



# Contract issues for governmental audits

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The AICPA State and Local Government Expert Panel ([SLGEP](#)) meets periodically with the Government Finance Officers Association (GFOA) [Committee on Accounting, Auditing and Financial Reporting](#) to discuss topics of mutual interest. Recently, the SLGEP and GFOA worked together to develop this joint article intended to educate both governments and their auditors about clauses in contracts and engagement letters in the governmental environment that may not meet AICPA professional standards and that may create uncertainty about the auditor's independence.

# Background

When contracting for audit services, a contract and/or an engagement letter typically are used to document the agreement between the government (client) and the CPA firm. Many governments use standard contract templates for audit services that the government has developed to procure all services or products. Other governments use similar standard contract language in engagement letters or in requests for proposal. In order to procure an engagement for independent audit services, standard provisions in government contracts often need to be revised by the CPA firm and the government in order to meet professional standards. Standard contract provisions that do not meet the requirements of professional standards may create uncertainty about the auditor's independence.

Both the external auditor and the government should carefully consider contract provisions to ensure that the contract terms appropriately reflect the nature of the services, protect the interests of the government, and do not cause threats to CPA firm independence under professional standards (AICPA, *Professional Standards*).

Examples of such provisions include:

- **Indemnification** – Some standard government contracts include a contractor’s indemnification obligation to the government. Indemnification clauses in contracts are commonly negotiated. Such discussions are best handled by legal counsel of the government and the CPA firm to arrive at mutually agreeable terms. Be mindful that auditors cannot agree to indemnify the client for damages, losses or costs arising from lawsuits, claims or settlements that relate, directly or indirectly, to the *client’s* acts.<sup>1</sup>
- **Intellectual property/ownership of records** – Auditors and governments often will exchange a variety of documentation as part of their working relationship. However, contract templates will sometimes include a generic statement that the government owns all the records or materials produced under the contract. From the perspective of an audit engagement, such generic statements could be interpreted to include works such as the audit documentation. While contracts should support collaboration between the parties, the agreements for audit services should be tailored to address the unique considerations related to audit documentation. Auditors may need to protect the privacy of their audit strategy, such as materiality calculations, risk assessments and testing thresholds. Additionally, potential risks could arise for both the government and auditor when audit workpapers are subject to freedom of information requests.
- **Approvals of work products or staffing** – Provisions in contract templates that require the government to accept or approve the auditor’s work, staffing plan or staffing replacements could also pose potential problems to a CPA firm. Additionally, some contracts include language that would require the auditor under contract to pay another contractor (auditor) to re-perform the work if the auditor’s work product is not accepted by the government. These clauses might create an *undue influence* threat to independence in that the engaging government is put in a position to direct and supervise the auditor’s work.<sup>2</sup> However, contract terms requiring CPA firms to avoid significantly revising the staffing from what was proposed in response to a request for proposal are generally permissible under AICPA Professional Standards. Similarly, provisions providing the government with the right to agree to replacements of the key leaders of a CPA firm’s audit engagement team would also generally be permissible.
- **Warranties** – Contract templates often include warranties for the products delivered under the contract. The work product a CPA firm provides for audit services is not a good or service that can be warrantied as often described within contracts. Warranty provisions should be revised to indicate that the auditor’s work will be performed in accordance with the applicable professional standards.

<sup>1</sup> The “Indemnification of an Attest Client” interpretation (ET sec. 1.228.020) of the “Engagement Contractual Terms” subtopic (ET sec. 1.228) under the “Independence Rule” of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*).

<sup>2</sup> An *undue influence* threat is defined in the “Conceptual Framework for Independence” interpretation (ET sec. 1.210.18) of the “Conceptual Framework Approach” subtopic (ET sec 1.210) under the “Independence Rule” of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*).

- **Insurance** — Certain provisions relating to insurance included in audit contracts may cause a CPA firm to be out of compliance with its own professional liability insurance policy, thus rendering the CPA firm's policy invalid. Examples of such provisions in audit contracts may include, depending on the policy, the following:
  - Indemnification provisions (see page 3)
  - A provision requiring the CPA firm to name the contracting government as an additional insured party
  - A waiver of subrogation rights

Governments should be aware that CPA firms often are not able to obtain waivers from their insurers related to the above types of provisions. Therefore, an understanding of these issues by management is necessary to protect the government and the firm from the risk of the CPA firm having an invalid insurance policy.

# Recommendations

The following recommendations are provided regarding contracting for auditing services:

- **Allow for dialogue in the procurement process** — Occasionally, a government will issue a request for proposals and state that all terms and conditions (such as those described above) must be accepted at the time of the proposal submission without an opportunity for discussion or modification. Requiring firms to adhere to all terms and conditions of a standard contract template in order to move forward in the procurement process may result in some CPA firms choosing not to propose on audits, especially if they believe the contract terms are not permissible under professional standards. This could reduce competition and eliminate well-qualified firms from the audit procurement process. Allowing firms to identify areas of concern, and having a dialogue during the procurement process would allow for contracts that meet professional standards, are appropriately tailored to the nature of the services, and meet the needs of the government.
- **Finance director involvement** — Involvement of the finance director or other similar government official to educate and liaise with the government's procurement or legal department will assist in reaching an acceptable agreement for all parties. Given the unique nature of contracting for audit services, understanding the issues cited above is critical. Finance directors typically are closest to the audit arrangements, and thus can serve a key role in achieving a workable arrangement for both parties.
- **Collective view of contract provisions** — Taking a collective view of the entire contract during negotiation is important. Negotiation of terms are common, and decisions reached in one area of a contract may influence both parties' flexibility in other provisions.

Collaborative discussions between the CPA firm and the government generally are needed to ensure that standard government contract terms are reviewed and revised.

## Conclusion

As highlighted in this document, collaborative discussions between the CPA firm and the government generally are needed to ensure that standard government contract terms are reviewed and revised, if necessary, to fit the nature of audit services and meet the needs of all parties.

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