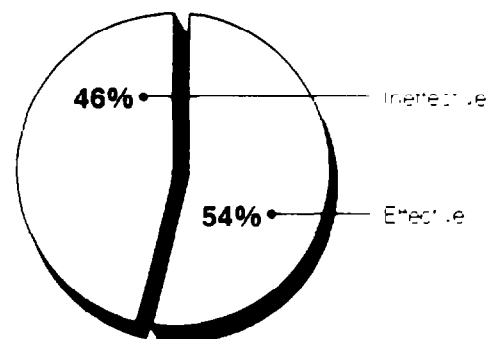
Solicitation



Technical Evaluation



Written Agreement



The following section describes the framework for procuring audit services developed for this review.

Framework for a Procurement Process

As stated earlier, one of our review objectives was to develop a framework that specifies criteria for an effective procurement process. We evaluated entities' questionnaire responses to see if the entity met these criteria for four critical attributes—competition, solicitation, technical evaluation, and written agreement. To the extent possible, entities should include these attributes in their procurement processes to increase the likelihood of receiving a quality audit at a reasonable price. Our panel of experts who helped us develop the procurement criteria

believed that they should provide flexibility because the requirements and complexity of audits vary among entities. Therefore, to evaluate entities' procurement processes, we applied criteria that experts characterized as "minimally acceptable" to ensuring an adequate procurement.

In addition to our framework, we believe that planning is very important to a successful procurement and is an activity that is inherent in every phase of the process. An entity that plans its procurement by properly investing the time and resources in one year can then benefit from this planning by using it as a basis for future procurements. Planning may include, for example, developing methods to obtain a population of bidders, determining the provisions to be included in solicitation documents, establishing a list of factors to be considered during the technical evaluation process, or developing a format for formal written agreements between the entity and its auditor.

We believe that entities were more likely to meet the procurement criteria if their questionnaire responses indicated that they spent time planning their procurement. This included activities such as (1) identifying all of the details and requirements of the audit, (2) identifying any federal, state or local statutes, regulations, agreements, or conditions that placed restrictions on the entity as it engaged its auditors, and (3) setting out for potential bidders a schedule of events that contained the significant milestones in the procurement process.

The following sections describe in greater detail each of the four critical attributes of the procurement framework. Each section addresses the importance of the attribute, the criteria used to evaluate the attribute, and the results of our analyses of entities' questionnaire responses in relation to the framework.

Competition: A Fundamental Premise in Government Procurement

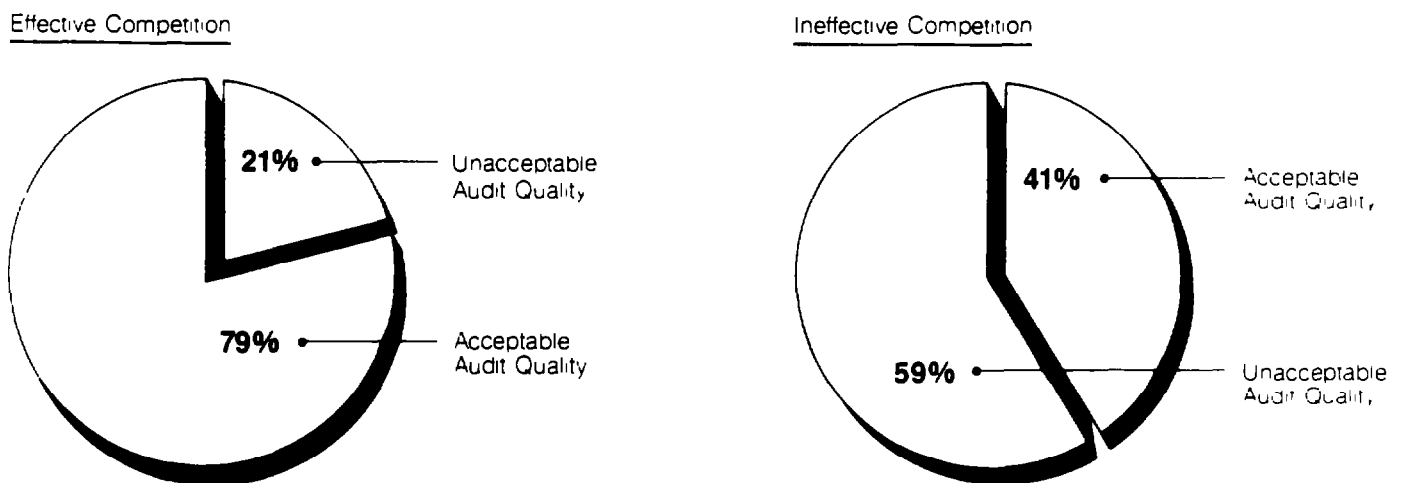
OMB circular A-102, attachment O, "Procurement Standards," states that maximum open and free competition should be a basic principle of all governmental procurements regardless of dollar value or method of procurement. In the procurement of audit services, competition takes place when a number of presumably qualified firms compete against each other to provide the entity with audit services by submitting their respective proposals. The presence of competition in the procurement process helps the entity control costs by increasing the likelihood that a quality engagement will be performed by an auditor at a fair price.

For an entity to meet the criteria for competition, it had to have indicated in the questionnaire that it attempted to identify at least two CPA firms which would potentially bid on the engagement. This could have been achieved through various means such as advertising, maintaining bidders list, or contacting firms as a result of referrals from other entities. These methods have traditionally been the accepted ways of obtaining competition.

Competition Could Improve Audit Quality

The questionnaire responses clearly indicate that competition could increase the likelihood of a quality audit. Our analysis of those responses showed that a third of the entities in our universe did not obtain competition. Of these, 59 percent received unacceptable quality audits. However, for those entities which did use competition, 21 percent received unacceptable quality audits. While the presence of competition may not directly affect audit quality, we believe it increases the likelihood of receiving a quality audit and encourages entities to incorporate the other three critical attributes as well. Figure 2.3 compares the frequency of acceptable and unacceptable audit quality when competition was used.

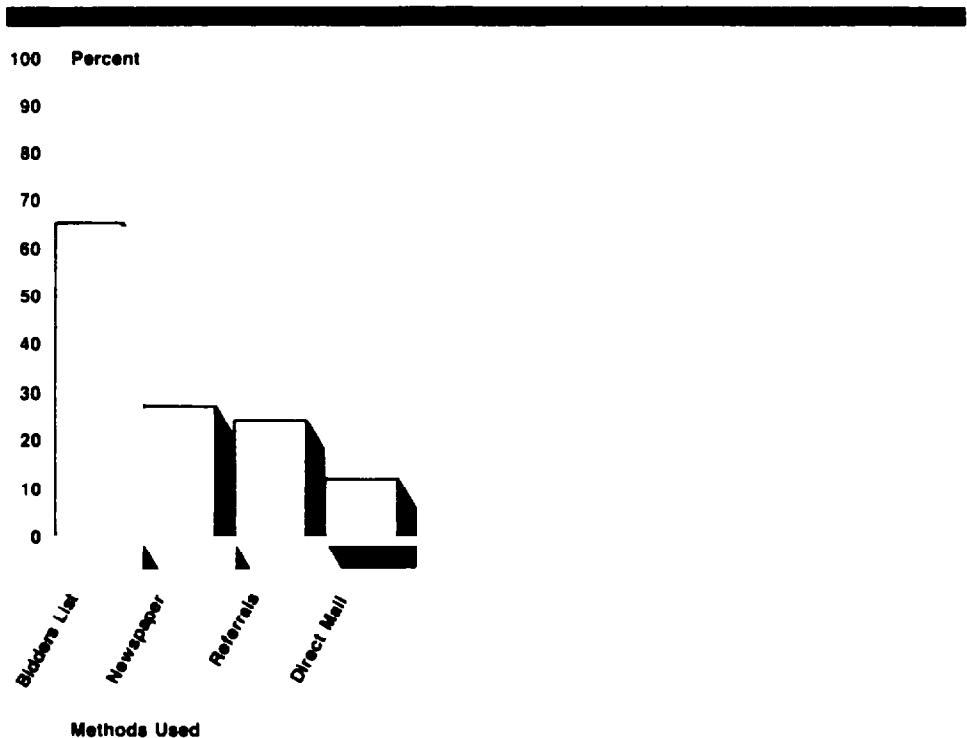
Figure 2.3: Effective and Ineffective Competition and Related Audit Quality



As one of the first steps in obtaining competition, entities should identify the population of bidders. Entities responding to the questionnaire stated that they used several methods to do so. They indicated that the

advertised in local or regional newspapers, made direct mailings to CPAs, or obtained referrals from other entities. Some entities also attempted to identify audit firms by compiling a bidders list from sources such as the "Yellow Pages," professional publications, references from other entities, or past experiences with some audit firms or firms previously expressing interest in the engagement for future years. Figure 2.4 shows the methods the entities in our sample used to obtain a population of bidders.

Figure 2.4: Methods Entities in Our Sample Used To Obtain a Population of Bidders



- Notes
1. Pertains to entities which met the competition criteria
 2. Percentages do not total 100 percent because some entities used more than one method of obtaining competition

Appendix III includes selected case studies where the lack of competition in the entity's procurement process may have led to the entity receiving an unacceptable quality audit.

Multiyear Agreements

We believe that competition can be obtained, while concurrently realizing the benefits of lower cost and efficiency, when an entity uses multiyear agreements. Such an agreement involves the entity engaging its auditor for more than 1 year at a time.

In discussions with us, many of our experts stated that multiyear contracts not only provided an incentive for an audit firm to devote time to submitting a well-developed proposal and to establish its learning curve in the early years of the engagement but also minimized staff resources the entity spent on procuring audit services. In addition, according to experts, the audit firm recovers some of its costs and realizes a profit in the second, third, or fourth year of the engagement. Further, two CPAS on our panel stated that their firms could minimize the risk of producing a poor quality audit and make the greatest contribution to improving program and financial operations in the final years of their multiyear agreements. This is due, in their opinion, to the knowledge a firm can acquire over a period of time while performing an audit.

During our study, we found that some entities engaged in multiyear agreements. These multiyear agreements normally provided for annual contract renewal at the entity's option—usually contingent upon the audit firm performing acceptable quality work. Although there was some disagreement as to the ideal length of a multiyear agreement, most of the experts we spoke with indicated a range of from 3 to 5 years. We agree that entities should consider using multiyear agreements, preferably of a 5-year duration, due to the potential cost savings and continuity benefits over the long-term.

We also asked experts to discuss the advantages and disadvantages of rotating audit firms once the multiyear contract period expired and the entity had to rebid the audit engagement. We found that opinions varied greatly as to whether the current audit firm should be allowed to submit a proposal. Those experts who favored rotation stated that they believed it was advantageous for the entity to obtain a "new perspective" from a different audit firm.

On the other hand, others stated that firms commonly assigned different staff to these audit engagements as a result of attrition or the unavailability of prior staff to work on the current-year audit. In these cases, experts felt that rotation of staff within the firm was sufficient to provide a new perspective, therefore eliminating the need to ban the current auditor from submitting a proposal. Regardless of how an entity

engages its auditor, it should consider the benefits of rotation and establish a policy regarding its use when appropriate.

Solicitation— Communicating Audit Requirements

The solicitation process addresses the manner in which the entity communicates its needs and requirements to potential bidders. When an entity uses an effective solicitation as part of its procurement process, it assures itself that all audit firms clearly understand the requirements of the audit and submit comprehensive proposals that can be evaluated on an equitable basis. Based upon the solicitation criteria, entities were more apt to obtain a quality audit when their solicitation process was formal and comprehensive and accurately conveyed all of the details and audit requirements to the audit firms.

We believe that effective planning can help ensure a more comprehensive solicitation process. Entities can plan their process by deciding on the provisions to include in their solicitation document, time frames for audit firms to respond to the solicitation, and the manner in which they would respond to follow-up questions from the CPAS.

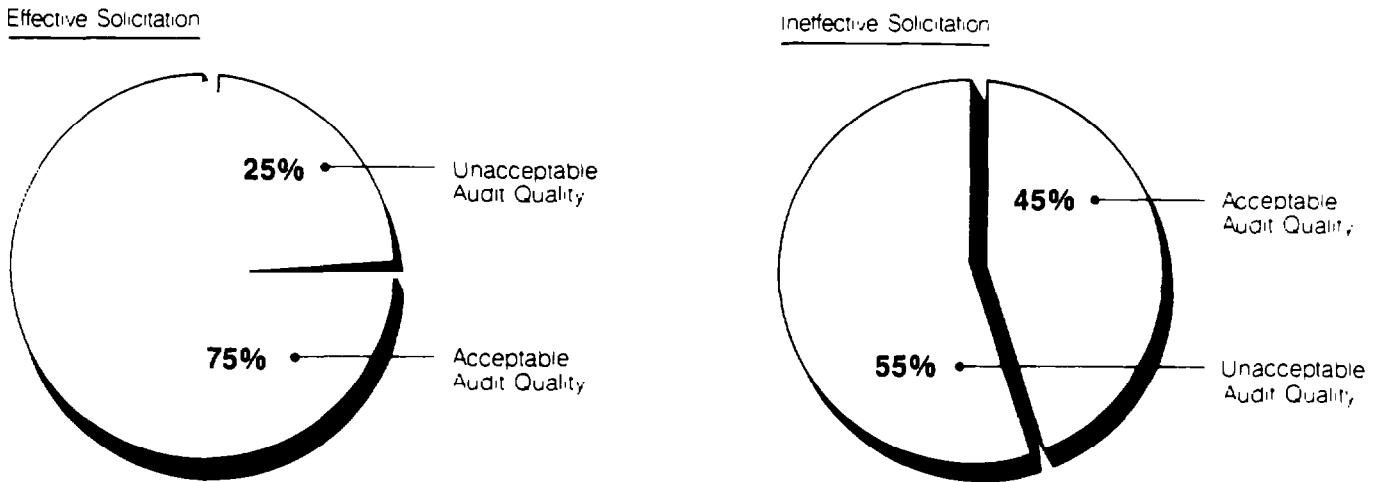
Because the complexity and requirements of audits vary among entities, the criteria for an effective solicitation process—as developed for this report—allows for flexibility. Therefore, for an entity to meet the criteria for solicitation, we, in consultation with our panel of experts, decided that it had to include at least four items in its communication with potential bidders. For example, at least two of these items had to address background information on the entity, the period to be audited, auditing standards to be followed, the types of reports required, or the specific audit guide or program to be followed. (Appendix IV includes a detailed list of provisions that entities may include in their solicitation documents.)

Meeting Solicitation Criteria Could Improve Audit Quality

Entities can improve the likelihood of receiving a quality audit if their solicitation process meets the criteria established during this review. Our analysis of the questionnaire responses showed that 29 percent of the entities in our universe did not meet the solicitation criteria and received unacceptable quality audits 55 percent of the time. On the other hand, 71 percent of the entities met the solicitation criteria and had unacceptable quality audits 25 percent of the time.

Figure 2.5 provides a comparison of the percent of times entities in our universe met the solicitation criteria and the quality of resulting audits.

Figure 2.5: Effective and Ineffective Solicitation and Related Audit Quality



Although basic provisions, such as auditing standards to be followed and type of reports required, should be present in all solicitation documents, we believe the amount of detail should coincide with the size and complexity of the audit engagement. Experts stated at our roundtable meeting that entities may unduly restrict competition when they develop inordinately detailed specifications. Further, experts believed that extremely detailed specifications could result in very complex and voluminous technical proposals which the entity is not prepared to properly evaluate.

Once an entity identifies the information to be included in its solicitation document, we found those meeting the solicitation criteria devised a formal method of communicating the information to the audit firms. One method was through the preparation of a "request for proposal" (RFP), which outlines all pertinent information for an audit firm to submit a satisfactory proposal. Other entities used an "invitation for bid" (IFB), which served much the same purpose as an RFP, except that it limited its award to that qualified firm which submitted the lowest responsive cost proposal. Last, instead of, or in addition to the RFP or IFB, entities responded that they sometimes held one or more formal meetings, or presolicitation conferences, with audit firms to provide them with pertinent or clarifying information. Regardless of the method used, entities should provide all perspective firms with the same information to ensure a fair and equitable process.

In addition to entities having effective methods for providing prospective firms with information at the outset of the procurement process, we found that many of the entities which met the solicitation criteria also had procedures to provide follow-up information or clarifications to potential bidders when requested. This was often done in group meetings with all bidders, through written communication with the bidders in separate communications directly with the audit firms, or informally through telephone responses to direct inquiries by various CPAs. We believe that where information is provided in response to CPAs' inquiries, however, it should be disseminated to all audit firms to ensure all proposals are based on the same information, thus ensuring fairness.

As stated earlier, we believe it is ultimately the CPA's responsibility to perform a quality audit. Therefore, in cases where the entity's solicitation process does not properly communicate all of the requirements of the engagement or the stated requirements are vague, the CPA must obtain this information before the final audit report is submitted, but preferably even before the contract document is prepared and the audit commences.

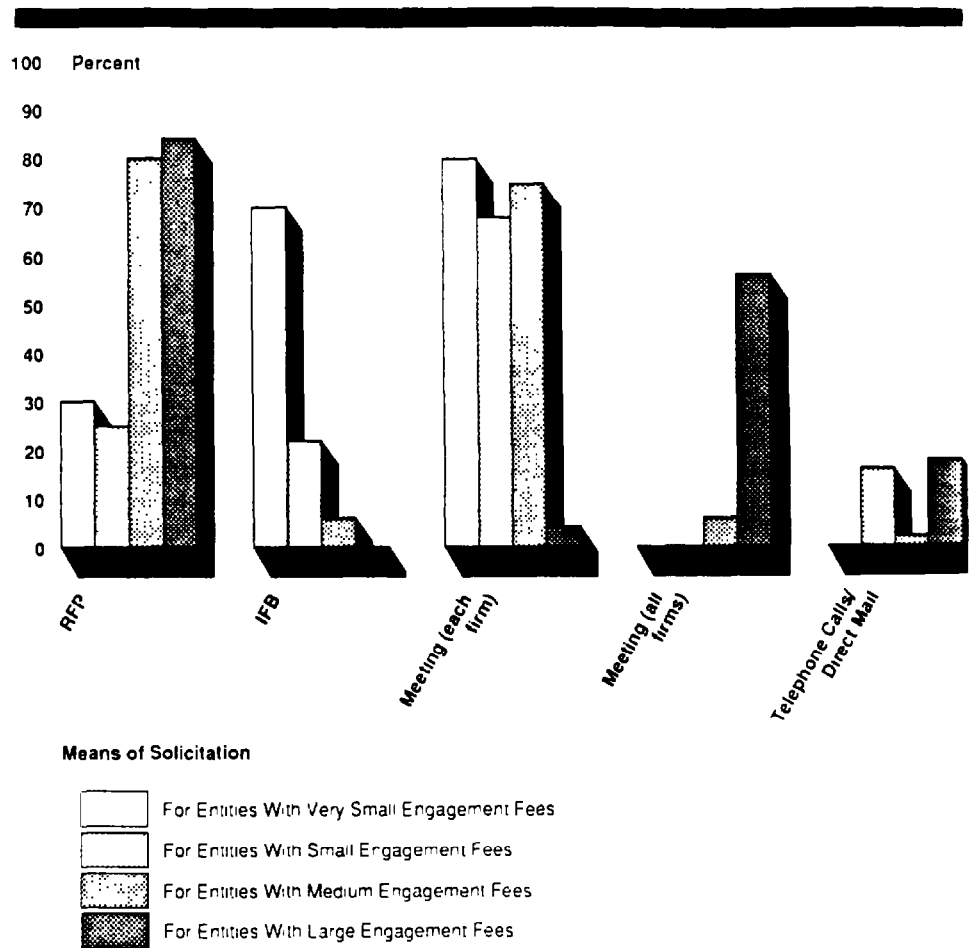
Figure 2.6, on the following page, highlights the solicitation methods used by entities in our sample which met the solicitation criteria. The charts show entities' methods for engagements of various sizes.

Appendix III includes selected examples of how entities engaged their auditors. One describes how the entity's solicitation process may have contributed to it receiving an unacceptable quality audit. In another example, the CPA may have effectively mitigated potential audit problems that could have resulted from a vague or incomplete solicitation document.

Technical Evaluation— Selecting a Qualified Auditor

The technical evaluation process requires that an entity devise a method for evaluating the merits of each audit firm's technical proposal and for selecting the CPA firm that can provide a quality audit at a fair price. The technical evaluation process focuses on the auditors' skills, experience, commitment, and understanding of the audit requirements—factors which are then considered in selecting the best audit firm. Based on questionnaire responses, we found that many entities (1) screened potential bidders to determine those that possess basic or mandatory qualifications, (2) developed adequate technical evaluation factors, other than cost, to assess CPAs' proposals, and (3) applied these factors, first technical then cost, to select a winner.

Figure 2.6: Various Solicitation Methods Used by Entities in Our Sample by Size of Engagement



Notes:

- 1 Pertains to entities which met the competition criteria
- 2 Very small (under \$1,000), small (\$1,000-\$10,000), medium (\$10,000-\$75,000) and large (over \$75,000)
- 3 Percentages do not equal 100 because entities may use more than one method
- 4 Meetings may be used as the single method of solicitation or in addition to an RFP or IFB

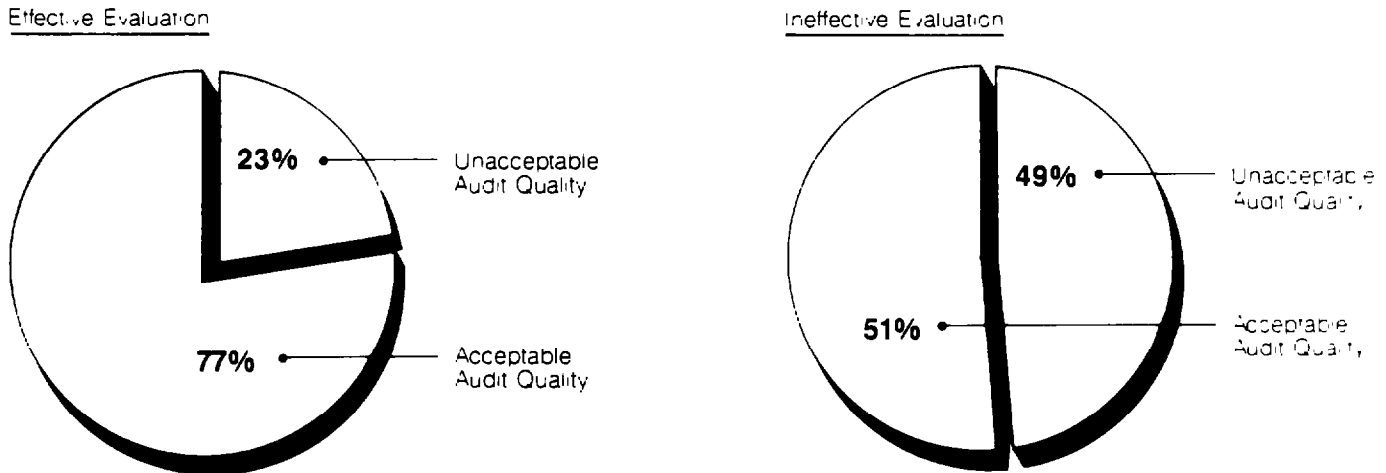
As stated previously, because the complexity and requirements of audits vary among entities, the criteria for an effective technical evaluation allow for flexibility. For an entity to meet the criteria for technical evaluation, we, in consultation with our panel of experts, decided that the entity had to indicate in the questionnaire that it considered at least three technical factors, other than cost, in its selection process. At least one of these had to be the firm's technical approach to performing the

audit, the qualifications and technical backgrounds of staff to be assigned to the engagement, or the firm's past governmental or industry experience.

Meeting Technical Evaluation Criteria Could Improve Audit Quality

Results of our review indicate that when entities meet the technical evaluation criteria they are more likely to receive a quality audit. Based on our analysis of questionnaire responses, we found that 43 percent of the entities in our universe did not meet the criteria for technical evaluation. These entities received unacceptable quality audits 49 percent of the time, while entities in our universe which met the technical evaluation criteria received unacceptable quality audits 23 percent of the time. Figure 2.7 compares the frequency of acceptable and unacceptable audit quality when an effective technical evaluation was performed and when it was not.

Figure 2.7: Effective and Ineffective Technical Evaluation and Related Audit Quality



Further, table 2.1 illustrates how an entity can increase the likelihood of obtaining an acceptable audit when it includes adequate technical criteria, in addition to cost, in its selection process.

Table 2.1: Frequency of Acceptable Audits Based on Type of Criteria Used To Evaluate Bidders

Type of criteria	Frequency of acceptable audit (percentage)
Cost was only consideration	1
Consideration given to technical factors, but not sufficient to meet the technical evaluation criteria	5
Consideration given to technical factors sufficient to meet the technical evaluation criteria	7

Prior to receiving technical proposals, entities meeting the technical evaluation criteria indicated that they developed procedures and technical criteria for evaluating proposals which considered the firms' qualifications as well as cost. The criteria could have considered such items as the auditors' skills, experience, commitment, and understanding of the audit requirements. The criteria should be conveyed to proposers, if only in general terms, to allow the firms to emphasize their particular strengths in their technical proposals. Further, the entity should make its final selection consistent with established evaluation procedures by evaluating each firm's strengths and weaknesses and ensuring that all qualified firms are fairly considered.

The extent and type of technical criteria used in the evaluation process can vary depending on the complexity of the engagement and extent to which the audit firms have been "prequalified." In addition to items included in the technical evaluation criteria, as discussed earlier, entities in our universe included factors such as

- the size and location of the firm,
- the range of activities performed by the firm,
- the firm's participation in training and continuing professional education in auditing governmental programs,
- a description of the firm's quality control procedures,
- results of internal and external quality control reviews of the firm,
- the firm's supervisory and review procedures,
- time frames for the fieldwork to commence and be completed,
- the firm's data processing capabilities, and
- the amount of assistance the firm expects from the entity.

Several sources, including the Western Intergovernmental Audit Forum in its May 1986 Guidelines for Preparation of Requests for Audit Proposals, suggest that an entity apply values to technical criteria factors

to identify qualified firms. By weighing selection criteria by relative importance in advance, the entity avoids later criticism of unfair selection methods and ensures equitable evaluation of all proposers. Most experts believe that only after an entity narrows the field of qualified firms to those which meet the technical criteria, should "cost" then be considered in the final selection.

We believe that the auditor selection process requires many subjective judgments. We agree that each firm's technical strengths should first be evaluated and ranked on the basis of the technical criteria before factoring in cost or price to arrive at a final selection. If an audit firm is judged not to be technically qualified to perform the audit, then it should not be selected, regardless of its cost proposal, because the risk of performing a poor quality audit is greatly increased.

Appendix III includes selected examples of instances where entities' selection of the winning audit firm was based on cost only, which may have contributed to their receiving an unacceptable quality audit.

Qualifying Audit Firms

In discussions with some contracting entities early in our review, we found that in an effort to make their evaluation process more efficient, entities sometimes eliminated many unqualified firms early in the evaluation process. They stated that they most often did this by requiring audit firms to meet preestablished mandatory criteria for their proposals to be judged minimally technically acceptable and to be considered for further evaluation. Where not precluded by law or regulation, entities may use a "request for qualifications," which is a screening device that ensures that only qualified firms are sent the solicitation document. By eliminating firms early, the entity is spared from applying the more time-consuming technical evaluation criteria to firms which do not appear to be qualified to perform the audit.

To meet mandatory criteria, for example, an audit firm might have to (1) affirm that it is licensed to practice in the applicable state, (2) affirm that its staff meets the independence standard outlined in generally accepted government auditing standards, (3) affirm that its staff does not have a record of poor-quality work, (4) maintain its resources and office locations which will potentially do the work within a reasonable distance of the entity, and (5) provide evidence of an independent review with a positive outcome. We believe that these mandatory criteria are items that, if included in an entity's technical evaluation process,

could help the entity meet the criteria for technical evaluation by eliminating firms that appear obviously unqualified to perform the audit.

We also found that entities with large or numerous engagements sometimes qualify prospective bidders as early as the competition or solicitation stages. This prequalification process sometimes included technical criteria that went beyond basic or mandatory qualifications. For example, a major procurer of audit services for the City of New York maintains a list of CPA firms which previously have been screened for mandatory qualifications and which have shown evidence of having received an acceptable independent review. Therefore, at the time of solicitation, RFPs are sent to firms already on the qualified bidders list, and responses are evaluated based on responsible cost and labor hours. This process facilitates a speedier and more efficient auditor selection process because audit firms are already judged "qualified" before they submit their technical proposals. It should be noted that this process also utilizes detailed quality control procedures after the audit is completed. In this postaudit monitoring (discussed in more detail in the next section of this report), the entity determines that the audit was of acceptable quality, thus allowing the firm to continue to be eligible to bid on future engagements. Additional firms may be added to the "qualified" bidders list at any time after they pass the prescreening process.

According to guidance issued by the Western Intergovernmental Audit Forum, the extent to which entities prequalify bidders should be consistent with the size of their audit engagements. For example, entities with several larger engagements more frequently expend the additional resources to prequalify audit firms to reduce the time involved in soliciting and evaluating technical proposals.

Written Agreement— Documenting Expectations Between Entity and Audit Firm

A written agreement assures the entity that agreements reached with the audit firm adequately (1) represent a mutual understanding as to how the audit will be conducted and (2) specify the accountability of all parties. After the entity and CPA reach a final agreement on the price and terms of the engagement, we believe that the entity should prepare a written contract to confirm the agreements reached.

Our analysis of questionnaire responses showed that entities in our universe that met the criteria for written agreement had contracts that contained specific work-related (product or deliverables), legal, time, and

cost provisions against which the firm could be held accountable. Entities indicated in their responses that engagement letters sometimes substituted for a written contract. However, when discussing this with our panel of experts, they cautioned that when engagement letters are used, they should contain provisions that protect the entity, in addition to the audit firm, in the event of poor quality work or nonperformance of the agreement.

For an entity to meet the criteria for adequate written agreement, the entity had to indicate in its questionnaire that it had a signed contract or engagement letter which included a statement of the specific audit work to be performed and related items, such as the scope of the audit, the audit period, the applicable audit standards, required reports, or applicable audit guide or program. The statement of work could have incorporated the provisions of the RFP as they apply to the specific audit work, included cost and technical proposals, or provided for reporting on internal controls and compliance with laws and regulations—reports that are often unique to governmental audits.

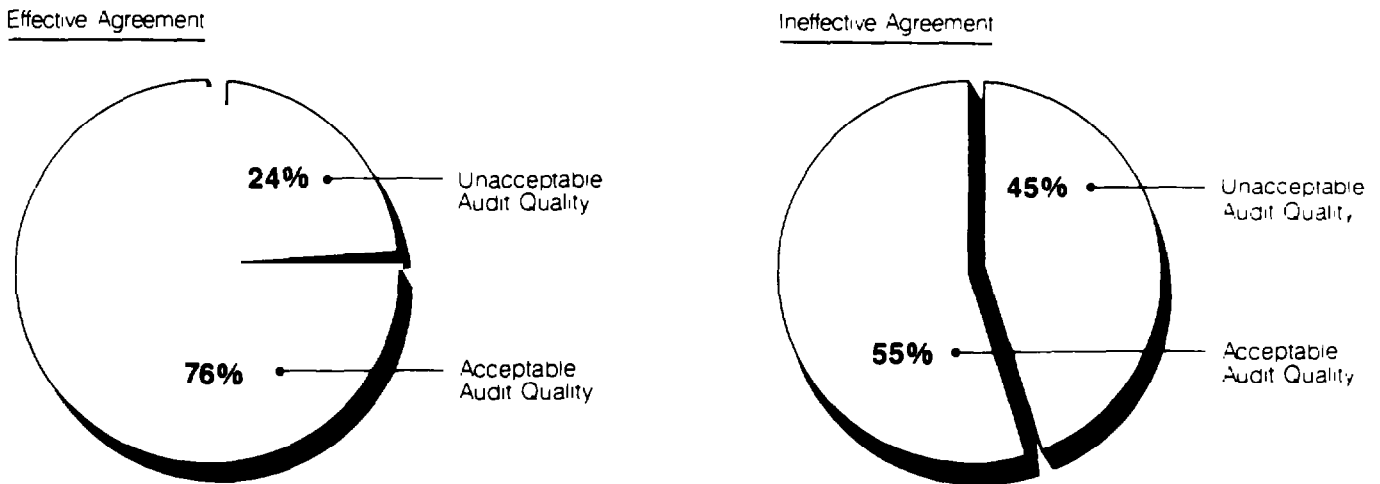
Written Agreement Could Improve Audit Quality

Results of our review indicate that when an entity includes an effective written agreement as part of its procurement process, it increases the likelihood that it will receive a quality audit. Our analysis of questionnaire responses showed that 46 percent of the entities in our universe did not meet the criteria for written agreement. These entities received unacceptable quality audits 45 percent of the time, while the incidence of unacceptable quality audits decreased to 24 percent when entities met the written agreement criteria.

Figure 2.8, on the following page, compares the frequency of acceptable and unacceptable audit quality when the entities in our universe included an effective written agreement as part of the procurement process.

In addition to increasing the possibility of obtaining a quality audit, entities which met the criteria for written agreement were in a better position to take recourse against the audit firm in the event of poor-quality work. Our panel of experts described recourse measures such as creating adverse publicity for the firm through negative references, referring auditors to the appropriate state licensing boards, and requiring the auditor to properly complete the engagement or withhold payment

Figure 2.8: Effective and Ineffective Written Agreement and Related Audit Quality



Appendix III includes selected examples of how the lack of a written agreement may have contributed to an unacceptable quality audit and may have prevented both the entity and the CPA from receiving satisfaction under the verbal agreement.

Monitoring Is an Important Activity

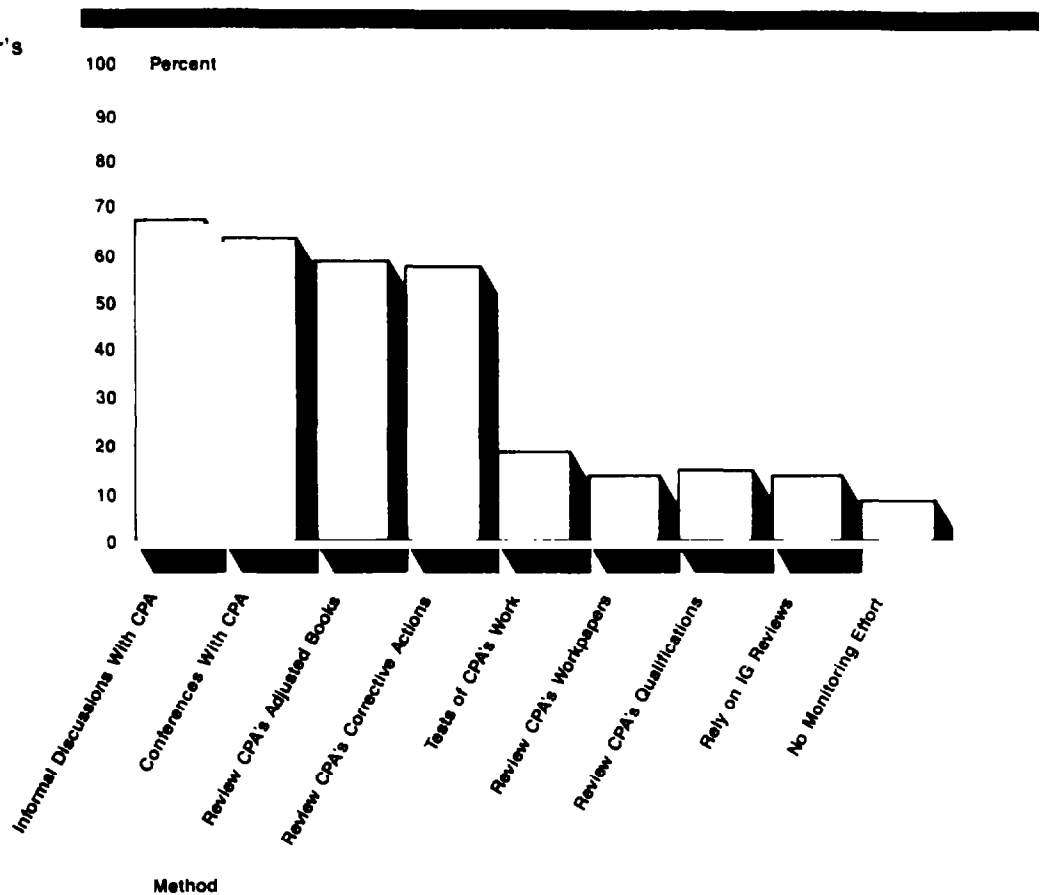
Although experts on our panel did not believe that the existence of a monitoring program was a factor in meeting the criteria for written agreement, they stated that a written agreement does enhance an entity's ability to monitor the firm's compliance with the agreement. OMB circular A-102, attachment O, states that entities should maintain a contract administration, or monitoring, system to ensure that the auditor performs in accordance with the terms and conditions of the agreement. Ongoing monitoring also allows the entity, on a timely basis, to identify potential problems with the quality of the audit work or other potential contract nonperformance problems. We believe monitoring helps ensure that entities get the services they paid for and that their audit reports are reliable and complete. Further, we believe entities should develop a system for monitoring the performance of the CPA firm, both at interim points in the audit engagement and at the conclusion of the audit.

Entities responding to the questionnaire indicated that they use several monitoring techniques during the course of an audit engagement. These

techniques included working paper reviews, formal and informal meetings with the auditor, and reviews of CPA recommendations.

Figure 2.9 illustrates various monitoring techniques and the frequency with which they were used by entities in our sample

Figure 2.9: Method Entities in Our Sample Employed To Monitor Auditor's Work



Note: Individual entities may use more than one monitoring technique

Our analysis of the questionnaire responses showed that entities with small or very small engagements (engagement fees less than \$10,000) sometimes found it difficult to properly monitor their CPAs' work due to a lack of resources and expertise. However, we believe that entities can take certain steps to monitor CPA performance, even on small engagements. For example, they can (1) ensure that the proposed staff are actually the ones performing the audit, (2) hire a consultant, for a short

period of time, to assist in monitoring the audit firm, (3) obtain volunteers from local professional and educational organizations to assist the entity, and (4) communicate with the appropriate RIG about the results of its desk review and possible quality control review of the CPA's audit.

The last example in appendix III illustrates the importance of monitoring contract performance.

Conclusions and Recommendations

As discussed in the previous sections, our analysis of questionnaire responses indicates that there is a strong relationship between procurement and audit quality. It further indicates that entities are much more likely to receive acceptable quality audits when they employ a procurement process that meets the criteria for each of the four attributes as described in this report. However, we believe that entities are not taking steps to ensure that they have an effective procurement process. As a result, entities are almost three times more likely to receive an unacceptable quality audit.

Accordingly, we recommend that entities carefully assess their procurement practices and take actions to include the framework established in this report to better assure themselves of obtaining qualified auditors at a reasonable cost. The following recommendations for improving current procurement procedures are not intended to supercede existing state or local law or regulation. Instead, entities should consider these recommendations in light of their own legal and administrative requirements and incorporate them where feasible. Specifically, we recommend that entities:

- Ensure that at least two audit firms are considered when selecting a qualified auditor. Where feasible, entities should obtain competition in all circumstances, except when exercising renewal options on multiyear contracts.
- Provide multiyear contracts when possible, preferably for 5 years, to the winning audit firm to benefit from the auditor's learning curve and experience and to take advantage of cost savings associated with not procuring audit services on an annual basis. However, once the contract period expires, entities should rebid to ensure that they receive a qualified auditor at a reasonable price. The entities must also decide whether they will permit their current auditor to submit a proposal for the upcoming audit.

- Ensure that their solicitation—whether it is a request for proposal, invitation for bid, or other method—is comprehensive and that all requirements for the audit engagement are communicated to interested audit firms.
- Ensure that they use specific technical factors in selecting a qualified audit firm. Entities should include items such as the audit firm's past governmental or industry experience, the firm's technical approach to performing the audit, and/or the qualifications of individual staff assigned to the engagement.
- Ensure that the technically qualified firm performs the audit engagement, at a price competitive with that of similarly qualified firms. In selecting an auditor, where entities are not required to procure on cost alone, cost should be one of the factors in selecting a CPA, but should not override a firm's technical qualifications.
- Prepare a written agreement, signed by the entity and the audit firm, which includes provisions that hold both the entity and the firm accountable. For example, a firm may have to deliver an audit report by a specified date, and the entity may have to have its financial records in auditable condition. This can usually be accomplished through a complete statement of work, which specifies the terms and scope of the engagement, the product or "deliverables," the engagement fee, and time and legal requirements. It should also contain provisions in the case of poor performance or nonperformance of the contract. An engagement letter may substitute for a written contract but should contain all of the provisions that protect the entity, in addition to the audit firm.
- Ensure that some monitoring techniques are employed so that the entities obtain the services they are paying for or are in a position to take recourse if the audit is of unacceptable quality.

Other Factors That Relate to Effective Procurement

In addition to analyzing the impact of the four critical procurement attributes on audit quality, we found that other factors or entity characteristics are strongly associated with the effectiveness of an entity's procurement process. Specifically, we found that the personnel involved in planning and implementing the procurement process, the size of the audit engagement, and the type of entity obtaining audit services are all related to an entity's meeting the four attributes. We identified these characteristics by analyzing entities' demographic data and current practices, as reported by them in our questionnaire.

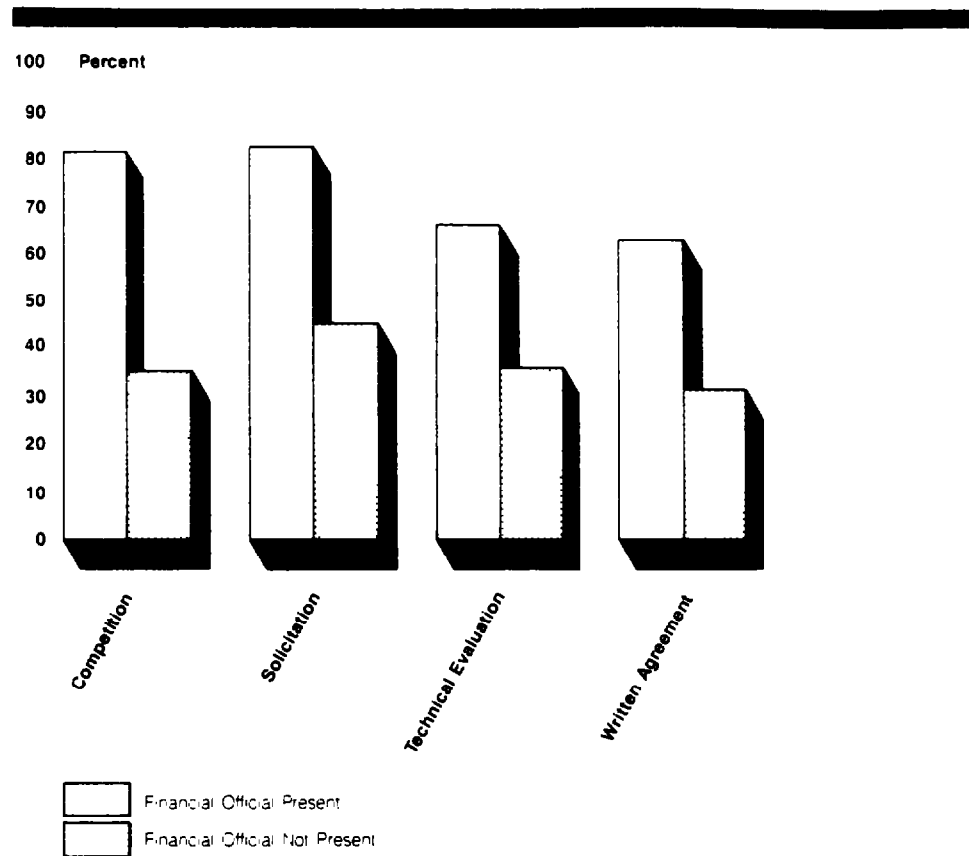
Personnel With Governmental Accounting and Auditing Skills Are Crucial to the Procurement Process

Our analysis of questionnaire responses showed that an entity is more likely to have an effective procurement process if financial officials—those people knowledgeable in governmental accounting and auditing—are involved in planning and implementing the process. Our analysis showed that financial officials were a major contributing factor in entities' meeting the criteria for each of the four critical attributes. To meet our criteria for financial officials, the entity had to indicate that its procurement involved an official with a financial background at any point in the process. Figure 3.1 compares entities' success in meeting the procurement criteria when financial officials were, and were not, involved in the procurement process.

Our questionnaire data showed that the types of financial officials involved in helping entities with their procurements consisted mainly of municipal treasurers, controllers, and business managers. Experts we spoke with felt that since governmental audits are specialized and have some unique audit requirements, persons with knowledge of governmental accounting and auditing—not just general financial backgrounds—are most desirable.

We have already stated that planning is crucial to effective procurement. We believe these officials with knowledge of, or experience in governmental accounting and auditing can help the entity plan and carry out its procurement process by such actions as identifying strategies to obtain competition, identifying the entity's audit requirements for its solicitation, helping develop specific technical factors and a selection approach, and encouraging the entity to develop a formal written agreement with the winning audit firm. These officials are in a good position to know the specific requirements of governmental auditing and, therefore, should know best how to solicit offers, evaluate proposals, and develop the written agreement that will help satisfy governmental auditing requirements.

Figure 3.1: Percent of Time Criteria for Four Attributes Were Met—With and Without the Presence of Financial Officials



Audit Committees Are an Effective Management Tool

The National Commission on Fraudulent Financial Reporting, chaired by James C. Treadway, Jr., issued an exposure draft in April 1987 that addresses factors that can lead to fraudulent financial reporting and recommends steps to reduce its incidence. In this report, the commission endorses the use of audit committees. The Commission states that audit committees should be mandated by the Securities and Exchange Commission to oversee the financial reporting process of all public companies. The Commission believes that an informed, diligent audit committee represents the single most potentially effective influence for minimizing fraudulent financial reporting and serves as an integral part of the internal controls of a company. The report states that one of the audit committee's responsibilities should be to assess the independence of the auditor and the auditor's review of the company's internal

accounting controls. The report suggests that members of the audit committee should be independent of the company and should be able to discuss financial and legal matters with company officials in an advisory capacity.

During discussions with experts on our panel, they repeatedly stated that audit committees could serve a very useful purpose in the public sector similar to the one they serve in conjunction with corporate entities, as discussed in the commission's draft report. Experts believed that in addition to overseeing entities' financial operations, audit committees can play an important role in assisting entities with planning and implementing their procurement processes.

Experts strongly recommended the use of audit committees and stated that they are effective in both large and small engagements. Further, experts have recommended that audit committees be used to

- participate in the entity's procurement process, including planning the procurement and identifying and evaluating potential bidders;
- participate in evaluating audit firms using preestablished technical factors;
- provide active oversight of the entity's procurement process;
- conduct ongoing monitoring to ensure that the terms of the contract are met; and
- review audit results and assist in postaudit quality evaluation.

We endorse the concept of audit committees, as recommended by experts on our panel. We believe, and experts agree, that audit committees can provide the broadest perspective and a greater range of assistance if they possess technical skills in accounting and auditing and expertise in the area of governmental contracting. However, some of these experts believed that audit committees lose their effectiveness if committee members do not have sufficient specialized training or if any are perceived as not being independent.

The National Association of Accountants is currently spearheading a project to establish independent advisory audit committees in municipalities among its 320 chapters around the country. This project focuses on using local citizens with knowledge of financial controls and reporting. Its aim is to assist local municipal entities in providing "useful financial information which will keep government expenditures under control."

Small Engagements Are More Vulnerable

Our analysis showed that there are differences among the procurement practices of entities with large, medium, small, and very small engagement fees and that smaller procurements were more vulnerable to ineffective procurement practices than were large engagements.

For our study, we define a "very small" procurement as one with an engagement fee of less than \$1,000, and a "small" procurement as having an engagement fee of between \$1,000 and \$10,000. (OMB circular A-102, attachment 0, and many state regulations define small purchases as those under \$10,000.) Further, we define a medium procurement to be between \$10,000 and \$75,000, and a large procurement to be greater than \$75,000. About half of the entities in our universe had very small or small procurements, while the other half met our definition of medium or large procurements.

Table 3.1 shows the relationship between the size of the engagement and the extent to which the entity met the criteria for all four attributes. The table shows that the smaller the engagement, the more likely the entity will not meet all of the procurement criteria. We believe that this occurs primarily for two reasons—first, our data show that small procurements are more often lacking adequate and knowledgeable personnel during the process, and, secondly, as reported in our March 1986 report, small engagements are often let to smaller audit firms, which have traditionally had more difficulty complying with professional audit standards.

Table 3.1: Percent of Entities in Our Universe Which Met the Criteria for All Four Attributes

	Size of engagement ^a			
	Very small	Small	Medium	Large
Percent of entities in universe	7	44	42	7
Percent meeting criteria for all four attributes	12	17	76	82

^aVery small (under \$1,000); small (\$1,000-\$10,000); medium (\$10,000-\$75,000); and large (over \$75,000).

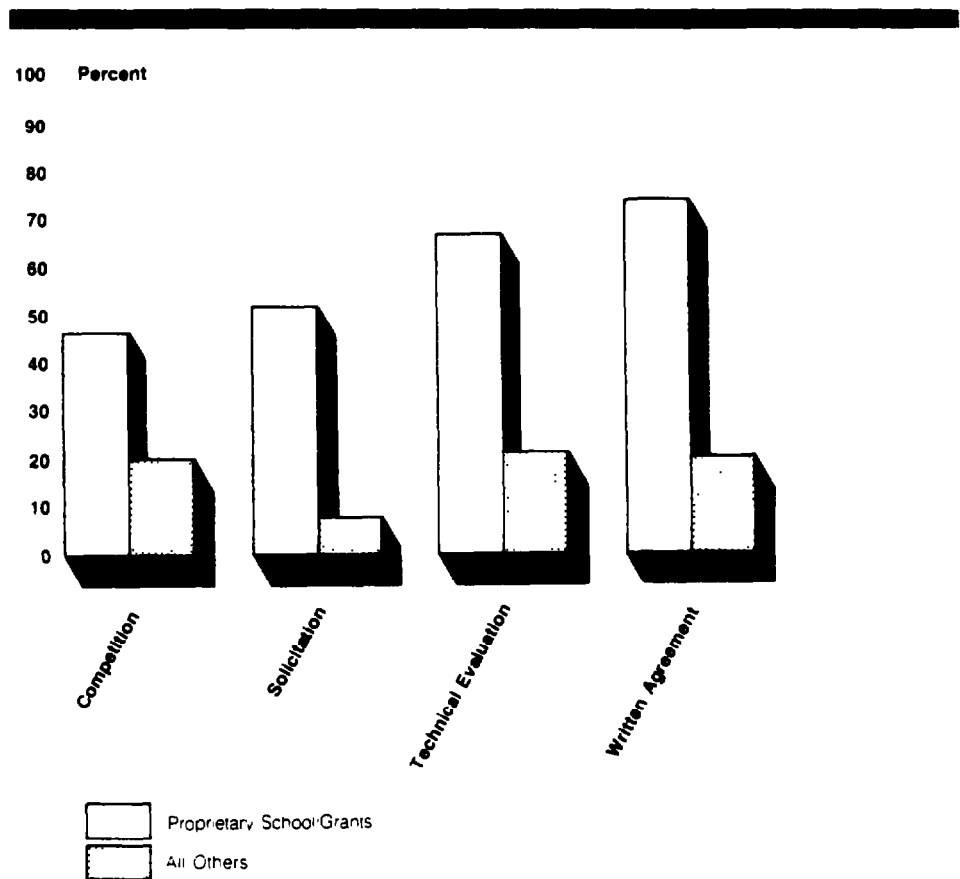
Type of Entity Relates to Procurement Effectiveness

We found that individual grant programs and proprietary schools were both much more likely to not meet the procurement criteria than were other types of entities. According to the questionnaire responses, individual grant recipients most frequently consisted of head start grants and community action agencies, while proprietary schools consisted of vocational and technical institutions, such as beauty and business schools. (See appendix I for a listing of other types of entities.)

Our analysis of questionnaire responses showed that these entities more often had very small or small engagement fees, which we have shown are more vulnerable to ineffective procurement practices. Further, we believe these entities were more at risk because, as our questionnaire data show, they had a financial official assisting in planning the procurement process only about 20 percent of the time, while other entities in our universe had such assistance 40 percent of the time.

Figure 3.2 shows the extent to which proprietary schools and grant entities did not meet the four procurement criteria, as compared to the rest of the population.

Figure 3.2: Proprietary Schools and Grant Entities Versus Other Entities in Our Universe—Percent That Do Not Meet the Procurement Criteria



Conclusions and Recommendations

Our analyses showed that when persons knowledgeable about governmental accounting and auditing assist the entity in planning and implementing its procurement process, the entity is much more likely to meet the criteria for the four critical attributes. We also found that certain types of entities and those with small engagement fees are more likely to have ineffective procurement processes, that is, processes that do not meet the procurement criteria. We believe entities should recognize these trends and, where feasible, take steps to ensure that their procurement processes incorporate the four critical attributes. In addition, experts believe that audit committees can play an important role in assisting entities, both large and small, with planning and implementing their procurement processes. While we did not do a detailed analysis of the impact of audit committees, we agree with this concept.

Accordingly, we recommend that entities:

- Ensure that qualified technical people—those with knowledge of governmental accounting and auditing—are involved in the procurement process. This is especially important for entities with small audit engagements and certain types of entities, such as individual grant programs and proprietary schools, which seem to be most vulnerable to receiving unacceptable quality audits. Qualified people should have knowledge in the technical aspects of governmental accounting, auditing, and contracting. Entities may be able to gain the assistance of such professionals by using in-house resources, skills of experts in the community, and audit committees.
- Consider the benefits of using audit committees, both to help plan and carry out the procurement and to act as an independent body to oversee the process.

Procurement Initiatives Are Continuing

The Single Audit Act of 1984 generally requires all entities receiving \$100,000 or more in federal funds to obtain an organizationwide audit of these funds. The act also requires entities which may have previously relied on federal auditors to obtain the services of independent auditors who are largely CPAs. As a result, the need for effective audit procurement practices by these entities has increased. Because entities currently have very little guidance and employ a wide variety of procurement techniques, guidance in the form of a procurement handbook could provide them with the means to more effectively procure audits. The report of the 1980 joint GAO and AICPA colloquium in Cherry Hill, New Jersey, recommended that a guide be published that would describe the types of procurement processes that are appropriate for obtaining audit services for various size engagements, as well as indicate when each should be used.

In 1980, the Western Intergovernmental Audit Forum published draft Guidelines for Preparation of Requests for Audit Proposals. The Forum recognized that a comprehensive request for proposal and a thorough, objective process for obtaining proposals can contribute significantly to the effectiveness of the audit procurement process and to the quality of the subsequent audit. This document has been widely used by state and local entities for the solicitation phase of audit procurements and revised over the years. However, in the hopes of securing a broader endorsement of the document, and thereby guaranteeing an even wider distribution, the National Forum has recently obtained comments on the document from other regional forums and organizations representing current and potential users of their "model" RFP. Although the National Forum's model provides suggested provisions for an audit RFP, the solicitation process is only one aspect of effectively obtaining audit services. Accordingly, thorough and objective guidance for the entire audit procurement process is still needed.

In March 1987, representatives of the Government Finance Officers Association, the National Association of State Auditors, Comptrollers and Treasurers, and other professional organizations involved in performing or procuring audits met with us to discuss the need for, and the possible avenues for developing, guidance on procuring audit services. Representatives from these organizations believe that this guidance should be in the form of a handbook which would contain a conceptual framework for procuring audit services similar to what we propose in chapter 2 of this report. However, since this framework provides general guidance, we and the representatives believe the handbook should

also include detailed procedures and checklists for entities to apply as appropriate to the size and specific circumstances of their audit.

We believe that such guidance would be an important vehicle to improving audit quality, and we applaud the initiatives of those groups that are desirous of developing this detailed handbook. We believe it can best be accomplished by all interested organizations working together under the auspices of an intergovernmental organization facilitating the project or by GAO leading the project with the assistance of an advisory committee.

Characteristics and Demographics of the Entities in Our Sample

The following figures describe the location and types of entities, the federal agency providing assistance funds, and the size of engagement fees for entities in our sample. We obtained these data from entities' responses to our questionnaire.

Figure I.1: Location of Entities—Region of Country

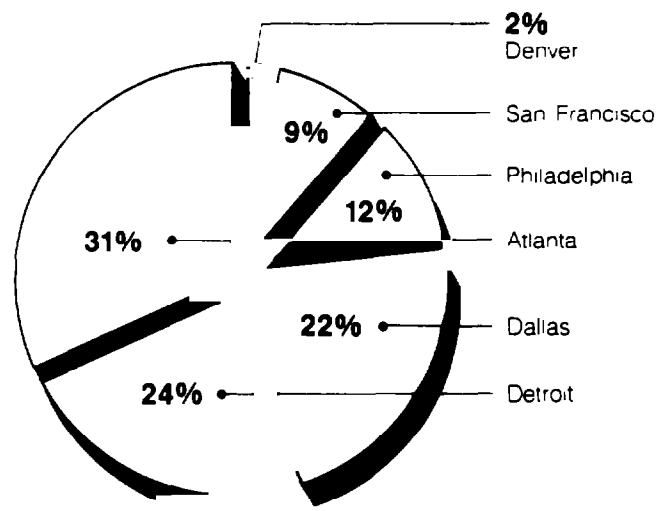
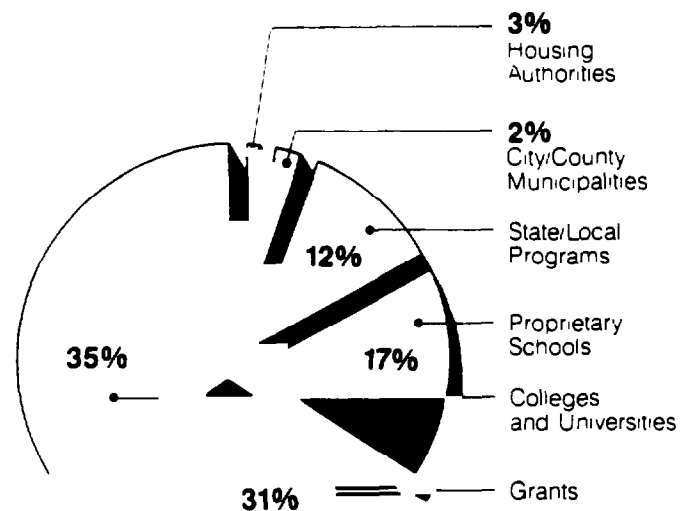


Figure I.2: Type of Contracting Entity



Appendix I
Characteristics and Demographics of the
Entities in Our Sample

Figure I.3: Entities by Federal Agency

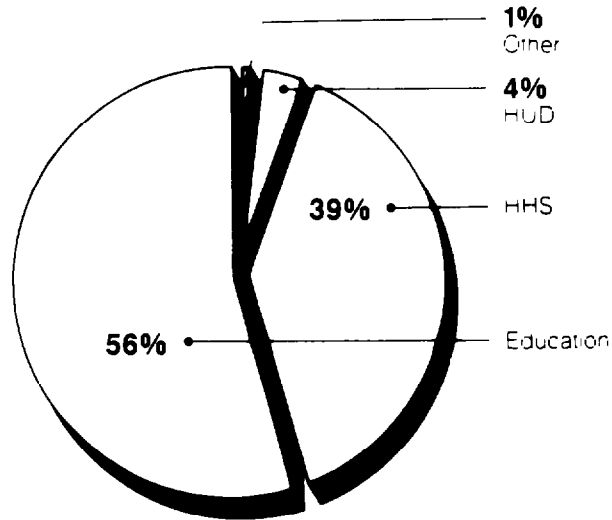
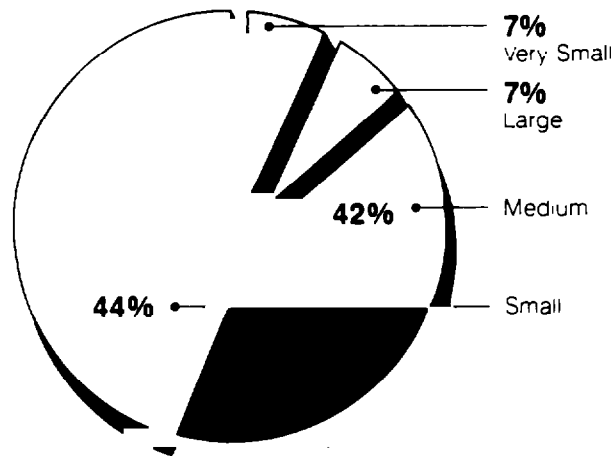


Figure I.4: Size of Engagement by Audit Fee



Sampling Errors for Statistical Projections

We used a statistical sample to determine whether there was an identifiable relationship between procurement and audit quality. We sent questionnaires to a random sample of 210 entities that contracted with a CPA for audit services and whose audit was subjected to a quality control review by the appropriate regional inspector general from October 1, 1984, through April 30, 1986. Questionnaire responses were subsequently weighted and are statistically projectable to an estimated universe of about 5,800 audits with a 95-percent level of confidence.

Statistical sampling enabled us to draw conclusions about our universe in this report based on information in the sample drawn from that universe and responses to our questionnaire. As with any statistical sample, the results of our sample are subject to some uncertainty, or sampling error, because only a portion of the universe has been selected for review and analysis and because not all of our 210 entities completed and returned the questionnaire.

The sampling error consists of two parts: confidence level and range. Our sample was designed so that the statistics derived from it could be projected to the estimated universe with a 95-percent level of confidence that each statistic falls within a given range.

Table II.1 presents the sampling errors for the major projections in the report. It shows the reference on which the statistic is based, its location in the report, the projected statistic to the estimated universe, and the associated range of sampling error.

**Appendix II
Sampling Errors for Statistical Projections**

Table II.1: Sampling Errors

Report chapter and reference	Percent	
	GAO statistic	Range of related sampling error
Chapter 2:		
Entities in our universe that		
Did not meet all critical attributes	58	47–69
Had an ineffective procurement process and an unacceptable audit	46	33–59
Had an effective procurement process and an unacceptable audit	17	11–23
Did not meet competition criteria	33	20–46
Did not meet competition criteria and had an unacceptable audit	59	46–72
Met competition criteria and had an unacceptable audit	21	11–31
Did not meet solicitation criteria	29	25–33
Did not meet solicitation criteria and had an unacceptable audit	55	42–68
Met solicitation criteria and had an unacceptable audit	25	15–35
Did not meet technical evaluation criteria	43	38–48
Did not meet technical evaluation criteria and had an unacceptable audit	49	36–62
Met technical evaluation criteria and had an unacceptable audit	23	11–35
Did not meet written agreement criteria	46	42–50
Did not meet written agreement criteria and had an unacceptable audit	45	37–73
Met written agreement criteria and had an unacceptable audit	24	12–36
Chapter 3:		
Entities in our universe that		
Met competition criteria with a financial official present	81	67–95
Met competition criteria with no financial official present	35	11–59
Met solicitation criteria with a financial official present	82	72–92
Met solicitation criteria with no financial official present	45	39–71
Met technical evaluation criteria with a financial official present	66	56–76
Met technical evaluation criteria with no financial official present	36	11–61
Met written agreement criteria with financial official present	63	53–73
Met written agreement criteria with no financial official present	32	9–55

(continued)

Appendix II
Sampling Errors for Statistical Projections

Report chapter and reference	Percent	
	GAO statistic	Range relative sampling error
Size and type of entities.		
Very small entities	7	4-
Small entities	44	38-
Medium entities	42	34-
Large entities	7	1-
Very small entities with an acceptable procurement process	12	3-
Small entities with an acceptable procurement process	17	7-
Medium entities with an acceptable procurement process	76	58-
Frequency that proprietary schools used a financial official in procurement process	20	7-
Frequency that all other entities used a financial official in procurement process	40	32-
Large entities with an acceptable procurement process	82	50-
Proprietary schools that did not meet competition criteria	47	20-
All other entities that did not meet competition criteria	19	12-
Proprietary schools that did not meet solicitation criteria	52	45-
All other entities that did not meet solicitation criteria	8	3-1
Proprietary schools that did not meet technical evaluation criteria	67	58-7
All other entities that did not meet technical evaluation criteria	21	13-2
Proprietary schools that did not meet written agreement criteria	74	64-8
All other entities that did not meet written agreement criteria	20	12-2

Selected Case Examples

During our fieldwork, we found cases where entities did not meet the four critical attributes for an effective audit procurement process. From this group, we selected 36 detailed case studies where we visited the contracting entity, the winning CPA firm which performed the audit, and the appropriate RIG charged with responsibility for ensuring audit quality. We considered factors such as the location and type of entity and the size and type of audit in selecting the 36 audits for detailed review.

In documenting these cases, we found that there could have been many other factors—some not even related to procurement—that would contribute to an entity receiving an unacceptable quality audit. However, we believe that an entity increases the likelihood of receiving a quality audit at a fair price when it incorporates our framework of the four critical attributes in its audit procurement process.

These case examples illustrate some of the problems that entities encountered when they did not use effective procurement practices. Two examples addressing each of the four attributes follow.

Competition

- A junior college in Pennsylvania paid about \$7,500 for an audit of its student financial assistance grant for a 2-year period. The college did not promote competition, but instead, hired the same CPA firm it had used for over 15 years. The college's director of finance stated that he used the same CPA firm because the college was satisfied with the firm's services and quality of work. The Department of Education RIG subsequently performed a quality control review on this audit and found it to be unacceptable.
- A city in California selected the prior year's CPA firm, on a noncompetitive negotiated basis, to perform its organizationwide audit. The city's finance director telephoned the CPA firm to advise it that the city required an audit and asked it to prepare and submit an audit proposal and fee to be approved by the city council. In addition to not obtaining competition, the city did not comply with OMB circular A-102, attachment O, which requires entities to obtain the federal agency's approval when negotiating contracts over \$10,000 on a noncompetitive basis. The cost of this audit was \$45,700. The RIG's quality control review showed that the firm's audit work was unacceptable.

Solicitation

- In Michigan, a community action agency executive director sent an RFP to five CPA firms requesting technical proposals for an upcoming audit of

their head start program. The RFP did not address many of the provisions needed for an effective technical response, such as: (1) a description of the contracting entity, (2) the specific audit guide or audit program to be followed, (3) the audit standards to be followed, and (4) the period to be audited. A representative of the winning firm who had previously audited the entity subsequently told us that the RFP did not provide enough information for any CPA to adequately respond to the request who was not already familiar with the program, thereby making his firm the only choice. This audit was quality control reviewed by the HHS RIG and determined to be unacceptable.

- In Ohio, a public health center used an RFP to obtain technical proposals from CPA firms. The RFP, which contained only minimal information, was sent to six CPA firms. Similar to the previous example, the RFP did not address many of the basic provisions of an effective solicitation document. The RFP also did not provide for any type of meeting where the firms could obtain clarification or additional information. Only one CPA firm responded to the RFP, and its engagement partner later told us that the RFP did not adequately communicate the entity's audit needs or provide sufficient information to adequately prepare a technical proposal. As a result, before submitting its proposal, the firm had to do preliminary work to determine the condition of the entity's financial records and assess the actual scope of the audit. After completing the preliminary work, the CPA commenced the engagement and performed an acceptable quality audit.

Technical Evaluation

- A small housing authority in Georgia notified five CPA firms about an upcoming audit and asked them to submit proposals by signing a "Model Form of Proposal and Contract Between Public Housing Agency and Independent Public Accountant for Audit Services" and inserting a price bid. This standard form did not require proposing firms to include any information on their technical qualifications. Instead, the firm's cost proposal was the only factor in selecting the audit firm. Two firms responded to the solicitation, and the contract was awarded to the CPA firm with the lowest bid. The audit was subsequently quality control reviewed by the HUD RIG and was deemed to be unacceptable in many areas. The CPA who performed the audit told us that he probably would not have been awarded the contract had consideration been given to the firm's past governmental experience because he was not very knowledgeable about how to perform a housing authority audit.
- A state human services department in the Denver region procured its organizationwide single audit using guidance provided by OMB to cover two consecutive 1-year periods. The RFP was comprehensive and

requested audit firms to submit evidence of qualifications such as (1) the proposer's experience as it related to this audit, (2) resumes of staff that would be assigned to the audit, (3) the proposed audit approach, and (4) references from other clients. Although the entity received responses from five audit firms, it did not consider the firms' qualifications; instead, it appears that it selected the audit firm almost exclusively on cost. The HHS RIG subsequently found the audit to be unacceptable based on its quality control review. The RIG stated that the CPA firm that performed the audit could not have been fully aware of all audit requirements and that the firm's low bid did not provide for enough labor hours to produce a quality audit. The engagement fee was estimated at \$25,200, and the audit report was released by the RIG more than 15 months after the report date with a recommendation from the RIG that federal users place no reliance on it.

Written Agreement

- The owner of a vocational college in New Mexico obtained an audit of its student financial assistance grant for a 3-year period. The entity official did this by contacting a former employee of the CPA firm which had previously been on retainer. The procurement did not result in any type of written agreement—neither an engagement letter with provisions protecting the entity and the auditor nor a contract signed by both parties. Both the CPA and entity official told us that all agreements were verbal. After performing a quality control review of the audit, the Department of Education RIG determined that the audit was of unacceptable quality, mainly due to the fact that it omitted one of the loan programs. At the time of our review, the entity had not paid the CPA its \$800 audit fee and, because there was no written contract, cannot require the firm to complete work on the omitted loan program. On the other hand, the CPA has been unsuccessful in obtaining its engagement fee because it cannot prove that the work performed was all that it contracted to provide.
- An education institution in Florida was required to obtain an organizationwide audit of its federal assistance funds in accordance with OMB circular A-110. The entity officials responsible for obtaining the audit contracted with the same CPA firm which had prepared the institution's general purpose financial statements since 1972. The entity did not prepare a contractual document setting forth the terms and conditions for the audit of its federal assistance funds, and an engagement letter for the audit was not prepared until several months after the audit was completed. The engagement letter, backdated 5 months, did not specify that the auditor would review internal controls and compliance with laws and regulations and issue reports thereon. It also did not contain such provisions for recourse in the event of substandard work, contract

**Appendix III
Selected Case Examples**

termination, or administrative and/or legal remedies for contract violations. Based on deficiencies noted by the HHS RIG in its quality control review, the audit firm voluntarily retracted and reissued the audit report after performing additional fieldwork.

Suggested Provisions for Solicitation Documents

Regardless of the type of solicitation document used, entities can increase the likelihood of obtaining a quality audit when the solicitation document is comprehensive and accurately conveys all the details and requirements of the audit. The following represents a list of suggested provisions that we believe entities should include in any solicitation document. Although these provisions should be present, the extent to which the entity elaborates on them should coincide with the size of the audit engagement and procurement method used.

(1) Administrative Information:

- background information on the entity;
- schedule of government funds by project or grant to be audited;
- description and magnitude of the entity's accounting records;
- description of the entity's computer system(s), if applicable;
- name and number of a contact person at the cognizant federal agency;
- period to be audited;
- term of contract engagement; and
- availability of prior audit reports and working papers.

(2) Work and Reporting Requirements:

- auditing standards to be followed;
- extent to which entity would assist firm;
- specific scope of audit work to be performed;
- number and types of reports required;
- list of restrictions, such as copy services or work space;
- exit conference requirements;
- specific audit guide or program to be followed; and
- minimum audit requirements under applicable laws such as the Single Audit Act.

(3) Time Requirements:

- date records would be ready for audit;
- dates for completing interim phases, such as fieldwork completion and draft report preparation;
- date of contract award;
- date final report is due;
- working paper retention requirements; and
- workpaper availability requirements for cognizant agency when applicable.

**Appendix IV
Suggested Provisions for
Solicitation Documents**

(4) Proposal Information:

- evaluation criteria against which the proposal will be judged and
- entity's right to reject proposal.

(5) Contractual Information:

- provision stipulating recourse in the event of poor quality work,
- provision for Equal Employment Opportunity,
- provision for termination of contract, and
- provision for administrative and/or legal remedies for contract violations.

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