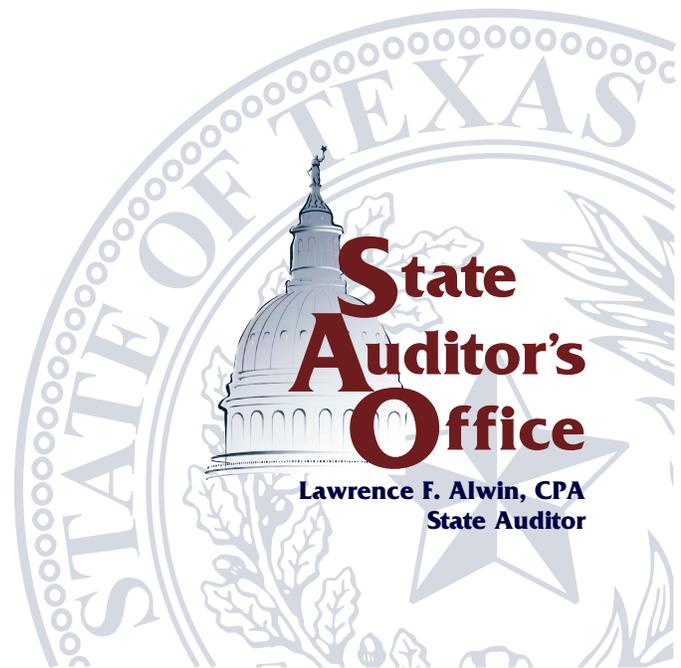


Financial Statement Opinion Audit

# Guide for Texas Public Community Colleges

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## Overview

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### What is the purpose of this guide?

The purpose of this guide is to help governing boards and college management ensure that their Texas public community colleges receive high-quality opinion audits on annual financial statements. The Texas Higher Education Coordinating Board cited numerous instances of noncompliance with reporting requirements, inappropriate classification of accounts and reporting that is not in accordance with generally accepted accounting principles receiving unqualified opinions. This guide is also intended to alert the users to certain federal and state audit requirements.

This guide includes the following information:

- General description of the audit process
- Recommendations for good business practices in the annual financial statement opinion audit process, in particular, procuring audit services
- Descriptions of each participant's responsibilities in the audit process

Rather than duplicate the efforts of other authoritative literature, this guide presents information at a summarized level. A list of more detailed resources appears in Appendix B.

In *Selecting an Auditor*, the National Association of College and University Business Officers (NACUBO) cites several reasons for considering a change of auditors:

- Problems/dissatisfaction with the current auditor
- Planned rotation
- Desire for fresh outlook
- Availability of other services
- Fee considerations

### How can community colleges help ensure that they receive a high-quality audit?

Governing boards and management of public community colleges should encourage the implementation of the following good business practices:

- Monitor the results of the audit as it progresses. Even when colleges use sound procurement processes, they should monitor auditor progress to ensure that external auditors fulfill their contractual obligations and that the college receives a high-quality audit (see "The Audit Process" on page 3).
- Use an audit committee to help the governing board fulfill its responsibilities to its constituents, the State, and other parties. The audit committee is a liaison

between the full board, management, and the internal and external auditors (see “Responsibilities in the Audit Process” on page 23).

- Carefully assess procurement practices for audit services and incorporate the four critical elements (competition, solicitation, technical evaluation, and written agreements) of an effective process as identified by the United States General Accounting Office (GAO). By incorporating these elements, community colleges can significantly increase the probability that they will receive a high-quality audit, according to a 1987 GAO research report (GAO Report No. AFMD-87-34, August 1987). (See “Effect of the Procurement Process on Audit Quality” on page 32.)

Continued monitoring throughout the audit, increased use of audit committees, and inclusion of the four critical factors during the procurement cycle should result in community colleges’ receiving high-quality audits. These actions will also increase the accountability of governing boards, college management, and external auditors.

Although this guide provides information about the annual financial statement opinion audit process and compliance with the Texas Public Funds Investment Act, management may also consider procuring additional audit services, either internally or externally, to identify opportunities to improve efficiency. Other types of audits include operational, efficiency, compliance, and investigative audits.

## The Audit Process

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### The Annual Financial Statement Opinion Audit

#### What is an annual financial statement opinion audit?

In an annual financial statement opinion audit, auditors (or an audit organization) render an opinion about a college's financial statements. The auditors must determine whether the financial statements fairly and accurately present the college's financial position and the results of college operations as of a given date. This opinion helps the general public, board members, donors, and creditors make decisions about the college.

#### Relevant Auditing and Accounting Standards Used in Financial Statement Opinion Audits

- Generally accepted accounting principles (GAAP)
- Governmental Accounting Standards Board (GASB)
- Generally accepted auditing standards (GAAS)
- Generally accepted government auditing standards (GAGAS)
- American Institute of Certified Public Accountants (AICPA) *Professional Standards*

The terms “fairly” and “accurately” are presented within the framework of generally accepted accounting principles. Fairness is based on the auditors' judgment of whether:

- The college's statements are appropriate and in an accepted format.
- The college used appropriate accounting principles.
- The annual financial statements, including the

related notes, are informative of matters that may affect their use, understanding, and interpretation.

- The information presented in the annual financial statements is neither too detailed nor too general, but is reasonably classified and summarized.
- The annual financial statements reflect the underlying transactions and events in a manner that presents the financial position and results of operations stated within limits that are reasonable and attainable in financial statements.

There are four types of opinions auditors can render when performing an annual financial statement opinion audit:

- **Unqualified.** The auditors believe that the college's financial statements fairly and accurately present its financial position and results of college operations as of a given date.
- **Qualified.** The auditors believe that the college's financial statements fairly and accurately present its financial position and results of college operations as of a given date, with one or a few exceptions. Financial statement exceptions include departures from generally accepted accounting principles, inconsistent application of accounting principles, or uncertainties affecting the financial statements that cannot be satisfactorily resolved.
- **Adverse.** The auditors believe that the college's financial statements do not fairly and accurately present its financial position and results of college operations as of a given date.

- **Disclaimer of Opinion.** The auditors cannot express an opinion on the financial statements because something has prevented them from gathering enough information to determine what opinion they should render.

#### Alternative Types of Audits

An annual financial statement opinion audit focuses on the financial statements of an institution and is therefore limited in its scope. It is not intended to evaluate management's effectiveness, efficiency, or performance.

Other types of audits are used to assess these issues. These audits include:

- **Operational audits** (also called performance or management audits) focus on the institution's internal control systems, how well an institution follows its own policies and procedures for recording transactions and maintaining records, and how well the institution is achieving its stated mission and goals.
- **Efficiency audits** focus on the detection and prevention of waste.
- **Compliance audits** focus on adherence to institutional policies and procedures, applicable laws and regulations, and terms of contracts.
- **Investigative audits** focus on the detection of financial abuses and are usually based on allegations or suspicions of fraud or misappropriation of funds. (Usually, there is no advance notification of an investigative audit.)

All opinions that are not unqualified require further explanation of the details prohibiting the unqualified opinion. This detail is communicated through the auditors' report.

During an annual financial statement opinion audit, auditors consider materiality. Materiality recognizes that some financial issues (when considered individually or together) are important enough to be considered in evaluating *fair presentation of financial statements*, while other issues are not. When auditors render an unqualified opinion, they believe that the financial statements are not materially misstated and can therefore be relied on by interested parties. The knowledge auditors gain through formal training and experience helps ensure that their opinions are appropriate.

Although an institution may receive an unqualified opinion in an annual financial statement opinion audit, there may still be concerns or problems in the institution's management system. For Texas public community colleges, this means that although their financial statements receive an unqualified opinion, internal control weaknesses or inefficiencies may exist. The contracting college should expect the auditors to bring to management and the audit committee details regarding internal control weaknesses, suspected and/or actual incidences of fraud, violations of provisions of contracts or grant agreements, and abuse that they become aware of during the audit. Management of the audited entity is responsible for taking timely and appropriate steps to remedy fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that auditors report to it. Colleges may wish to use other types of audits (see text box) to identify opportunities for improvement and to identify weaknesses. Other services that may be contracted include but are not limited to:

- Evaluation of internal control.
- Evaluation of software systems.
- Evaluation of the internal audit function.
- Accounting/financial advice.
- Management consulting.

However, the auditor must ensure that there is independence in fact and appearance.

## What are the steps in the financial statement opinion audit process?

There are 10 steps in the annual financial statement opinion audit process to consider. The first four steps relate to the contracting process a community college should generally follow in procuring audit services. Steps five through eight cover the actual audit procedures and considerations that will result in the external auditors' opinion on the fair presentation of the financial statements. The last two steps detail how the auditors communicate the results of their audit work to the governing board and how these results should be used.

Although the time that auditors actually spend at an institution may be only a few weeks, the steps taken to get the auditors to the campus and then review the results should take much longer. The following sections specifically explain each step in the financial statement opinion audit cycle, highlighting the responsible parties.

## Contracting for Audit Services

Contracting for annual financial statement opinion audits is a cyclical process. Experiences from previous audits feed into the next cycle's planning and procurement phases.

### Step 1a: Prepare to Procure Audit Services

Because governmental auditing differs from audits of public companies in many respects, governing boards must ensure that their procurement processes result in contracts with independent auditors who comply with local, state, and federal requirements. Careful planning will ensure that the auditors' services match the college's needs. Those people responsible for procuring audit services should consider the following steps, as outlined in the Government Finance Officers Association's *Audit Management Handbook*:

- Research state and local requirements to determine whether they are applicable. The State requires that community colleges submit audited financial statements annually. The State also requires annual reviews by independent auditors of certain investments by community colleges. Local requirements may include financial or performance audits. The governing board and management should determine which audit requirements apply. They should also determine whether they could benefit from additional audits that are not necessarily required.
- Determine legal and regulatory requirements applicable to the audit procurement process. Local, state, and federal laws often regulate the procurement of audit services. The governing board and management should determine whether the local, state, or federal governments legally mandate how the college can solicit proposals and contract for audit services.
- Determine whether the college is subject to the provisions of the Single Audit Act. The United States Office of Management and Budget (OMB) and the Single Audit Act establish detailed audit requirements for institutions receiving federal funds. Recipients of federal assistance are required to undergo an audit of those federal funds when expenditures from federal funds total \$500,000 in any fiscal

year. (See OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.)

- Define the institution to be audited. The governing board and management should determine what components or divisions are included in the reporting institution to be audited. The reporting institution may contain legally separate institutions in the college's financial statements if these separate institutions are component units of the college. The governing board and management should consider multiple criteria when determining whether component units of the college exist. (Refer to Governmental Accounting Standards Board Statement No. 39 – Determining Whether Certain Organizations are Component Units and Statement No. 14 – Financial Reporting Entity for guidance. Statement No. 39 provides amendments to Statement No. 14.)
- Determine whether the auditor will be required to report on financial statements prepared on a basis other than generally accepted accounting principles. The college may have to submit additional financial statements prepared on a basis of accounting other than generally accepted accounting principles to comply with legal requirements. The governing board and management should determine whether statements and schedules prepared according to principles that are other than generally accepted accounting principles need to be included in the scope of the audit.
- Define the relative audit scope of each audit firm if more than one firm is to be engaged or relied upon. There is no requirement that a single audit firm perform an entire audit of a college's financial statements. Although the common practice in community colleges is to retain a single auditor or firm, the governing board could elect to hire multiple auditors to perform different parts of an audit. If multiple auditors are contracted, the governing board should designate one of the auditors as the principal auditor or firm. The principal audit firm is the only firm that can express an opinion on the financial statements for the institution as a whole. The board should take care to minimize overlapping coverage.
- Determine how the institution can assist the auditors. Community colleges can limit audit costs by assisting the auditors. If a college plans to do this, it must provide the promised assistance in a timely manner and ensure that someone at the college has clear responsibility for coordinating the assistance. Colleges can provide the following:
  - ♦ Internal audit support
  - ♦ Clerical support
  - ♦ Electronic data processing
  - ♦ Use of specialists
  - ♦ Collection of documentation prior to the audit
  - ♦ Preparation of the financial statements

- ◆ Access to workspace
- ◆ Communication equipment
- ◆ Use of audit contacts to help the external auditors address inquiries
- Establish time lines for auditor reporting and preparation of the financial statements. The Texas Higher Education Coordinating Board (Coordinating Board) requires that colleges submit audited financial statements by January 1 every year. In addition, there may be federal or local deadlines. To ensure that all deadlines are met, the officials planning the audit must establish an ongoing timetable so that delays are identified and corrected quickly. Some institutions require periodic status reports from their external auditors so that the financial statements can be issued in a timely manner. The governing board should also establish a schedule for the college's own preparation of the annual financial report.
- Establish the procedures for selecting the external auditor. The process used to select an external auditor should be both systematic and well documented. The process should ensure that the audit meets legal requirements and that the auditor qualifications meet quality standards. Essentially, at least three factors should be considered when selecting external auditors: their qualifications, the audit approach to be followed, and the price. At no time should a college select an auditor based on price alone. Price should be used to select between equally qualified audit firms providing similar services. The selection process should place the most weight on an auditor's qualifications, while ensuring that legal requirements are met.

### Step 1b: Consider the Public Funds Investment Act

#### Texas Government Code, Section 2256.005(n)

Except as provided by Subsection (o), at least once every two years a state agency shall arrange for a compliance audit of management controls on investments and adherence to the agency's established investment policies. The compliance audit shall be performed by the agency's internal auditor or by a private auditor employed in the manner provided by Section 321.020. Not later than January 1 of each even-numbered year, a state agency shall report the results of the most recent audit performed under this subsection to the state auditor.... The state auditor may, based on its review, require a state agency to also report to the state auditor other information the state auditor determines necessary to assess compliance with the laws and policies applicable to state agency investments. A report under this subsection shall be prepared in a manner the state auditor prescribes.

#### Texas Government Code, Section 2256.023(d)

If an entity invests in other than money market mutual funds, investment pools or accounts offered by its depository bank in the form of certificates of deposit, or money market accounts or similar accounts, the reports prepared by the investment officers under this section shall be formally reviewed at least annually by an independent auditor, and the result of the review shall be reported to the governing body by that auditor.

Community colleges should consider requesting the external auditor's services in their efforts to comply with the Public Funds Investment Act while they are performing the annual financial audit.

The Public Funds Investment Act, Section 2256.005(n), requires community colleges to provide investment information to the State Auditor's Office, and Section 2256.023(d) requires an annual review of the quarterly reports by an independent auditor for certain types of investments (see text box).

To assist in compliance with the act, the State Auditor's Office provides assistance for external auditors on its Web site at <http://www.sao.state.tx.us/intaud/pubfunds.cfm>. This Web site provides a full compliance audit program, the prescribed format for submitting the annual investment report, and other Coordinating Board reporting requirements.

*Note: No allowances are made for compliance with the Public Funds Investment Act due to materiality.*

## Step 2: Prepare a Request for Proposal (RFP) and Solicit Responses

A governing board should consider the following steps as outlined in the Government Finance Officers Association's *Audit Management Handbook*:

- Describe how the proposals will be evaluated. If the RFP clearly indicates that quality and price will be considered in selecting the audit firm, high-quality firms may be more inclined to submit proposals. A college may go as far as explaining the risk-ranking methodology used to evaluate proposals, the personnel that will evaluate the proposals, and the minimum qualifications that will be considered. By outlining minimum qualifications, the governing board is more likely to receive proposals from competent firms.
- Provide information on how an audit firm should make its proposal. The RFP should indicate how the proposal should be formatted. If the same format is required of all proposals, then it will be easier to compare proposals from different audit firms. Also, the RFP should indicate whether the governing board will hold a pre-proposal conference to answer questions from potential bidders. A pre-proposal conference allows the governing board to answer most bidders' questions at once. Finally, the RFP should clearly outline timeframes for the submission and evaluation of proposals.
- Describe the community college and its accounting structure. Potential bidders need to know whether they have the expertise and resources necessary to complete the audit within required timeframes. Helpful information to provide includes the following:
  - ♦ The institution's organizational structure
  - ♦ The institution's fund structure and basis of accounting
  - ♦ Whether the audit needs to include federal and state financial assistance
  - ♦ Whether the institution maintains a pension plan
  - ♦ Whether component units and joint ventures exist
  - ♦ The complexity of the institution's electronic data processing activities
  - ♦ Whether the institution maintains an internal audit function
  - ♦ Whether prior year reports exist and where they can be located
  - ♦ Auditing and reporting requirements of the Texas Public Funds Investment Act
- Describe known weaknesses in the college's internal controls. The RFP should contain a complete list of all audit findings from the previous year's audit report,

even if findings are resolved prior to the release of the RFP. This helps the audit firm evaluate the complexity of the audit.

- Describe potential problems that may arise from new accounting standards or legal requirements. New accounting standards are often difficult and costly to implement. Potential bidders need to be aware of developments that could significantly affect the scope of their work.
- Provide information on the auditors' principal contacts inside and outside the college. It would be helpful for potential bidders to know who they are expected to work with during the engagement. Examples of contacts include the chief financial officer of the college, members of the audit committee, the director of internal audit, legal counsel for the college, the Coordinating Board, and the State Auditor's Office. In addition, there may be contacts stemming from federal or local laws.
- Describe the auditing standards required for the engagement. The RFP should state that the audit is to be conducted in accordance with generally accepted auditing standards, as well as generally accepted government auditing standards. If the college must receive a single audit for federal funds, the external auditors must follow standards established by the United States Office of Management and Budget. Any state or local requirements should also be disclosed. This information allows potential bidders to determine whether they are qualified to perform the audit.
- Describe the auditors' specific reporting requirements. Although auditing standards dictate most of the auditors' reporting duties, the RFP should reiterate the required reports to lessen the chance of misunderstanding. The auditors have reporting requirements in the following areas:
  - ♦ Auditors' report
  - ♦ Reportable conditions
  - ♦ Non-reportable conditions
  - ♦ Nonmaterial instances of noncompliance
  - ♦ Fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse
  - ♦ Other matters to be brought to the attention of the board
- Describe the required audit timetable and audit deliverables. The RFP should include the deadlines established during audit planning, including the latest acceptable dates for the entrance conference, the completion of interim and year-end fieldwork, the submission of audit adjustments and draft findings, the exit conference, and the issuance of the audit report. This information will allow potential bidders to determine whether they have sufficient resources to complete the audit on time.

- Describe additional services required of the auditor. If the college desires any non-audit services, such as assistance in drafting the financial statements, they should be clearly described in the RFP. This will help prevent miscommunication, especially if the college changes auditors. Requesting additional services may hinder competition; qualified firms may be unwilling to provide additional services. If the external auditors perform certain non-audit services for a college, the 2003 Revision to *Government Auditing Standards* may preclude them from performing a financial audit for the same college.
- Describe any assistance that will be available to the auditors. The RFP should indicate whether the college plans to provide assistance to the external auditors, such as furnishing workspace and office equipment to the audit staff. By furnishing clerical support, internal audit support, or other types of assistance, the college may lower its audit costs. If the college wishes to place restrictions on the audit staff, such as using computer equipment at low demand times or requiring the auditors to meter photocopying, these requirements should be disclosed in the RFP. The RFP should also state when schedules prepared by the college will be provided to the auditors.
- Describe the procedures necessary to determine whether additional audit work is needed and the fee basis for such work. The final price bid establishes the maximum amount that the college will pay for the audit work described in the RFP. In some instances, the scope of an audit must be expanded based on weaknesses uncovered in the audit. It is essential that the RFP dictate that the audit scope can only be expanded with express written consent of the college. The RFP should also require that the audit firm provide a revised fee proposal for any additional fieldwork.
- Describe specific information needed to evaluate the proposals. The RFP should request the following information from bidding audit firms to determine whether they satisfy quality thresholds:
  - ♦ Description of the audit firm
  - ♦ Qualifications of audit staff assigned to the engagement
  - ♦ Circumstances under which audit staff can be changed
  - ♦ Ability of the governing board to approve or reject audit staff replacements
  - ♦ Additional relevant information about audit staff qualifications
- Require a statement from the auditors that they meet the appropriate criteria for independence. The RFP should require the auditors to provide formal statements indicating that they are independent of the college and any material component units, in fact and appearance, according to standards established by generally accepted auditing standards or generally accepted government auditing standards as appropriate.
- Request references from other governmental clients. The RFP should ask bidding firms to supply the names of other institutions where they have recently

performed similar audits if the college intends to use references as part of the evaluation process. The proposal should also provide the name of a contact person at each institution so that the college can verify the quality of the audit work performed. If the college does not use references as part of the evaluation process, the RFP should not require that references be provided.

- **Request information on prior peer reviews.** Generally accepted government auditing standards require firms that audit governmental units to undergo external peer reviews every three years. The RFP should require bidders to supply the results of their latest peer reviews and to indicate whether these peer reviews examined fieldwork performed on governmental audits. In addition, the RFP should require the auditors to provide the results of any desk reviews or field reviews performed by federal, state, or local agencies.
- **Request the status of any disciplinary action taken against the firm.** The State Board of Public Accountancy regulates the Certified Public Accountant (CPA) profession in Texas. Additionally, the American Institute of Certified Public Accountants (AICPA) has the ability to take action against audit firms or individuals that engage in unethical practices or perform substandard work. The RFP should require bidders to disclose any disciplinary action taken against individuals or the firm. This disclosure should include the status of the action and relevant details of the circumstances. If a bidder fails to respond to the request or provides incomplete information, the college should contact the State Board of Public Accountancy to determine whether any disciplinary action has been taken against any individual or the firm.
- **Request detailed information on the anticipated audit plan.** The RFP should request a detailed description of the bidder's planned audit approach. This will help the governing board evaluate whether the audit firm has a good understanding of the audit's scope and the college's environment. The RFP should ask to what degree the firm relies on audit sampling and analytical testing, what types of analytical testing the firm would use, and how staff members will be split among various segments of the audit.
- **State requirements for audit documentation and cooperation with other auditors.** Audit documentation composes the main record of audit work and supports audit conclusions. Therefore, it is necessary for quality reviews and for developing an understanding of the auditors' judgment. Although audit documentation remains the property of the auditor, the RFP should describe how long audit documentation should be retained and who can access the documentation. The RFP should also state the auditors' responsibility to cooperate with successive auditors.
- **State the college's policy toward joint proposals or subcontracting.** Unless the RFP specifically prohibits joint proposals or subcontracting, it should contain provisions retaining the college's right to accept or reject subcontracting firms. If joint proposals or subcontracting are allowed, the RFP should require the audit firms to designate a principal auditor.

- Specify the college's right to reject proposals, demand additional information, and use information from unsuccessful proposals for other purposes. The RFP should ensure that the college is not legally forced to select an unqualified or unresponsive firm by stating that:
  - ♦ The college has the right to refuse any or all proposals.
  - ♦ The college has the right to request additional information from bidders and that failure to comply may be grounds for rejection.
  - ♦ The college reserves the right to retain proposals and use any information contained within.
  - ♦ The college is not obligated to reimburse firms for costs incurred in responding to the RFP.
- Provide additional language needed to meet the requirements of applicable laws and regulations. Procurement of professional services is generally subject to local, state, and federal laws. These provisions sometimes require certain language in an RFP. The governing board should consult with general counsel to determine whether all legally required language has been included in the RFP.

### Step 3: Evaluate Proposals

If an RFP is written effectively, proposals should contain the information necessary for the college to determine the candidate that offers the best value. It is important to remember that price should never be the solitary factor in awarding a contract. A college is less likely to receive a quality audit if price is the only criterion used. It is important for a college to include in the planning process people who are knowledgeable about governmental accounting and auditing, and it is imperative that these people be involved in the evaluation process. While a well-written RFP will ensure that important information necessary for evaluation is submitted, the process is likely to fail without a sound system to judge which bid should be selected. The Government Finance Officers Association's *Audit Management Handbook* suggests that colleges adhere to the following steps when evaluating proposals:

- Review mandatory criteria. The proposal should contain the minimum requirements as stated in the RFP. Any proposals that fail to meet these standards should be rejected. Mandatory criteria should include the following:
  - ♦ Evidence that independence standards are met
  - ♦ Evidence of licensure by the State Board of Public Accountancy
  - ♦ Evidence that audit firm personnel have sufficient and relevant continuing professional education
  - ♦ Evidence that the proposing firm has had a satisfactory quality control review in the past three years
  - ♦ Evidence that the audit firm is capable of performing the audit

Mandatory criteria should be limited to only the skills necessary to perform the audit. Once unqualified proposals are rejected, the college can concentrate on evaluating the relative qualifications of bidders that do qualify.

- Establish a rating method for technical qualifications. Evaluators should develop a methodology to rank the remaining firms by their technical skills. Some institutions establish a point system that assigns a number of points for expertise and experience, audit approach, and price. There is no single methodology that will work for every college. Every college must tailor its methodology to address its unique operating environment. Evaluators should develop a sliding scale when evaluating the proposals instead of using an “all-or-nothing” score. This helps firms that are highly qualified rank higher than those firms that are only marginally qualified. For example, Firms A and B may be proficient in automated data systems, but Firm A may be familiar with the system used by the college. Because this makes Firm A more skilled in the college’s unique environment, it should receive more points than Firm B.
- Ensure that evaluators are unaware of price until technical qualifications are evaluated. In the evaluation process, it is important that the evaluators are not influenced by the price. Therefore, the evaluators should not see the price bid until they determine the bidders’ technical qualifications. One way to do this is to follow a multistep process. In the first step, the bidders submit their technical qualifications. Firms that satisfy the mandatory technical qualifications would then be asked to submit information about their planned audit approach. Finally, firms that fulfilled both requirements would be asked to propose their bids for audit services. Whatever method is employed, the college should ensure that evaluators do not see prices until their technical review has been completed.
- Ensure that price is accorded a proper role in the auditor selection process. Although price cannot be the determining factor in auditor selection, it is an important factor. If the point system established (see “Establish a rating method for technical qualifications” above) splits total points between technical qualifications, audit scope, and price, the points allocated to price should represent the appropriate weight when compared with the other factors. Price should not control the selection of the auditor; it should be used as a way to select between equally qualified bidders. The college should determine how many points will be awarded based on price and how the bids will be scaled. One method is to develop a ratio comparing the lowest bid from a qualified firm to the bid being reviewed. This would indicate how many points the firm would receive based upon its price bid. The college should also consider invoking an unpublished price floor or ceiling to help reject bids that are unreasonably low or high.
- Consider legal provisions from local, state, and federal sources. Local, state, and federal requirements may regulate the college’s procurement process. For example, state regulations prohibit the selection of an auditor based solely on price. These regulations require auditor selection based on demonstrated competence and a fair and reasonable price. There may also be state or local laws that dictate how the college should procure professional services. The college should consider these requirements when evaluating proposals.

By following the steps outlined above, the college is more likely to secure a qualified audit firm that can perform a quality audit.

#### Step 4: Contract for the Audit

Once the college has identified the proposal offering the best value, the college needs to write a contract to ensure that the audit meets quality standards. The written contract is the last step in the audit procurement process. The GAO's research report on procuring audit services indicates that the written contract is one of the four necessary components in a successful procurement process.

Although many colleges rely on the engagement letter to serve as the contract, *a properly prepared audit contract is essential in procuring audit services*. The final contract needs to contain specific language documenting the understanding between the auditors and the college.

Most of the information mentioned below will already be contained in the RFP, so the college should consider referencing the RFP in the final contract. The following provisions are illustrative only. The college must determine what items need to be included in the contract. Legal counsel should always be consulted to help draft the final contract.

The college should consider having the written contract include provisions that:

- Designate the responsibilities of the independent auditors and the college.
- Require the audit firm to formally assert that staff members assigned to the audit are independent.
- Outline the circumstances under which the auditors can expand the scope of the audit.
- Require the auditors to defend the college in the event of claims arising from the audit work.
- State the college's commitment to equal economic opportunity (historically underutilized businesses), and require the auditors to afford such individuals and businesses similar consideration.
- Clarify policies regarding the audit documentation arising from the audit; state who may access audit documentation and how long the audit firm must retain it.
- Ensure that any reports provided to the college by the auditors become the property of the college; clarify the auditors' duty to confidentiality of sensitive information.
- Give the college the right to terminate a multiyear contract and establish the procedures used to do so; describe how the firm's performance will be evaluated.

- Establish the auditors' sole liability for claims arising from the auditors' performance of the engagement; call for both the auditors and the college to attempt to resolve differences agreeably.
- Document what constitutes legal notice (such as registered mail). Specify how terms of the contract can be modified or waived. Include language indicating that the provisions of the contract stand alone; thus, if one party fails to satisfy a single provision, the entire contract is not nullified.
- Include any other legal provisions needed in the written contract (for example, whether the auditors must secure insurance or if the college prohibits subcontracting out portions of the audit).

The steps outlined above complete the contracting portion of the audit. Until now, the audit cycle has mainly focused on the college and its governing board. While their job is not complete, the focus now shifts to the external audit firm.

## The Auditing Process

### Step 5: External Auditors Plan the Audit (the Auditors' Perspective)

Once an audit firm is awarded the contract, it must begin planning for the audit to comply with auditing standards. Although the audit firm had to do preliminary planning in developing its RFP response, it is unlikely the audit firm committed a great deal of resources prior to the awarding of the contract. Once this happens, the audit firm will begin by determining what the objectives of the audit are. This should already have been described during the RFP process, but the audit firm will need to decide what it needs to do to render an opinion on the financial statements.

An audit must be performed effectively and efficiently. Therefore, the audit firm must determine where and when to commit its resources. If the RFP process was sound, the audit firm will have already been alerted to and accepted deadlines for its work.

According to the AICPA's *Audits of State and Local Governmental Units* guide, the auditors should follow these steps during the planning phase:

- Identify the engagement's reporting objectives. The reports required by the college should have been identified in the RFP and incorporated into the final contract.
- Identify the audit firm's role as principal, component unit, or joint auditor. This information should be contained in the final written contract, as well as in the firm's proposal.
- Develop the audit focus and materiality thresholds based on the reporting format established by the Coordinating Board. Because the Coordinating Board's reporting guidelines require colleges to present combined financial statements, the auditors should alter their scope and materiality thresholds to address the funds and accounts presented in the financial statements. A materiality threshold

is the amount by which the financial statements can be over- or understated and still not be misleading to a competent reader.

- **Develop an understanding of the college.** The auditors should research background information about the college to use when planning the audit. External auditors may be able to rely on work performed by the college's internal audit staff.
- **Develop the audit approach.** The RFP may have requested the bidding firms to provide a proposed audit approach. Therefore, the audit firm may have already prepared a preliminary audit approach. However, as the auditors learn more about the college and its environment, they will revise their preliminary plans. The approach should provide assurance that audit fieldwork is directed to secure the evidence necessary to support the auditors' opinion while helping to prevent unnecessary work.
- **Conduct pre-audit communication with the college.** The responsibilities of each party should have been established through the written contract. However, the auditors should consider conducting an entrance conference to provide more detailed information than is contained in the contract. At the entrance conference, the audit firm will generally introduce its team and explain the audit objectives, purpose, and limitations. This information may also be included in the engagement letter.
- **Determine whether an additional audit will be required.** The auditors should be aware of requirements for additional audits based on local, state, or federal laws. Although these should be described in the written contract, the auditors should ensure that legal provisions are appropriately satisfied. For example, auditors should inquire about their responsibility for compliance with OMB Circular A-133 and the Public Funds Investment Act, if these are applicable and not part of the RFP.
- **Determine compliance requirements.** The auditors should obtain an understanding of laws and regulations that have a direct and material effect on determining the amounts reported in the financial statements. The auditors should also assess whether the college has done the same.

### **Step 6: External Auditors Perform the Audit (the Auditors' Perspective)**

- **Review the financial statements.** The financial statements are the responsibility of both the college's governing board and management. However, they are often the result of an ongoing consultation between the auditors and the college. The auditors provide expert advice on a variety of matters such as form, application of accounting principles, and suggestions for wording. The extent of participation varies greatly from engagement to engagement. Some colleges prepare their own financial statements, for which the auditors will conduct a review and propose form or content adjustments. Other colleges have the auditors prepare the draft financial statements, which the colleges review. It is important to remember this: the financial statements are the responsibility of the governing board and reflect its decisions. Management must approve any

proposed adjusting, correcting, and closing entries. The auditor who prepares the notes to the financial statements must use information determined and approved by management. The auditor who drafts the financial statements must remember that the financial statements are the college's representations, not his or her own. Therefore, auditors who draft statements should ensure that they do not reflect the auditors' decisions regarding accounting treatments, presentation, or any other decisions normally reserved for the board.

- **Complete the audit.** The auditor assesses internal control and performs tests to determine whether controls exist and are effective. The auditor's final determination of internal control determines the extent of subsequent tests. During the subsequent testing, the auditor will attempt to determine whether the account balances and management's decisions regarding the financial statements are accurate.
- **Issue the opinion.** The opinion letter is one of the most recognizable deliverables of an engagement. The letter indicates whether or not the financial statements fairly present account balances and the results of operations of the college for a certain point in or period of time. The opinion is not an indication that management operated as intended or that internal control is effective. A college could receive an unqualified opinion even if it did not have effective controls. The auditors must base their opinion on the evidence they collected during the engagement. The audit firm must ensure that looming deadlines do not force it into prematurely issuing an opinion that cannot be logically supported.
- **Consideration of fraud.** Statement on Auditing Standards No. 99, issued by the AICPA, is effective for audits of financial statements for periods beginning on or after December 15, 2002. The standard addresses the external auditors' responsibility to obtain reasonable assurance about whether the financial statements are free from material misstatements due to fraud.

The standard stresses the importance of professional skepticism, identifying and assessing potential risks, and evaluating audit risks. Identifying and assessing risks involves methods such as analytical procedures, the evaluation of controls, and inquiries of management and employees.

The AICPA has identified fraud as an intentional act that results in a material misstatement in financial statements that are the subject of an audit. Per the AICPA, two types of misstatements are relevant to the auditor's consideration of fraud—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets.

Three conditions generally are present when fraud occurs:

- ♦ Incentive (pressure)
- ♦ Opportunity
- ♦ Rationalization

Even though the auditor is charged with considering fraud in an audit of financial statements, it is management's responsibility to design and implement programs and controls to prevent, deter, and detect fraud. Management should expect the auditor to address the possibility of fraud and inquire about whether fraud has occurred and how it could occur.

### **Step 7: Monitor the Audit's Progress**

Even if a college uses sound procurement processes and selects a qualified audit firm, there is no guarantee it will receive a quality audit. However, the chances are increased if the college monitors the audit once the audit firm has been selected. According to the Government Finance Officers Association's *Audit Management Handbook*, an audit committee or governing board must stay current regarding the progression of audit work to help ensure that the audit is appropriately conducted.

A well-written contract will have clearly defined timetables for both the audit firm and the college. The contract will allow for periodic status meetings to ensure that the audit committee or governing board is well aware of how the audit is progressing. When the audit committee learns of timing problems, it should immediately take steps to ensure that the audit can be satisfactorily completed within the required timeframes. If the audit firm has encountered problems with the college's management or personnel, the auditors should communicate these problems to the audit committee or governing board.

### **Step 8: Evaluate the Quality of the Audit**

If auditors follow generally accepted government auditing standards, they will increase the likelihood of an acceptable audit. To ensure that standards are followed, the audit firm should have a sound quality review process in place, which should be conducted throughout the audit. The audit firm should ensure that a review of audit documentation takes place. This review should provide assurance that the audit documentation is complete and logical and that it allows objective confirmation of conclusions made by the audit firm.

Someone other than the person who prepared the audit documentation should review it. The quality control reviewer should have sufficient technical skills to determine whether the conclusions are appropriate. Therefore, it is important that an experienced auditor—someone who can bring all of the pieces of the audit together from the planning through the fieldwork—carefully review the auditors' work. The experienced auditor should be able to develop the same conclusions that the audit team did based on the work and evidence documented in the audit documentation.

A competent and objective review of the audit documentation also provides assurance that weaknesses and other material findings have been communicated to the appropriate level of management at the college.

## Reporting and Resolution

### Step 9: Communicate the Audit Findings

Auditing standards require that the auditors communicate the results of their audit work to the college. Many of the reports that are optional under generally accepted auditing standards are required by generally accepted government auditing standards. The number and scope of reports will vary according to the engagement and written contract. Some of the more common reports include the following:

Report on the financial statements	In all financial statement opinion engagements, the auditors will prepare a report on the fairness of the presentation of the financial statements. This report indicates whether or not the financial statements are materially accurate. This report will contain one of the four different types of opinions: unqualified, qualified, adverse, or disclaimed (see “What is an annual financial statement opinion audit?” on page 3).
Report on internal control	Generally accepted government auditing standards require that auditors issue a report on their study of internal control. Although the amount of work that the auditors do is generally not enough to render an opinion on internal control, the auditors’ report often lists any reportable conditions and material weaknesses found.
Report on compliance with applicable laws and regulations	Generally accepted government auditing standards require that auditors issue a report on the results of compliance testing they did in the course of the audit. The report must indicate that all transactions tested, unless otherwise noted, complied with applicable laws and regulations.
Report on the Schedule of Expenditures of Federal Awards (Schedule)	Colleges expending \$500,000 or more in federal funds in a single year are required to have those federal funds audited. While the Schedule itself does not have to be audited, the audit firm must provide a statement that the information in the Schedule has been subjected to the auditing standards applied during the review of the institution’s financial statements.
Report on internal controls used in administering federal financial assistance programs	Auditors performing single audits are required to report on both financial and administrative controls over federal funds used by a college.

Report on compliance for federal financial assistance	The Single Audit Act requires auditors to report on compliance for federal financial assistance programs. In this report, the auditors must report all known instances of material noncompliance, render an opinion on whether the college has complied with the requirements for each federal financial assistance program tested as a major program, and report on compliance with general requirements applicable to major federal programs.
Letters to management	Generally accepted auditing standards require the auditor to communicate reportable conditions and material instances of noncompliance to specified external parties if the audited entity fails to report the findings. These standards also require the auditor to communicate in a management letter conditions that are not reportable and instances of noncompliance that are immaterial.
Reporting fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse	Generally accepted government auditing standards require auditors to address the effect fraud or illegal acts may have on the audit report and determine whether the audit committee or others with equivalent authority and responsibility are adequately informed about the fraud or illegal acts. The standards require the information to be in writing and also include reports of significant violations of provisions of contracts or grant agreements and significant abuse .

The audit committee should review all reports furnished by the auditors to gain a thorough understanding of any underlying conditions. The audit committee should use this understanding to determine how to proceed in resolving any problems.

### Step 10: Resolve the Audit

As the governing board receives information during the audit, it is responsible for taking appropriate action. Before the audit report is published, the board should coordinate with both the college's management and the external auditors to correct any deficiencies encountered during the audit. This review should include the following:

- The nature of any unresolved accounting and auditing problems
- The nature of any significant adjustments, reclassifications, or other disclosures suggested by the auditors
- Any material errors, deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse
- The sufficiency of financial statement disclosures and compliance with applicable laws and regulations
- Changes in accounting principles or policies during the year

- Any disagreements with management that, if unresolved, would have resulted in a modified opinion on the financial statements
- Reasons for major year-to-year fluctuations in financial statement balances
- Unusual situations or circumstances reflected in the financial statements
- The nature of management's underlying assumptions
- Any significant changes in the format of the financial statements from previous years
- Any material weaknesses in internal controls
- Recommendations in the auditors' management letter for improving internal controls and the status of previous recommendations

When the governing board receives the auditors' recommendations and report on the status of previous recommendations, the board should ensure that it has a thorough understanding of what the auditors are recommending. The board should then determine whether the auditors' recommendations are appropriate for the college.

If the governing board decides that the auditors' recommendations should be implemented, it should require that the college's management develop an implementation plan with a timetable. If the board decides not to implement the auditors' recommendations, the board should document its reasons. The board should review the college's progress on implementing the recommendations until they are complete. Throughout the audit, the audit committee or governing board should monitor the external auditors to ensure that the engagement progresses as planned (see Step 7, "Monitor the audit's progress" on page 18).

Once the audit is complete, the audit committee should conduct a review to determine whether anything in the audit process needs to be changed before a new audit starts. This review concentrates more on the auditors than on the audit itself. According to the Government Finance Officers Association's *Audit Management Handbook*, the audit committee should meet with the college's management, without the audit firm present, to discuss the quality of the auditors' work. This meeting should focus on the following items:

- How well the audit staff met the timeframes established in the contract
- How well the audit staff complied with the other provisions of the contract
- The competence and cooperation of the audit staff
- The thoroughness and reasonableness of audit adjustments, findings, and recommendations

The results of this discussion should allow the audit committee to present a recommendation to the full board about whether to retain the audit firm for the next year or whether the firm should not be considered for the next audit. If the audit

committee finds that the audit firm did not provide a quality audit, it should recommend to the members of the governing board that they exercise the exit clause in their written contract to terminate the audit firm's services. The audit committee should also meet with the audit firm, without management present, to determine whether the auditors found management, at all levels, to be competent and efficient.

## Responsibilities in the Audit Process

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### Governing Boards and Audit Committees

#### What are the responsibilities of the governing board?

Each member of the governing board has the legal responsibilities of a fiduciary in the management of funds under the control of institutions subject to the board's

control and management, according to the Texas Education Code, Chapter 51, Section 352 (e). To meet this obligation, the board should ensure that the college's annual financial statements accurately present its financial position and results of college operations. Other parties frequently aid the board in this endeavor:

#### The Benefits of an Audit Committee

An audit committee is a subcommittee of the board that focuses on audit issues. A vigilant and informed audit committee benefits several parties in the community college environment. These benefits include the following:

- The audit committee can allow the board to make better use of its limited time and resources.
- The audit committee can help improve communication between the full board and the management of the college when a portion of the board is already familiar with the college's financial matters.
- The audit committee enhances the external auditors' independence; the committee shields the auditors from inappropriate management influences, allowing them to work more efficiently.
- Internal auditors often find that board and management support for their work and recommendations increases as a result of working with an audit committee.
- The public can see that the audit committee provides active oversight to the college. Taxpayers and creditors (bondholders) are assured that the board is functioning in their best interest.

- The board usually relies on the college's management to prepare annual financial statements.
- The board usually relies on internal and external auditors to ensure that the information in the statements is reliable and fairly presented.
- The board can rely on an audit committee (see text box) to help fulfill its numerous duties.

Although the board may rely on these other parties to assist it in its duties, board members are elected to provide effective oversight to the college.

Therefore, the board should not forget that it is responsible for the content of the college's financial statements.

#### What is the audit committee's role in the annual financial statement opinion audit process?

Traditionally, an audit committee selects external auditors to audit the college's annual financial statements and to review the auditors' scope and opinion and any problems with management. If the governing board decides not to implement an audit committee, then these responsibilities fall to the full board. In recent years, an increasing demand for greater organizational accountability has expanded the governing board or audit committee role.

According to the GAO's 1987 research report on procuring audit services and to *Audit Committees for State and Local Government* (1988), by KPMG Peat Marwick, the following activities are common for a governmental audit committee:

- Select the external auditors. The external auditors give an opinion on the accuracy of the college's annual financial statements (see "The Audit Process")

on page 3). This helps the board fulfill its accountability to its stakeholders. The audit committee should:

- ♦ Work with management to plan the procurement for audit services and identify potential bidders.
- ♦ Participate in evaluating audit firms using pre-established technical factors.
- ♦ Actively oversee the procurement process.
- Review the audit plan with the external auditors. Annually reviewing the audit plan with the external auditors helps the audit committee fulfill its responsibility to oversee the nature and scope of the annual audit. The audit committee should also review any problems the auditors expect and the procedures designed to resolve them. Although the plan must be based on the auditors' professional judgment, most audit committees are interested in the basis for the auditors' judgment and the extent of audit work planned. Many audit committees devote a full meeting with the auditors to reviewing the audit plan.

Prior to the meeting, the audit committee should request a summary of the audit plan so that it can discuss the following points:

- ♦ Type(s) of audit(s) to be performed, such as financial, compliance, single (federal), performance, economy and efficiency, management control, and/or program results
- ♦ Extent and timing of the auditors' proposed coverage
- ♦ Timing and nature of specific procedures to be performed
- ♦ Extent of planned reliance on the work of the internal audit staff
- ♦ Assistance management will provide in the initial preparation of audit documentation
- ♦ Review of automated systems
- ♦ Use of computer auditing and statistical sampling techniques
- ♦ Effect of new or proposed changes in accounting principles, regulations, or financial reporting practices
- ♦ Types and formats of statements to be issued
- ♦ Potential restrictions on audit scope and other matters that could affect the auditors' opinion
- ♦ Other significant problems that the auditors can foresee and how they will be handled

After reviewing the audit plan, the audit committee may request that the auditors perform additional work or perform a more comprehensive review of internal control, depending on specific areas of concern.

- **Monitor the progress of the audit.** The audit committee should monitor the progress of the audit to ensure that it is completed within required timeframes. The timeframes can be internally designated (as in a contract deadline) or externally required (as specified by statute or regulation). Even if there are no time restrictions, audit results should be communicated in a timely manner. Periodic monitoring by the audit committee will help ensure that the audit is completed on time and that reports are issued without delay.
- **Review the audited annual financial report and audit results.** The most important task of the audit committee is to review the results of the audit and the audited annual financial report (AFR). This review should include discussions with management and the external auditors. It should occur close to the auditors' projected completion date and before management plans to issue the AFR. Such timing is necessary to give the audit committee sufficient time to consider problems.

According to KPMG Peat Marwick's *Audit Committees for State and Local Government*, the audit committee should discuss the following items in the review:

- ♦ Unresolved accounting and auditing problems
- ♦ Significant adjustments, reclassifications, or additional disclosures the auditors propose
- ♦ Material errors, deficiencies in internal control, fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse
- ♦ Adequacy of annual financial statement disclosures and compliance with applicable statutes and regulations
- ♦ Changes in accounting policies or principles during the year
- ♦ Disagreements with management on financial accounting and reporting matters and on auditing procedures that, if not satisfactorily resolved, would have caused the issuance of a modified opinion (not a clean or unqualified opinion) on the annual financial statements
- ♦ Reasons for major year-to-year fluctuations in annual financial statement balances
- ♦ Unusual circumstances or situations reflected in the annual financial statements
- ♦ Nature and reasonableness of the underlying assumptions and estimate of management accounting and disclosure considerations associated with material contingencies

- ♦ Significant changes in the format of the annual financial statements (compared with previous years) or significant differences in format between the college's presentation and the presentations of similar community colleges (Financial statement presentation guidelines for Texas public community colleges are established by the *Annual Financial Reporting Requirements for Texas Public Community Colleges*, published by the Coordinating Board.)
- ♦ Material weaknesses in internal accounting control
- ♦ Recommendations in the auditors' letter to management for improving the accounting and internal control systems and the status of action on previous recommendations
- Present the audit report to the board. If the board has a separate audit committee, the audit committee should present the reports to the full board following the review of the AFR and management letter with assistance from the external auditors as necessary. The presentation should help the board members who are not financially oriented better understand the information contained in the AFR and highlight data that is particularly pertinent to the full board's decision-making needs.

For more information about audit committees, see Resources in Appendix B.

Presenting useful information to the full board is the key function of audit committees. The board cannot benefit from the audit committee's efforts unless the committee presents all the important points and findings clearly. An effective presentation can increase the board members' knowledge and assist them in fulfilling their responsibilities and contributing to taxpayers' interests.

- Perform general responsibilities. In addition to the above functions, audit committees are often responsible for:
  - ♦ Overseeing the internal audit function and reviewing or approving the annual internal audit plan.
  - ♦ Receiving periodic status reports from the chief internal auditor on internal audit activities including accomplishments of the annual plan, major deviations, and significant audit findings.
  - ♦ Understanding the nature and complexity of institutional operations.
  - ♦ Grasping any technical problems the college might encounter in applying generally accepted accounting principles.
  - ♦ Comprehending accounting principles applicable to the college.
  - ♦ Reviewing the procedures followed by internal and external auditors.
  - ♦ Identifying difficulties or problems in complying with regulatory agency requirements.

- ♦ Reporting to the full board on the adequacy of internal controls over financial and administrative transactions.
- ♦ Ensuring that matters of noncompliance with institutional policies, generally accepted accounting principles, regulations, and laws are resolved.

## Management of the College

### What are the responsibilities of the college's management?

The governing board is ultimately responsible for the reliability of the annual

#### Establish a System of Internal Controls

Management is responsible for establishing internal controls to safeguard assets, ensure accurate accounting data, further institutional effectiveness, and encourage adherence to managerial policy. The following are components of internal controls:

**Integrity, ethical values, and competence** – Integrity and ethical values must be practiced at all levels of the organization, and staff must be competent.

**Control environment** – The institutional environment must be conducive to internal controls.

**Objectives** – Objectives and related implementation strategies must be established for the institution as a whole, as well as for significant activities.

**Risk assessment** – Risks related to achievement of the objectives should be identified and analyzed.

**Information systems** – Information requirements must be identified and systems put into place to provide needed information.

**Control procedures** – Control procedures must be in place to ensure adherence to policies and to address risks related to the achievement of objectives.

**Communication** – Communication paths must allow relevant messages and information to travel in any direction.

**Managing change** – Change affecting the institution's ability to achieve its objectives must be identified and responded to in a timely manner.

**Monitoring** – Internal controls must be monitored, and policies and procedures must be modified as necessary.

financial statements. However, it will typically delegate its authority for preparing the annual financial statements to the college's management.

Management must prepare the annual financial statements so that they fairly present the results of the college's financial position and of college operations according to generally accepted accounting principles.

This section focuses on management's role within the annual financial statement opinion audit, but it also outlines management's general responsibilities.

### What are management's general responsibilities?

The management of a Texas public community college has a fiduciary duty to the State of Texas, the college's governing board, the faculty and students, and taxpayers in the district to appropriately use the resources with which it is entrusted. Therefore, management should:

- Adopt sound accounting policies.
- Maintain an adequate and effective system of accounts.
- Safeguard assets.
- Establish and maintain a system of internal controls that will, among other things, help ensure the production of proper annual financial statements. (See the text box above for the elements of an internal control environment.)

It is management's responsibility to determine how to correct internal control problems. During the annual financial statement opinion audit, the external auditors must assess the college's internal controls to plan and conduct the audit.

Although a college may receive an unqualified opinion because its annual financial statements are materially accurate, it is still possible that its internal controls may not be effective. However, external auditors are required to inform management about any internal control deficiencies identified, including material weaknesses.

### **What are management's responsibilities in the annual financial statement opinion audit process?**

Management's responsibilities in the annual financial statement opinion audit process are as follows:

- **Prepare the annual financial statements.** The annual financial statements are the responsibility of the college's governing board and management. Management prepares the underlying data from which the annual financial statements are derived. (This preparation includes analyzing, recording, posting, and preparing adjusting and closing entries.)

In addition, management should prepare the annual financial statements according to the annual reporting requirements published by the Coordinating Board.

External auditors may help draft the annual financial statements or suggest changes in presentation. However, management must decide whether to accept these suggestions. According to the general standards in *Government Auditing Standards* (see "Why Have Audit Standards?" on page 31), the external auditors' independence may be impaired if they perform a substantial part of the accounting work.

During the course of fieldwork, the auditors may propose adjustments to the annual financial statements. Management should consider whether to make and book these adjustments in its accounting systems. Although management is not required to make proposed audit adjustments, the auditors may not be able to render an unqualified opinion otherwise.

The college is required to prepare the basic financial statements, notes to the financial statements, and supporting schedules as required by the Coordinating Board. Based on its informational needs, the college may wish to prepare comprehensive annual financial statements, which contain a greater level of detail than the basic financial statements.

- **Make annual financial statement assertions.** Management makes several assertions in the annual financial statements that the external auditors must test to determine if the assertions are supported. Assertions are representations by management that the components of the annual financial statements are accurate (AICPA *Professional Standards*, Section 326.03. Evidential Matter).

Assertions can be either explicit or implicit and are classified according to the following broad categories:

- ♦ **Existence or occurrence.** Management asserts that assets and liabilities of the institution exist at a given date and that recorded transactions have occurred during a given period.
- ♦ **Completeness.** Management asserts that all transactions and accounts that should be presented in the annual financial statements are included.
- ♦ **Rights and obligations.** Management asserts that the college has rights to the assets and obligations for the liabilities listed at a given date.
- ♦ **Valuation and allocation.** Management asserts that asset, liability, revenue, and expense components have been included in the annual financial statements at appropriate amounts.
- ♦ **Presentation and disclosure.** Management asserts that particular components of the annual financial statements are properly classified, described, and disclosed.

If external auditors find that the annual financial statement assertions issued by management are supported and in accordance with generally accepted accounting principles, they can issue an unqualified opinion.

- **Record management representations.** During the course of the audit, the external auditors must obtain written representations from management according to generally accepted auditing standards (Statements on Auditing Standards Nos. 85, 89, and 99 ). Without management's written representation, external auditors cannot render an unqualified opinion.

Management's representations can differ from one audit to the next but generally include the following:

- ♦ Management accepts that the fair presentation of the annual financial statements is its responsibility.
- ♦ Management believes that the annual financial statements comply with generally accepted accounting principles.
- ♦ Management believes that the effects of uncorrected financial misstatements aggregated by the auditor are immaterial.
- ♦ Management made all financial records and related data (including board and board committees' minutes) available to the external auditors.
- ♦ Management believes that no significant misstatements or unrecorded transactions exist in the annual financial statements.
- ♦ Management disclosed all related-party transactions.

- ♦ Management believes that all component units have been included in the annual financial statements.
- ♦ Management complied with budget ordinances.
- ♦ Management complied with grant requirements.
- ♦ Management disclosed all significant information subsequent to the balance sheet date.
- ♦ Management acknowledges compliance with aspects of contractual agreements.
- ♦ Management acknowledges its responsibility to design programs to prevent and detect fraud and acknowledges that it has disclosed detected, alleged, or suspected fraud.
- ♦ Management disclosed all litigation that may have a material effect on the annual financial statements and may have a reasonable possibility of being judged unfavorably against the institution, according to counsel.

Management should have direct knowledge and control over transactions reflected in the accounts and in the annual financial statements. However, because external auditors know about transactions only through their examination, they must rely on the fairness of management's representations in forming their opinion. The external auditors may help draft the annual financial statements or suggest changes in presentation based on management's accounts and records. However, their responsibility for the statements they have examined is limited to the expression of their opinion. The annual financial statements remain the representations of management and are its responsibility.

## External Auditors

### What are the responsibilities of the external auditors during the annual financial statement opinion audit?

The external auditors have three main responsibilities:

- Render an appropriate opinion as to whether the annual financial statements are fairly stated. The auditors' opinion helps those not directly involved with the college understand its financial situation.
- Ensure that the annual financial statements do not materially deviate from the Coordinating Board's annual reporting requirements. However, it is the college's responsibility to prepare the statements according to these guidelines.
- Conduct the audit in accordance with requirements created by oversight bodies. The GAO and the AICPA, along with other oversight institutions, establish requirements for conducting audits of governmental institutions. Audits of governmental institutions should be conducted according to generally accepted government auditing standards and generally accepted auditing standards.

Guidance on annual financial statement opinion audits of public community colleges can be found in the AICPA's *Audits of Colleges and Universities* and *Audits of State and Local Governmental Units*.

## Why have audit standards?

Since 1985, both the GAO and the AICPA have cited concerns about the quality of audits conducted for governmental institutions. Reports from both groups indicated that external auditors' failure to comply with professional auditing standards resulted in poor-quality audits. The audit standards provide a benchmark to ensure that auditors conduct quality engagements.

The standards for conducting financial and performance audits are divided into three groups:

- General standards
- Fieldwork standards
- Reporting standards

The standards are designed to build on one another and should be interpreted together rather than individually.

In the 2003 Revision to *Government Auditing Standards*, the Comptroller General of the United States cited auditor independence as the first consideration under the general standards. Provisions under the new independence standard were strengthened, which limits the range of services that an independent auditor may provide if performing a financial statement opinion audit. While the underlying principle of the independence standard is independence in both fact and appearance, the new standard details in greater depth situations in which reasonable third parties

For more information on auditing standards, see Appendix A.

may conclude that the auditor is not independent in fact or appearance. New interpretations in the revised standards may preclude external auditors from accepting certain financial audits.

A more detailed list of the standards for conducting financial and performance audits are provided in Appendix A.

## ***Effect of the Procurement Process on Audit Quality***

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### **How does a college's procurement process affect the quality of its audit?**

The GAO's 1987 research report on procuring audit services established a link between the procurement practices an entity used and the quality of the audit it received. The GAO's report identified four components critical to the procurement process:

- Competition
- Solicitation
- Technical evaluation
- Written contract

If these components are effectively included in the college's procurement framework, the likelihood of a quality audit substantially increases.

### **How can the college increase competition?**

To increase competition, colleges should identify multiple firms when planning the procurement of their audits. While there is not a "best" method for identifying qualified auditing firms in an area, the most common method is using a bidder's list developed from sources such as a phone book or by advertising for proposals in the newspaper. Audit firms outside of the immediate area may also be considered, as firms from other cities may be willing to travel to conduct the engagement. Other methods include posting an RFP at the Texas State Board of Accountancy or using direct mailings. The governing boards should ensure that local, state, and federal guidelines are followed in the solicitation process.

By identifying qualified audit firms, colleges can help ensure that at least two audit firms are considered when selecting a qualified auditor. Where feasible, entities should obtain competitive bids in all circumstances, except when exercising renewal options on multiyear contracts.

Colleges must make their audits attractive to potential bidders. One way to do this is to provide multiyear contracts to the winning audit firm whenever possible. This will allow colleges to benefit from the auditors' learning curve and experience and to take advantage of cost savings by not having to procure audit services on an annual basis. However, once a contract does expire, *institutions should submit a new RFP to ensure that they can select qualified auditors at a reasonable price.* According to OMB Circular A-76 "... competition enhances quality, economy and productivity."

### **What is the solicitation process?**

The GAO research report on procuring audit services describes the solicitation process as the steps taken by colleges to communicate their needs and requirements to potential bidders. Once qualified audit firms have been identified, the governing

board and institution should prepare an RFP. A well-prepared RFP and the audit firms' proposals will give each side the important information needed to determine whether they are compatible.

For example, the RFP should outline the minimum qualifications necessary for the audit and the schedules that must be followed to release the financial statements at the correct time.

Proposals should outline an audit firm's qualifications, the staff who would be assigned to perform the work, and other information that will allow the governing board to make an informed decision.

Effective planning is essential to ensure that the college provides the potential bidders with enough information to effectively respond to the solicitation. This in turn allows potential bidders to determine whether they are qualified to bid on the engagement. Firms should also be prompted to submit enough information for evaluators to select the most qualified auditors at a fair price. According to the GAO, an effective solicitation process includes at least four items in its communication with potential bidders. Examples of items colleges should address include background information on the entity, the audit period, applicable audit standards, required reports, or specific audit guides that should be followed. The GAO found that when entities used an effective solicitation process they received audits of acceptable quality 75 percent of the time.

### **How often should the college go through the solicitation process?**

In its report, the GAO suggested that *contract periods should last for five years*. As a contract enters into its final years, colleges should again begin the planning and solicitation process. Colleges must consider how to balance cost savings incurred by using the same audit firm against the different perspectives of new auditors. The rotation of auditors is essential to get fresh perspectives on an audit and to ensure that audit staff rigorously attempt to identify and test risk. However, colleges should determine whether their current audit firms could achieve this influx of new ideas by rotating their own staff. Regardless of what a college decides about rebidding, it should consider the benefits of rotation and establish policies regarding rotation when appropriate.

In cases where an institution of higher education maintains a long-term relationship with an independent auditor, NACUBO recommends (in Advisory Report 2003-3) that "institutions should require a rotation of the lead partner every seven years with a timeout of two years."

### **How should a college evaluate submitted proposals?**

According to the GAO's research report on procuring audit services, colleges must devise a method to evaluate the proposals that are submitted by bidding firms. Colleges should develop evaluation processes prior to soliciting proposals and may include descriptions of their evaluation methodologies if a firm meets minimum technical qualifications to perform the audit. The evaluation process should also rank proposals that meet minimum qualifications according to the bidding firms' skills, experience, commitment, and understanding of the audit responses. The GAO

decided that in an effective technical evaluation process, an entity considered at least three technical factors (*other than cost*) in the selection process. Further guidance on evaluating proposals is presented in Step 3 of the audit cycle (see page 12).

### **Why is a formal, written contract necessary to help ensure audit quality?**

The GAO research report indicates that written contracts help to ensure a mutual understanding and division of responsibility between the governing board, the college's management, and the audit firm. In its study, the GAO stated its belief that an entity had an effective written contract when the entity had a signed contract or engagement letter that included the following items:

- Statement of the specific audit work to be performed
- Audit scope
- Duration of the audit
- Applicable audit standards
- Required reports
- Applicable audit programs or guides

For more information about the procurement process, see Resources in Appendix B.

The written contract should also contain the final terms to which the governing board, college, and audit firm agreed.

# Appendices

## Appendix A: Government Auditing Standards

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*Government Auditing Standards*, also called generally accepted government auditing standards (GAGAS), are published by the United States General Accounting Office (GAO). They are composed of general standards that apply to financial, performance, and attestation engagements and include standards that are specific to each type of engagement. This summary of GAGAS covers the general standards as well as the fieldwork and reporting standards for financial audits. The auditors are responsible for ensuring that any audit work they undertake complies with these requirements.

### The General Standards

General standards concern the fundamental requirements for ensuring the credibility of the auditors' results. The general standards provide the underlying framework that is critical in effectively applying the fieldwork and reporting standards. These standards are divided into four categories:

- **Independence.** In all matters relating to the audit work, the audit organization and the individual auditor should be free both in fact and appearance from personal, external, and organizational impairments to independence.

Auditors and the entire audit organization should maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as impartial by knowledgeable third parties. In auditing, independence implies an obligation of fairness and fiduciary responsibility to management of the audited institution, stakeholders, and others who rely on information in the report. For Texas public community colleges, these include the state government, boards of directors, bondholders, students, and other citizens of the state of Texas.

To be considered independent, the auditors must be recognized as independent by the public. Therefore, the auditors should be free from any obligation to or interest in the audited institution, its management, or its stakeholders.

Auditors are relied upon because the public accepts their professional integrity as an assurance that they will use their skills and knowledge to the fullest and place the interests of the audited entity and the public ahead of their own.

The external auditor should take care not to impair independence by performing substantial accounting functions for the institution. Although auditors commonly help draft annual financial statements, management is still responsible for the statements. External auditors should take care not to audit their own work.

- **Professional judgment.** The auditor is required to exercise professional judgment in planning and performing audits and attestation engagements and in reporting the results.

This standard requires auditors to exercise reasonable care and diligence and to observe the principles of serving the public interest and maintaining the highest degree of integrity, objectivity, and independence in applying professional judgment to all aspects of their work.

Professional judgment requires auditors to exercise professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of the evidence.

Exercising professional judgment allows auditors to obtain reasonable assurance that material misstatements or significant inaccuracies in data will likely be detected if they exist. However, absolute assurance is not attainable because of the nature of evidence and the characteristics of fraud.

- **Competence.** The staff assigned to perform the audit or attestation engagement should collectively possess adequate professional competence for the tasks required.

For audits that lead to an opinion on the reliability of an institution's annual financial statement, the external auditors should be CPAs or should work for a licensed public accounting firm. In addition, the individual auditor or auditing organization must be *collectively* proficient in accounting, auditing, and any special, specific, or unique environment under which the audited institution operates. Because each member of the team may have specific knowledge of an area relating to the audit, it is not necessary for any single auditor on an audit team to know all the details of the institution being audited.

For Texas public community colleges, the auditor or audit team should be collectively proficient in each of the following fields: general accounting and auditing, Texas government accounting and auditing, and Texas community college financial reporting and operations.

Although this knowledge is initially obtained through formal education and on-the-job experience, continuing professional education (CPE) is a key element in maintaining an auditor's skill. Generally accepted government auditing standards require every auditor to complete at least 80 hours of CPE every two years. At least 20 hours must be completed each year. All CPE hours should contribute to the auditor's professional proficiency.

Generally accepted government auditing standards also require auditors responsible for planning, directing, and conducting fieldwork or preparing the audit report to participate in specific types of continuing education and training to maintain their technical skills. Therefore, 24 of the 80 required hours should be directly related to the type of specific or unique environment in which the auditor operates. Auditors who audit Texas public community colleges should ensure that 24 of their 80 hours of CPE relate directly to the environment in which these colleges operate.

To ensure that its team is in compliance with *Government Auditing Standards*, the audit firm should provide the college with a list of the auditors who will be conducting the audit. The list should contain the auditors' titles, experience levels, any areas of specialization, and CPE hours with course names.

- **Quality control and assurance.** Each audit organization conducting audits in accordance with these standards should have an appropriate internal quality control system in place and undergo an external peer review.

The internal quality control system established by an audit organization should provide reasonable assurance that it:

- ♦ Has adopted and is following applicable auditing standards.
- ♦ Has established and is following adequate audit policies and procedures.

Generally accepted government auditing standards go beyond generally accepted auditing standards and require independent auditors to participate in an external quality control review program at least once every three years by a third-party organization. For Texas public community colleges, this means that the auditors or audit organization used to audit the college should undergo a review of their auditing and attestation engagement practices at least once every three years. Results of the review should verify that a quality control system is in place and operating effectively to provide reasonable assurance that established policies and procedures and applicable auditing standards are being followed.

In order for a Texas public community college to ensure that its auditors are in compliance with *Government Auditing Standards*, the auditors should provide the college with their most recent external peer review report.

## The Fieldwork Standards

GAO fieldwork standards require auditors to do the following three things:

- **Adequately plan the audit and supervise assistants.** To ensure that the audit is effective and efficient, the auditors must determine where to commit audit resources. In planning for an audit, the auditors should gain an understanding not only of the institution to be audited but also of the environment in which it operates. The auditors should also review the *Annual Financial Reporting Requirements for Texas Public Community Colleges*, published by the Coordinating Board. These requirements provide guidance on presentation and accounting treatments for the annual financial statements of public community colleges.
- **Develop an understanding of internal control of the audited institution that is sufficient to plan the audit and to determine the nature, timing, and extent of tests to be performed.** The auditors should examine the control environment (for example, safeguarding controls, controls over compliance with laws and regulations, and control risk assessments). Any internal control deficiencies that could result in material misstatements in the annual financial statements should be reported to the governing board, preferably in writing. If internal control

weaknesses are less significant, they should be communicated to the institution's management.

- Obtain sufficient and competent evidence to afford a reasonable basis for an opinion regarding the financial statements under audit. This evidence should be comprehensive enough to allow an experienced auditor who has no previous connection to the audit to draw the same conclusions.

By following these standards, the auditors help ensure that their audit work results in an appropriate opinion.

## The Reporting Standards

The AICPA established four reporting standards, which are incorporated in generally accepted government auditing standards, that the independent auditors' report must follow. These standards require the auditors' report to:

- State whether the annual financial statements are in conformity with generally accepted accounting principles.
- Identify situations where such principles have not been consistently observed in the current period in relation to the preceding period.
- Identify where informative disclosures in the annual financial statements are not adequate.
- Either express an opinion on the annual financial statements as a whole or explain why such an opinion cannot be expressed.

In addition to the above reporting standards, the GAO has prescribed these additional reporting requirements:

- The auditors must state that they conducted the audit according to generally accepted government auditing standards or disclose the standard(s) not followed, the reason therefore, and how not following the standard affected or could have affected the audit.
- The auditors' report should describe either the scope of the auditors' testing for compliance with laws, regulations, and internal controls or refer to separate reports containing this information.
- The auditor should report deficiencies in internal controls considered to be reportable conditions, all instances of fraud and illegal acts unless clearly inconsequential, significant violations of provisions of contract or grant agreements, and abuse
- The auditors must disclose whether information is omitted from the report because of legal restrictions.
- The auditors' report should be submitted to the appropriate officials in the audited institution, to officials with oversight responsibilities, and to any other

people authorized to receive such reports. Unless restricted by law or regulation, copies should be made available to the public.

## ***Appendix B: Resources***

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In the process of developing this guide, it became apparent that literature existed that described most of the processes we have outlined. Rather than duplicate the efforts of these publications, the State Auditor's Office decided to summarize the information provided by other sources so that this guide could be used as a primary resource, with directions to more extensive guidance when necessary. Please consult the resources listed below for additional information.

### **Responsibilities in the Audit Process**

Apostolou, Barbara, Ph.D., CPA, and Raymond Jeffords, Ph.D., CPA, *Working with the Audit Committee*, The Institute of Internal Auditors, Altamonte Springs, FL, 1990.

KPMG Peat Marwick, *Audit Committees for State and Local Government*, Peat Marwick Main & Co., USA, 1998.

### **Procurement Processes**

*CPA Audit Quality: A Framework for Procuring Audit Services* (Report # GAO/AFMD-87-34), United States General Accounting Office, U.S. Government Printing Office, Washington, D.C., August 1987.

Gauthier, Stephen J., *Audit Management Handbook*, Government Finance Officers Association of the United States and Canada, Chicago, IL, 1989.

Ostrom, John S., *Selecting an Auditor*, NACUBO Financial Accounting Guidebook Series, 1992.

### **Guidance on Auditing Standards**

*Audits of Colleges and Universities*, American Institute of Certified Public Accountants, New York, NY, 1998.

*Audits of State and Local Governmental Units*, American Institute of Certified Public Accountants, New York, NY, May 1995.

*Codification of Statements on Auditing Standards*, American Institute of Certified Public Accountants, New York, NY, 1998.<sup>1</sup>

*Government Auditing Standards*, United States General Accounting Office, U.S. Government Printing Office, Washington, D.C., June 2003.

*The Sarbanes-Oxley Act of 2002: Recommendations for Higher Education*, NACUBO Advisory Report 2003-3, November 2003.

### **General Accounting and Reporting Guidance**

*Annual Financial Reporting Requirements for Texas Public Community Colleges*, Texas Higher Education Coordinating Board, Austin, TX.<sup>1</sup>

*Codification of Governmental Accounting and Financial Reporting Standards*,  
Governmental Accounting Standards Board, Norwalk, CT, 1998.<sup>1</sup>

McDonald, Deirdre (ed.), *Selecting an Auditor*, College and University Business  
Administration, National Association of College and University Business Officers,  
Washington, D.C., 1992.

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<sup>1</sup> These resources are published on a periodic basis. The governing board, college, and external auditors should ensure they are using the latest version.



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