

# **STATE OF NEW JERSEY OFFICE OF THE STATE COMPTROLLER**

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## **SELECTION AND USE OF AUDIT FIRMS BY NEW JERSEY GOVERNMENT UNITS**

**Report 2008-1**



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## **INTRODUCTION**

The Office of the State Comptroller (OSC) undertook a survey of all government entities in the State concerning the manner in which they select and rotate their external audit firm. The survey reveals that many New Jersey government units are not selecting and rotating their auditors in a way that is in the best interest of New Jersey taxpayers. As explained below, the system being used to obtain external audit services in New Jersey is a significant obstacle to obtaining the quality audits that are central to the State's financial well-being.

### **SURVEY OBJECTIVE AND BACKGROUND**

New Jersey law requires all government units to hire an external auditor to perform an annual audit of the unit's books, accounts, and financial transactions. It is a system that recognizes the difficulty of imposing centralized financial oversight on more than 1,900 separate units of government, each with independent authority over expenditures, contracting, and other financial matters affecting public dollars. It is also a system that, by its nature, places great reliance on external auditors performing quality audit work with diligence, integrity, and independence.

In contrast to some other states where a single state office is responsible for auditing financial statements of all or most government units, in New Jersey the number of separate government units would render any such effort exceedingly difficult. It is therefore vital to ensure the State's use of external

auditing firms is resulting in appropriate fiscal oversight.

That interest is even more significant in view of the millions of taxpayer dollars spent annually in New Jersey on these government audits. In 2007, for example, fees for school district audits alone were nearly \$15 million. In addition to these direct costs, external audits are a primary source of fiscal oversight for the spending of billions of taxpayer dollars.

Against this backdrop, and pursuant to N.J.S.A. 52:15C-8, in May 2008 this office sent notices to every government unit in the State requesting information including the following:

- A copy of the government entity's most recent audit;
- The length of time the auditor has served as auditor for the entity (auditor rotation practice); and
- A statement of whether the auditor was selected by competitive contracting and, if so, a description of the process used.

We sought that information, in part, to determine whether government units in this State are using the kinds of auditor selection and auditor rotation practices most likely to yield the effective and independent audit work upon which New Jersey's system of financial oversight so heavily depends. In short, we found that many government units are not using such practices.

## SURVEY RESULTS

The analysis herein is based on information received by this office as of July 11, 2008. As of that date, 996 submissions had been received from municipalities, school districts, tax boards, parks commissions, bridge commissions, and State and local authorities including housing, improvement, utilities, parking, and sewerage authorities. Not all 996 survey respondents answered each of the questions posed. We are following up with those entities that have yet to submit the required information.

The recommendations in this report are also based on prevailing professional literature, cited herein, as well as experiences and practices of other states.

### Audit Firm Rotation

Audit firm rotation refers to the policy adopted by some government entities and private sector companies that requires periodic changing of the entity's external audit firm. As detailed below, many New Jersey government units are not rotating their auditors with frequency sufficient to ensure maximum audit quality.

The issue of auditor rotation became prominent in 2001, when a series of publicly traded companies had their audit results questioned after substantial and permanent declines in stock value. The issue received close attention as observers noted that "almost all of the largest accounting scandals in recent years, including those at Enron, WorldCom, and HealthSouth, occurred

on the watch of auditors who had been on the job at least a decade."<sup>1</sup>

Professional literature confirms that "[t]he absence of rotation has potentially serious detrimental effects" on the outcome of an audit.<sup>2</sup> Scheduled auditor changes provide a check against lax analysis and reporting that can occur after a protracted relationship. Specifically, frequent auditor changes provide each party to the contract with reassurances that professional standards will be maintained for the following reasons:

- **Familiarity fatigue.** Closeness to management may compromise the independence of the auditor. "The continuous relationship between the auditor and its client creates professional and sometimes personal ties that develop an increasing complicity."<sup>3</sup> Through daily interaction with the organization, the auditor moves from being an "outsider looking inward" to being an "insider looking inward." In this

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<sup>1</sup> Gideon Mark, *Accounting Fraud: Pleading Scienter of Auditors under the PSLRA*, 39 Conn. L. Rev. 1097, 1197 (2007).

<sup>2</sup> *Id.* at 1197; see also Barbara Arel et al., *Audit Firm Rotation and Audit Quality*, 75 The NYSS CPA Journal (2005); Richard G. Brody and Stephen A. Mosgrove, *Mandatory Auditor Rotation*, 49 The National Public Accountant (1998); Thomas J. Healy and Yu-Jin Kim, *The Benefits of Mandatory Auditor Rotation*, 26 Regulation (2003); Michael E. Bamber and Venkataraman M. Iyer, *Auditors' Identification with Their Clients and Its Effect on Auditors' Objectivity*, 26 Auditing (2007).

<sup>3</sup> Jose Joao Mantes Ferreira-Gomes, *Note: Auditors as Gatekeepers: The European Reform of Auditors' Legal Regime and the American Influence*, 11 Colum. J. Eur. L. 665, 683 (2005).

situation, the auditor may lose the requisite skepticism or may overlook important details of the auditee's financial statements during the audit because of familiarity fatigue.

- **Seeking the client's approval.** Without a predetermined audit assignment period, there is an eagerness to keep the client's approval in the hope of the steady income flow that would result from continued retention as auditor. "If an auditing firm knows that it can remain employed by its client indefinitely, as long as it remains in management's good graces, it has a powerful incentive to approve the client's accounting decisions, even if that accounting is fraudulent."<sup>4</sup> With a predetermined assignment period, the motivation to appease the client for financial reasons is less of an issue since the firm's income flow will be coming to an end regardless of the client's views of the firm. As a result, the auditor may no longer be hesitant to report on internal control weaknesses.
- **Accountability.** With a new pair of eyes scrutinizing the organization periodically, accounting firm "A" is more likely to ensure the client is in compliance with appropriate industry standards, guidelines, and principles, because accounting firm "B" will be reviewing "A's" work after "A's" term as auditor concludes.

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<sup>4</sup> Mark, *supra* note 1, at 1197.

This system ensures the work of each auditor will be reviewed by its peers. "If, for example, Arthur Andersen had known in 1996 that a competitor firm was going to be auditing the Enron books in 1997, they may have been much less inclined to fudge and compromise."<sup>5</sup>

Within the audit profession, some have expressed concerns about mandatory auditor rotation, arguing, for example, that frequently scheduled changes in auditors can be expensive and because time is needed to educate an audit firm about the intricacies of the client organization. In the public-sector context, however, where there is a baseline of financial commonality among government units, these concerns seem less substantial.<sup>6</sup>

In fact, in 2007 the Association of Government Accountants compiled results from a survey of government auditors and other government entities pertaining to government internal controls and related management responsibilities. Sixty-seven percent of survey respondents stated that the public sector would benefit from auditor rotation, as well as auditor communications to audit committees and stronger conflict of interest rules.

Despite the professional literature, our survey of New Jersey government units revealed that those units have generally continued to use the same audit firm for

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<sup>5</sup> John R. Kroger, *Enron, Fraud, and Securities Reform: An Enron Prosecutor's Perspective*, 76 U. Colo. L. Rev. 57, 136 (2005).

<sup>6</sup> See N.J.A.C. 5:30-5.1 et seq.; N.J.A.C. 6A:23-2.1 et seq.; see also Mark, *supra* note 1 at 1201-02 (discussing and rejecting the cost argument).

extremely long periods of time. In fact, 45% of all of the units that responded to the survey have been using their current auditor for more than ten years. Only 30% have been using the same auditor for five years or less. More than 40 government units in the State have had the same auditor for more than 30 years, and some units have used the same auditor for 50 and even as long as 61 years.

than 35 years. The information in quotation marks is set forth exactly as reported by the government entities themselves.

Table 1 below reflects the survey results on the rotation issue. Table 2 on the following page lists the government entities responding to the survey that have used the same audit firm for more

**Table 1: Number of Entities and Duration of Audit Firm Engagements**

<b>Type of Entity</b>	<b>0-5 yrs.</b>	<b>6-10 yrs.</b>	<b>11-30 yrs.</b>	<b>Over 30 yrs.</b>	<b>Total</b>
School Districts	124	118	157	13	412
Municipalities	85	53	118	18	274
State and Local Authorities	30	16	25	4	75
Fire Districts	8	13	15	1	37
Colleges/Universities	9	5	2	2	18
Counties	3	6	3	2	14
Other	4	4	28	1	37
<b>Total</b>	<b>263</b>	<b>215</b>	<b>348</b>	<b>41</b>	<b>867</b>

**Table 2: Government Entities Using the Same Audit Firm for Over 35 Consecutive Years**

<b>Government Entity</b>	<b>Years Used</b>
Haddon Township Board of Education	61
Township of Maple Shade	“approximately 60+ years”
South Hackensack Township Board of Education	50
Township of Warren	46
Burlington County Institute of Technology	45
Eastern Camden County Regional School District	45
Township of West Milford	45
Hillsborough Municipal Utilities Authority	43
Borough of Garwood	41
Galloway Township Public Schools	40
Pennsauken Township Board of Education	“over 40 years”
Voorhees Township Public Schools	“over 40 years”
Camden County College	“approximately 40 years”
Raritan Community College	“approximately 40 years”
Borough of Lindenwold	“over 40 years”
Borough of Merchantville	“over 40 years”
Borough of Woodlynne	“over 40 years”
Township of Berlin	“over 40 years”
Township of Waterford	“approximately 40 years”
Township of Randolph	39
Delran Township Fire District No.1	39
Township of Rockaway	38
Borough of Roselle Park	38
Somerset County Parks Commission	38
Cumberland County	36
Elk Township	“36+ years”
Township of Glen Ridge	36
Township of Livingston	36

The fact that New Jersey government entities are not employing suggested practices in the area of auditor rotation raises the question of whether these external audit firms are capably fulfilling their mission of financial oversight. While future OSC reviews and audits will continue to examine that issue, recent reviews commissioned by the New Jersey Department of Education (DOE) heighten concerns in this area.

Specifically, in furtherance of a 2006 New Jersey Supreme Court order, DOE contracted with KPMG, LLP and Wiss & Company, LLP for reviews of the 31 “Abbott” school districts’ internal controls and other fiscal circumstances. Separately, the Cherry Hill School District recently contracted with KPMG for a similar review.

We compared the KPMG/Wiss reviews with the annual audits of the 22 of these districts that provided their audits to OSC. While the information reviewed by no means dictates that auditor rotation alone is the answer to better audit quality, the results reflect that generally the longer the district’s audit firm held the engagement, the greater the disparity between the KPMG/Wiss results and the district audit firm’s results. The following represent examples of our comparative results:

- One auditor that held the engagement for eight years identified the district as “low risk” with no internal control deficiencies. The subsequent review identified 13 deficiencies.
- One auditor that held the engagement for ten years identified the district as “low risk” and cited four control deficiencies. The subsequent

review identified the district as “high risk” in every department with 157 total deficiencies.

- One auditor that held the engagement for 14 years identified the entity as “low risk” with five control deficiencies. The subsequent review identified 33 deficiencies.
- One auditor that held the engagement for 17 years identified the district as “low risk” with no control weaknesses. The subsequent review identified the district as “high risk” with 60 deficiencies.

### **Audit Firm Selection**

In addition to surveying auditor rotation practices in New Jersey, our survey also asked all government units whether their current auditor had been selected through competitive contracting (as opposed to direct assignment of the contract to a preferred auditor). Responses revealed that many of New Jersey’s government units are not using competitive selection practices. As discussed below, use of such a non-competitive process can have a significant negative impact on audit quality.

Under State law, government entities in New Jersey may use a competitive contracting process to select an auditor, but are not statutorily required to do so. A competitive contracting process includes, at a minimum, public advertisement of the contract, up-front establishment of selection criteria, written evaluation and ranking of proposals, and public reporting on the results.

Observers of the government contracting process conclude, with apparent unanimity, that failure to use such a competitive process is generally contrary to the public interest.<sup>7</sup> Specifically, competition protects the public by helping to ensure that government gets the best value for services it buys. It guards against both unfair favoritism as well as inadvertent waste of taxpayer dollars. Awarding a contract through non-competitive assignment is particularly problematic in the case of audit work, where the “vendor” is performing an oversight role where independence is critical.

A competitive selection process for auditors and other professional services also serves as a safeguard against fraud, collusion, bribery, and other illegal activity.<sup>8</sup> New Jersey has an unflattering history of public officials obtaining illegal payments in return for assignment of contracts, including those for audit services. In just the last several years, the former mayor of Hoboken has plead guilty to obtaining a bribe from the municipal audit firm, the former county executive of Hudson County plead guilty to obtaining a bribe from the same firm, and the auditor for Ocean Township plead guilty to paying bribes to the town’s mayor. This type of illegal activity is far more difficult to accomplish when the government entity uses a procurement process that includes public advertisement of the auditing contract, up-front establishment of

selection criteria, and written evaluation of proposals by an evaluation committee.

In fact, an August 1987 study done by the United States General Accounting Office (GAO) found that “the process an entity follows to engage its auditor significantly relates to the quality of the audit and the final report.” GAO referred to competition as a “critical” aspect of the procurement process, since it “increases the likelihood of receiving a quality audit.” GAO also found that a competitive process “helps the entity control costs by increasing the likelihood that a quality engagement will be performed by an auditor at a fair price.”<sup>9</sup>

The GAO report also discussed the importance of using a comprehensive request for proposals (RFP), predetermined factors for evaluating and selecting the auditor, and a written contract that outlines the rights and responsibilities of both parties. The Government Finance Officers Association advocates for a similar process.

For these reasons, the federal government requires that a competitive process be used when procuring an auditor for the “single audit” required of any state or local government entity that expends federal funds of \$500,000 or more in a year. (Many government units in New Jersey are subject to this single audit requirement.) Specifically, circulars issued by the U.S. Office of Management and Budget (OMB) instruct that “[a]ll procurement transactions shall be conducted in a manner to provide, to the maximum extent practical, open and free competition.” (OMB Circular A-110.43). “In requesting proposals for audit services, the objective and scope of

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<sup>7</sup> See, e.g., Scott J. Kaplan, *Trustworthiness in Public Contracting: Back to Boss Tweed?*, 31 Pub. Cont. L. J. 237, 238-39 (2002) (citing authority); Lani A. Perlman, *Note: Guarding the Government’s Coffers: The Need for Competition Requirements to Safeguard Federal Government Procurement*, 75 Fordham L. Rev. 3187, 3195-96, 3232 & n.302 (2007) (same).

<sup>8</sup> Kaplan, *supra* note 7, at 238-39; Perlman, *supra* note 7, at 3232 & n.302.

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<sup>9</sup> U.S. General Accounting Office, *CPA Audit Quality: A Framework for Procuring Audit Services (AFMD-87-34)* at 22-27 (1987).

the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price.” (OMB Circular A-133.305(a)).

Similarly, to address identified problems with single audits, the U.S. Department of Housing and Urban Development has issued *Procuring an Audit*, which outlines procedures for using a competitive RFP process and explains how to evaluate proposal submissions. The guidance also includes instructions for documenting the agreement for services and for on-going monitoring of the audit process by an audit committee.

Some states have mandated these requirements through state legislation. For example, in New York, following financial scandals in several Long Island school districts, in 2005 the state legislature passed legislation requiring school districts to use a competitive RFP process for selection of external audit firms at a minimum of every five years.

In New Jersey, Executive Order No. 122, issued in 2004, addresses this issue but is limited in scope to State authorities. The order explicitly requires use of a competitive contracting process by those authorities: “The auditor selection process shall be based upon public, competitive bidding principles

and shall take place no less than once every five years.” The order further details the competitive process to be used, including issuance of a request for proposals, establishment of an evaluation committee, establishment of selection criteria, and ranking of proposals received.

In addition, the New Jersey Department of the Treasury has promulgated regulations requiring State agencies to use a competitive selection process for professional services contracts (including audit services) unless a waiver is provided by the State Treasurer. (N.J.A.C. 17:12-1A.1; N.J.A.C. 17:12:1A.2). Such waivers are granted only in limited circumstances. (Treasury Circular 08-08-DPP).

In compliance with these requirements, all New Jersey State agencies and authorities responding to our survey indicated that they had used a competitive process in selecting their audit firm. Survey results presented a different picture, however, as to the hundreds of New Jersey government units that retain a degree of discretion in determining whether to use a competitive process for auditor selection. In fact, despite all of the above guidance and despite the federal mandates, nearly half (48%) of the units responding to this question indicated they do not use a competitive process. Table 3 on the following page details these results.

**Table 3: Use of Competitive Contracting Process for Selecting Audit Firms**

<b>Type of Entity</b>	<b>Competitive<sup>10</sup></b>	<b>Non-Competitive<sup>11</sup></b>	<b>Total</b>
School Districts	182	189	371
Municipalities	137	135	272
Local Authorities	44	23	67
Fire Districts	3	29	32
Colleges/Universities	17	3	20
Counties	11	3	14
Other	26	11	37
<b>Total</b>	<b>420</b>	<b>393</b>	<b>813</b>

<sup>10</sup>The competitive category includes (but is not limited to) those entities that reportedly use the following bidding processes: “Request for Proposals” or “RFP”; “Request for Qualifications” or “RFQ”; “Fair and Open Process”; “Advertised for Public Bidding”; and “Competitive Contracting under the Pay to Play Statute.”

<sup>11</sup>The non-competitive category includes (but is not limited to) those entities that reportedly used the following bidding processes: “Non-Fair and Open Process”; “Appointed”; “Non-Competitive Contracting”; “Resolution Authorizing Firm;” “Unfair Process of the Pay to Play Statute”; “Not Selected by Competitive Bid”; “No Competitive Bidding-N.J.S.A. 40A:11.1 & 18A:18A-5”; “Informal Competitive Pricing”; “Professional Service Contract & Negotiations”; “Recommendation of the Governing Body” and “Renewal of Prior Years’ Contract.”

One hundred fifty-seven of the survey respondents did not respond to the question of whether they use competitive contracting for auditor selection. Moreover, a closer look at the responses that were given to this question provides reason to doubt how “competitive” a process was used by some entities that asserted or implied that they in fact had used such a process. For example, 13 of the units whose responses are classified as “competitive” have hired the same audit firm for 40 or more consecutive years. We question how competitive the process can truly be when the same result is achieved every year for several decades.

In fact, a review of information publicly available through the Election Law Enforcement Commission indicates that political contributions, rather than a truly competitive selection process, may be the primary driver in some instances of auditor selection.

By way of background, “pay to play” legislation was enacted in New Jersey in 2004 to add transparency where government contracts are awarded to firms making political contributions. (See N.J.S.A. 19:44A-20.4 et seq.). In short, that legislation provides that a local government entity may not contract with firms that have made otherwise disqualifying political contributions unless a transparent selection process is used.

Based on the responses to this survey question, we thus analyzed the level of political contributions by New Jersey accounting firms (and their employees) that audit government entities. The data reveals that the audit firm with the largest number of government clients in the State also is the firm that has made

the largest amount of political contributions, totaling nearly half a million dollars in 2006 and 2007. Collectively, the top ten firms with the largest number of government clients made political contributions exceeding \$1 million during that time period. These results are detailed in Table 4 on the following page.

In contrast, we also analyzed political contributions made by the 18 identified firms with only one government client. Of those 18 firms, only one made any political contributions during the time period in question.

**Table 4: Top 10 Audit Firms for All Government Units**

<b>Firm</b>	<b>Number of Public Clients</b>	<b>Political Contributions by Firm &amp; its Employees 2006 &amp; 2007</b>
Bowman & Company, LLP	98	\$ 494,800
Nisivoccia & Company	88	0
Lerch, Vinci & Higgins, LLP	80	145,490
Suplee, Clooney & Company	61	2,000
Ferraioli, Weilkotz, Cerullo & Cuva, P.A.	60	224,230
Holman & Frenia, P.C.	55	90,459
Ford, Scott, Seidenburg & Kennedy, LLC	47	31,130
Inverso & Stewart, LLC	42	45,500
Dickinson, Vrabel & Cassells, P.A.	40	0
Hutchins, Farrell, Meyer & Allison	38	43,050
<b>Total</b>	<b>609</b>	<b>\$1,076,659</b>

## CONCLUSIONS

- Use of a competitive contracting process in selecting an auditor is central to obtaining a quality audit and to securing the highest-value auditing services at the lowest cost.
- Survey results reveal that many government units in this State are not using a competitive process in selecting an auditor.
- As long as financial oversight in New Jersey remains heavily dependent on the role of external auditors, it is vital that government audit work be conducted by firms whose incentives are to exercise appropriate oversight with true independence from the government unit they are auditing. Those interests are best obtained through rotation of external audit firms.
- Survey results reveal that many government units in the State are not rotating their external audit firm in accordance with the professional guidance in this area.
- Separating audit firms from the political process in this State would further promote the independence of those firms.
- Publicly available political contribution data, read along side of our survey results, suggests the 2004 “pay to play” legislation has not broken the connections between political contributions

and the securing of government audit work.

## RECOMMENDATIONS

1. All government units in New Jersey that are required to have an annual audit performed should procure their auditor using a competitive selection process at a minimum of every five years. We recommend specifically that auditors be selected using a process that includes preparation of a request for proposals, public advertisement of that request, up-front establishment of selection criteria (both cost and quality-related), establishment of a methodology for evaluating and ranking proposals, and public reporting on the results. The system for competitive contracting set forth in the Local Public Contracts Law provides a model in this regard. (See N.J.S.A. 40A:11-4.1 et seq.). We recommend that the State Legislature consider enacting legislation that would make these competitive contracting rules mandatory where auditing services are being procured.
2. In no event should a government unit use the same audit firm for more than ten consecutive years. We recommend the Legislature consider enacting legislation that would impose this ten-year time limit.
3. Government units should follow a policy of not hiring any audit firm that has made political contributions on a local or State level in the year preceding the

audit engagement. We further recommend the Legislature consider enacting legislation that would bar government units from hiring such firms for their audit work. Such legislation could be crafted as an expansion of the current “pay to play” law. Alternatively, the legislation could be drafted as an expansion of current law that bars entities such as casinos, banks, and insurance companies (and certain of their employees) from making political contributions. (See N.J.S.A. 5:12-138; N.J.S.A. 19:34-45).