
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Item Number: # TBD

Proposed Agreement with Macias Gini & O'Connell to provide Outside Audit Services for Fiscal Years 2009 through 2013

OVERVIEW

At their meeting on January 12, 2009, the Audit Committee requested the IBA to work with the Purchasing and Contracting Department and the City Auditor to develop a Request for Proposals (RFP) for outside audit services for the five-year period beginning with FY 2009 and ending with FY 2013. The RFP was reviewed by the Audit Committee and distributed to numerous audit firms on February 26, 2009. This report discusses the background for oversight/administration of the outside auditor agreement, reviews the RFP process leading to the recommendation made by the Audit Committee to authorize the Agreement with Macias Gini & O'Connell (MGO), and summarizes aspects of the proposed agreement.

FISCAL/POLICY DISCUSSION

Administration and Oversight of the Outside Auditor Agreement

The outside auditor selection process and ensuing contract administration has historically been overseen by City Auditor and Comptroller (now the Office of the City Comptroller). The City Comptroller reports to the Mayor's Chief Financial Officer. The integrity and independence of the outside audit can be questioned when the outside auditor's agreement is administered by the department responsible for preparing the financial statements being audited. The Kroll Report recommended that a reputable independent auditing firm be retained by the City's new Audit Committee for the annual audit of the City's financial statements beginning with FY 2008.

In order to respond to the Kroll recommendation, the IBA was asked to administer the outside audit agreement with MGO for FY 2008 until the new Audit Committee was seated and the City

Auditor had been appointed. Following an outside audit performed by KPMG for FY 2003, the City has retained MGO on a sole source basis to perform the outside audit work for fiscal years 2004 through 2008. On June 3, 2008, voters approved Proposition C which amended the City Charter to create the Office of the City Auditor reporting to a reconfigured Audit Committee; however, the City Auditor appointment process could not begin until public Audit Committee members had been seated. The public members were seated in January 2009 and the City Auditor was appointed on April 14, 2009. The Audit Committee has requested that the City Auditor oversee the outside audit agreement and the annual work of the outside auditor going forward.

Outside Auditor RFP Process

As a competitive process to select an outside auditor for fiscal years 2009 through 2013 was needed, the Audit Committee asked the IBA to work with the Purchasing and Contracting Department and the City Auditor to develop/issue a RFP for outside audit services. On February 23, 2009, the Audit Committee reviewed the draft RFP and directed the IBA to issue it in accordance with a proposed timeline. The RFP was issued and notifications were sent to 94 audit firms on February 26, 2009.

Proposals were due to the City by March 27, 2009. This provided just over four weeks for response. The RFP was also advertised in the San Diego Daily Transcript. Despite direct notification to 94 audit firms and the advertisement, the City only received one response to the RFP from MGO. The City Auditor has informed the IBA that it is not uncommon for large municipalities to receive a very limited number of bids. For example, the City of San Jose only received one bid (from MGO) in response to their RFP for outside audit services over five years in 2005. While there is no clear explanation for the limited response, the following factors may have contributed:

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

The Audit Committee appointed a Technical Evaluation Committee (TEC) to review proposals in response to the outside auditor RFP. The TEC was comprised of Audit Committee member Wade McKnight, City Auditor Eduardo Luna, Audit Manager Kyle Elser, and IBA Fiscal & Policy Analyst Jeff Kavar. The TEC was further supported by the Purchasing and Contracting Department. Despite receiving only one proposal, the TEC carefully reviewed the MGO's technical and price proposals for adherence to the requirements of the RFP. Additionally, the TEC interviewed all members of the proposed MGO team on April 8, 2009. Based on this review, the TEC judged the MGO proposal to be responsive noting the following significant representations from the proposal in recommending MGO to the Audit Committee:

- In order to satisfy the best practice of rotating lead partners every 5 years, Audit Principal Kathryn Beseau would replace Partner Jim Godsey as the lead on the proposed engagement. Partner Ken Macias would serve as the "concurring partner" and Mr. Godsey would still be available to the City as the "managing Partner" of MGO's southern California office. Auditor Anthony Neequaye would continue to lead the local audit team and work closely with Kathryn Beseau.
- Having performed the City's audit for the last 5 years, MGO is certainly familiar with the City's accounts and has a good sense of the City's internal control environment. This should help them facilitate a timely and thorough audit. Additionally, the MGO team proposes to utilize a ERP/SAP system implementation specialist who is skilled at ascertaining where risks associated with new IT systems (like OneSD) should be tested.
- MGO submitted a fee proposal that would reduce the FY 2009 cost of audit services to the City by **19%** from the **total cost of the FY 2008 audit - \$1,272,505**. The fees would be reduced by an additional **11%** for both the FY 2010 audit and FY 2011 audits, and then would be increased by 5% in FY 2012 and FY 2013.

MGO Fee Proposal for the 5 years beginning with FY 2009 audit work:

FY 2009: Total - \$985,769	CAFR Audit - \$703,450
FY 2010: Total - \$880,252	CAFR Audit - \$597,933
FY 2011: Total - \$780,306	CAFR Audit - \$483,480
FY 2012: Total - \$818,685	CAFR Audit - \$507,300
FY 2013: Total - \$858,462	CAFR Audit - \$531,900

- The MGO team also expressed to the TEC that they understand the shift in their reporting relationship from the Mayor to the legislative body via the City Auditor and the Audit Committee. They have expressed an intention to promptly apprise the Audit Committee and the Auditor and/or IBA as may be needed regarding any audit needs or challenges encountered. That would include regular updates to the Audit Committee (and audit-related training if requested) as has been the standing practice with this Committee.

On May 11, 2009, the Audit Committee unanimously recommended that a proposed five-year agreement with MGO be forwarded to the City Council for consideration.

Proposed Five-Year Agreement with MGO for Outside Audit Services

The Specifications section of the City's RFP details the Core Requirements and Deliverables for the proposed agreement (Attachment 1). Funding was not budgeted in the FY 2009 budget for the FY 2009 outside audit; however, the year-end amendment to the FY 2009 appropriations ordinance will provide funding for the first year of the agreement. Funding for the outside audit of the FY 2010 financial statements has been built into the City Auditor's budget in FY 2010. In accordance with the Audit Committee's direction, the City Auditor will administer and oversee the outside audit agreement beginning with the audit of the FY 2009 financial statements. The City retains the right to terminate the agreement with advance notice if it is determined to be in the City's best interest.

CONCLUSION

The IBA and the City Auditor support the Audit Committee's recommendation to approve the agreement with MGO noting: 1) their experience performing audits for the City, 2) their familiarity with City accounts and organizational structure, 3) a significant reduction in audit costs for the next three years, and 4) MGO's understanding that they need to promptly apprise the Audit Committee regarding any audit needs or challenges they might encounter. If the City Council or the Audit Committee were to become concerned with MGO's role as the City's outside auditor, the agreement can be terminated with advance notice and another RFP could be issued for the following fiscal year's audit. If the agreement is approved by the City Council on June 2, 2009, MGO is prepared to begin pre-audit fieldwork for the audit of the FY 2009 financial statements.

[SIGNED]

Jeff Kavar
Fiscal & Policy Analyst

Attachment

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst

I. SPECIFICATIONS

A. CORE REQUIREMENTS AND DELIVERABLES

1. An annual audit of the financial statements included in the City's Comprehensive Annual Financial Report (CAFR) shall be conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States. The auditor shall conduct the audit of relevant financial statements and schedules in conformity with Generally Accepted Accounting Principles (GAAP) in the United States enabling the City to meet the requirements of the Government Finance Officers Association (GFOA) Certificate of Achievement of Excellence in Financial Reporting, and sufficient to enable the certified public accounting firm to express an informed written opinion on:
 - a. The fair presentation of the financial position and changes in financial position of the governmental activities;
 - b. Business-type activities;
 - c. The aggregate discretely presented component units;
 - d. Each major fund;
 - e. The aggregate remaining other fund information; and
 - f. Fiduciary funds.
2. An annual organization-wide financial and compliance audit shall be conducted under the Single Audit Act of 1984 (as amended in 1996) and the U.S. Office of Management and Budget (OMB) Circular A-133, including the internal accounting and other control systems as required by the Single Audit Act. The Single Audit shall include the City's Redevelopment Agency. Audits shall meet required standards as revised by Generally Accepted Audit Standards (GAAS) guidelines and Generally Accepted Governmental Auditing Standards (GAGAS), as issued by the Comptroller General of the United States. It shall include tests of accounting records, a determination of major program(s) in accordance with Circular A-133, and other procedures considered necessary to:
 - a. Express an opinion on the City's compliance requirements of the laws, regulations, contracts and grants applicable to each of its major federal programs;
 - b. Provide an accompanying schedule of findings, recommendations and questioned costs, if any;
 - c. Express an opinion, in consideration of the City's internal control over compliance regarding the existence of any control deficiencies or any material weaknesses in internal control as they relate to expressing an opinion on

compliance but not for the purpose of expressing an opinion on the effectiveness of the City's internal controls over compliance; and

- d. Express an opinion as to whether the schedule of federal awards and any required supplementary schedules are fairly stated in all material respects in relation to the basic financial statements taken as a whole.
3. The Outside Auditor may issue a management letter to the extent considered appropriate, or as requested by the City. The Outside Auditor may recommend improvement in any areas brought to its attention during the course of the audit.
 4. The Outside Auditor shall issue an audit opinion for each of the following annual reports:
 - a. The City of San Diego Comprehensive Annual Financial Report, which includes the basic financial statements, Management's Discussion and Analysis, other Required Supplementary Information, combined and Individual Fund Statements, and statistical data for each fiscal year. The outside auditor shall issue an opinion as to whether the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City, for the fiscal year audited. In accordance with Government Auditing Standards, the Outside Auditor shall also issue a report regarding the City's internal control over financial reporting and tests of compliance with applicable provisions of laws, regulations, contracts and grant agreements and other matters. The purpose of this report shall be to describe the scope of the testing of internal control over reporting and compliance with the results of testing, and not to provide an opinion on the internal control over financial reporting or on compliance.
 - b. The City of San Diego Sewerage Utility allocation for billing Metropolitan System of the City of San Diego Sewer Utility to ensure that costs have been properly allocated to the participating agencies.
 - c. The City of San Diego Appropriation Limit Worksheet (GANN Limit) to ensure that the City's appropriation limit has been properly calculated.
 5. The Outside Auditor shall issue an audit opinion on the individual Annual Financial Statements for each of the following:
 - a. Redevelopment Agency;
 - b. Abandoned Vehicle Abatement Authority; and
 - c. City of San Diego schedule related to Naval Training Center Economic Development Conveyance.

6. The City will periodically prepare a preliminary official statement and a final official statement for City bond offerings. When requested by the City, the selected Outside Auditor shall provide a consent letter allowing for the inclusion of their audit opinion related to a particular City Comprehensive Annual Financial Report in both the preliminary official statement and the final official statement for various City bond offerings. This service shall be provided whenever requested for the CAFRs released for the fiscal years ending June 30, 2009 through June 30, 2013.

The entities listed below are included as component units within the City's CAFR; however, these entities will individually contract for their outside auditor work:

- a. San Diego Housing Commission;
- b. Southeastern Economic Development Corporation;
- c. Centre City Development Corporation;
- d. San Diego Convention Center Corporation;
- e. San Diego Data Processing Corporation;
- f. San Diego Medical Services Enterprises, LLC; and
- g. San Diego City Employees Retirement System.