



**TOWN OF LOS GATOS
FINANCE COMMISSION REPORT**

MEETING DATE: 4/29/2024

ITEM NO: 1

DESK ITEM

DATE: April 26, 2024
TO: Finance Commission
FROM: Laurel Prevetti, Town Manager
SUBJECT: Review the Staff Report to Town Council on April 16, 2024 (Item #19) and Discuss Options and Scope of Services Potentially Required Arising from the Finance Commission's Recommendation to Retain a Separate Firm to Provide the Non-Attest Services as Outlined in the Chavan and Associates Engagement Letter.

REMARKS:

Attachment 7 contains commissioner comments received after 11:00 a.m. on Friday, April 26, 2024, and before 11:00 a.m. on Monday, April 29, 2024.

Attachments Previously Received with the Staff Report:

1. Council Staff Report 4/6/2-24 – Item 19
2. American Institute of Certified Public Accountants (AICPA) Professional Conduct – Section 1.295 – Non-Attest Services
3. Chavan and Associates Engagement Letter
4. Auditor Communication
5. Commissioner's Communications

Attachments Previously Received with the Addendum:

6. Commissioner's Communications received after distributing the staff report and before 11:00 a.m. on Friday, April 26, 2024

Attachments Received with this Desk Item:

7. Commissioner's Communications received after 11:00 a.m. on Friday, April 26, 2024, and before 11:00 a.m. on Monday, April 29, 2024

PREPARED BY: Eric Lemon, CPA
Finance & Accounting Manager

Reviewed by: Town Manager, Town Attorney, and Finance Director

From: [Phil Koen](#)
To: [Laurel Prevetti](#)
Cc: [Linda Reiners](#); [Andrew Howard](#); [Ashby Monk](#); [Joseph Rodgers](#); [Rob Rennie](#); [Matthew Hudes](#); [Mary Badame](#); [Maria Ristow](#); [Rob Moore](#); [Gitta Ungvari](#); [Gabrielle Whelan](#); [Wendy Wood](#)
Subject: Agenda Item #1 - Finance Commission - Auditor Independence concerns
Date: Monday, April 29, 2024 7:42:16 AM
Attachments: [Staff Memo - Item #1 - April 29 2024.pdf](#)
[Pages from GAO-24-106786.pdf](#)
[Pages from GAO-24-106786\(1\).pdf](#)

[EXTERNAL SENDER]

Dear Ms. Prevetti,

We have read your report for agenda item #1 which is attached. We are encouraged the Town Council agrees with the Finance Commission's recommendation to address the Commission's concern regarding the long-standing AICPA professional requirement that auditors who provide services to entities (regardless of the entity being a company or a state or local government) for which independence is required, be independent both in fact (that is, of mind) and in appearance.

In addition to the AICPA requirement, the Government Accountability Office sets independence rules that apply to entities audited under Government Auditing Standards (referred to as GAGAS). The Government Auditing Standards apply to the Town of Los Gatos and the auditor must also comply with these independence rules. We have attached the relevant GAGAS rules for your review. For sake of clarity, the AICPA rules also require a member to comply with more restrictive independence provisions if applicable, such as the Government Accountability Office.

In listening to the Town Council discussion of this topic and reading the attached staff memo, we believe more disclosure is required so both the Town Council and the public fully understand and appreciate the "self-audit" concerns we have raised.

With this in mind, we respectfully offer the following comments and observations:

- The threat to independence as outlined in GAGAS section 3.88

is triggered by the auditor preparing the basic financial statements and footnotes from a client provided trial balance. Creating a threat of independence increases audit risk which must be addressed. Please refer to the attached flow chart of independence considerations for preparing accounting records and financial statements prepared by the Government Accountability Office.

- While it may be common practice for municipalities to have basic financial statements prepared by their “independent” auditor (the Finance Commission is not able to agree or disagree with this assertion), this is not a “best practice” and is not recommended by GFOA or the Government Accountability Office. This might be convenient or expedient but so doing creates a “significant” threat to independence which requires mitigation.
- As a result of preparing the basic financial services (called non-attest service), the auditor must meet several requirements which are safeguards to clear the presumptive hurdle of impairment of independence. The auditor must document actions taken to mitigate this impairment to an acceptable level. This adds additional cost, time, and risk to the audit process.
- Auditing a trial balance does not provide sufficient assurance the **basic financial statements** are free from material misstatements and certainly does not “allow” the auditor to issue an opinion on the Town’s basic financial statements. The auditor is expressing an opinion on the basic financial statements taken as a whole, not an opinion on an “audited” trial balance. Please refer to Chavan and Associates engagement letter dated March 9, 2022.
- The Town should prepare the basic financial statements and footnotes on their own to avoid tripping section 3.88. If the Town is unwilling or incapable of preparing the basic financial statements and footnotes, then a separate firm should be retained to prepare the financial statements and footnotes.

This would avoid the “self-audit” independence concern arising from performing a non-attest service when also performing an attest engagement.

- The auditor is currently performing the non-attest work (approximately 16% of engagement work) and with proper scheduling a third party or the Town staff should be able to take on this work without elongating the audit schedule or materially increasing the cost of the audit. To be clear, the Town currently issues its ACFR 6 months after the close of the fiscal year.

We look forward to discussing with Staff the best way to achieve the objective of reducing the independence concerns arising from the non-attest services currently performed by the auditor as outlined in his engagement letter.

Sincerely,

Phil Koen
Chair of the Finance Commission
the Finance Commission

Linda Reiners
Vice Chair of



TOWN OF LOS GATOS
FINANCE COMMISSION REPORT

MEETING DATE: 4/29/2024

ITEM NO: 1

Item 1.

DATE: April 24, 2024
TO: Finance Commission
FROM: Laurel Prevetti, Town Manager
SUBJECT: Review the Staff Report to Town Council on April 16, 2024 (Item #19) and Discuss Options and Scope of Services Potentially Required Arising from the Finance Commission’s Recommendation to Retain a Separate Firm to Provide the Non-Attest Services as Outlined in the Chavan and Associates Engagement Letter.

RECOMMENDATION:

Discuss the Town Council’s action to move forward with the Finance Commission’s recommendation to hire a separate firm to compile the Annual Comprehensive Financial Report (ACFR), including the financial statements, as distinguished from the work of the Town’s independent auditor.

BACKGROUND:

The Finance Commission Chair requested this agenda item (see Attachment 4). At the December 11, 2023 Finance Commission meeting, Commissioners passed a motion to “make a recommendation to the Town Council to adopt a practice to hire a separate accounting firm who will perform the work and someone else who will do the final preparation of the financial statements.”

At the January 8, 2024 Finance Commission meeting, the intent of the motion was clarified verbally to be “make a recommendation to the Town Council to adopt a practice to hire separate entity from our independent audit firm to perform work necessary for the preparation of the Town’s financial statements.”

At the April 16, 2024 Council meeting, the Council approved the Finance Commission’s recommendation and directed that staff engage in a process of selection a separate entity for

PREPARED BY: Eric Lemon, CPA
Finance & Accounting Manager

Reviewed by: Town Manager, Town Attorney, and Finance Director

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SUBJECT: ACFR Preparation Services – Staff Presentation to Council

DATE: April 24, 2024

BACKGROUND (continued):

assisting with the preparation of the Annual Comprehensive Financial Report (ACFR) (Attachment 1 contains the report to Town Council).

DISCUSSION:

At the December 11, 2023 meeting, the Finance Commission indicated that the reason for the motion was to avoid a misconception by having the Town's independent auditor complete the preparation of the financial statements. During the discussion portion of the meeting, the Town's independent auditor agreed with the recommendation and clarified that the firm is currently following all audit standards and do not audit their own work. The process is first to complete the audit, and then prepare the financial statements.

At the April 16, 2024 Town Council meeting, staff presented the Commission's recommendation accurately and provided additional information regarding other municipalities in Santa Clara County that have their independent auditors complete the same work to allow efficiency (Attachment 1). During discussion, a question was asked by a Council member regarding the reason for the recommendation and staff answered that it was due to a potential threat to independence. The potential threat to independence is mitigated by safeguards as described in the following paragraphs.

Financial Statement preparation is a common non-attest service completed by the external auditor of municipalities. Non-attest services are permitted under the American Institute of Certified Public Accountants (AICPA) Code of Conduct section 1.295.040-.01. The details of the AICPA Code of Conduct are contained in Attachment 2. Based on review of the Engagement Letter, the Town's independent auditor has met all the requirements to perform the non-attest service (see Attachment 3).

To issue an opinion on the financial statements and the related opinion units, the independent auditor tests the underlying accounts and supporting records. All of this starts with the Town's Trial Balance (TB) which is the hub of the audit in terms of substantiating the numbers via the audit procedures. The financial statements and notes in the ACFR are prepared from this audited Trial Balance. The audited trial balance allows the independent auditor to issue opinions on each opinion unit contained within the ACFR.

The Town's most recent Request for Proposal for Auditing Services was reviewed by the Finance Commission at its August 9, 2021 meeting (see Item 11 at the following link):

<https://mccmeetings.blob.core.usgovcloudapi.net/losgatos-pubu/MEET-Packet-a5e23a0ea71d484fb5efa614cd507771.pdf> .

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SUBJECT: ACFR Preparation Services – Staff Presentation to Council

DATE: April 24, 2024

DISCUSSION (continued):

The Finance Commission participated in the selection of the current independent auditor (see Item 4 from the 12-6-2021 Special Finance Commission meeting at the following link):

<https://mccmeetings.blob.core.usgovcloudapi.net/losgatos-pubu/MEET-Packet-3e79e964cfd94a859b41582bfc08c498.pdf> .

The Town's independent auditor will be available via Zoom to address the Commissioner's questions at the meeting.

CONCLUSION:

As staff mentioned at the Council meeting, staff is open to hiring a separate consultant. Staff is in the process of developing the Request for Qualifications. As this is not a common practice in local government, staff will make all efforts to promote this opportunity to find qualified consultants to assist with the completion of the ACFR. Once responses are received, the Town will select the most qualified firm. The cost of the service will not be known until responses are received.

Staff anticipates that the independent auditor will closely work with the selected consultant, providing the audited trial balance for the compilation of the data. Setting up the mapping of the accounts and providing the audited data require additional preparation time for the ACFR. It is likely that the first year of this agreement will cause delays in the preparation of the ACFR. This also means that the timeline of a special meeting to discuss the ACFR will likely change, and the Finance Commission will receive the ACFR less than seven days prior to the special Finance Commission meeting at which the Commission begins its discussion of the document.

FISCAL IMPACT:

There is no fiscal impact associated with the Commission's discussion of this item.

ENVIRONMENTAL ASSESSMENT:

This is not a project defined under CEQA, and no further action is required.

Attachments:

1. Council Staff Report 4/6/2-24 – Item 19
2. American Institute of Certified Public Accountants (AICPA) Professional Conduct – Section 1.295 – Non-Attest Services
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United States Government Accountability Office

By the Comptroller General of the
United States

February 2024

GOVERNMENT AUDITING STANDARDS

2024 Revision

Requirements: Providing Nonaudit Services

3.83 Auditors who previously provided nonaudit services for an entity that is a prospective subject of an engagement should evaluate the effect of those nonaudit services on independence before agreeing to conduct a GAGAS engagement. If auditors provided a nonaudit service in the period to be covered by the engagement, they should (1) determine if GAGAS expressly prohibits the nonaudit service; (2) if audited entity management requested the nonaudit service, determine whether the skill, knowledge, or experience of the individual responsible for overseeing the nonaudit service was sufficient; and (3) determine whether a threat to independence exists and address any threats noted in accordance with the conceptual framework.

3.84 Auditors in a government entity may be required to provide a nonaudit service that impairs the auditors' independence with respect to a required engagement. If, because of constitutional or statutory requirements over which they have no control, the auditors can neither implement safeguards to reduce the resulting threat to an acceptable level nor decline to provide or terminate a nonaudit service that is incompatible with engagement responsibilities, auditors should disclose the nature of the threat that could not be eliminated or reduced to an acceptable level and modify the GAGAS compliance statement as discussed in paragraph 2.17b accordingly. Determining how to modify the GAGAS compliance statement in these circumstances is a matter of professional judgment.

Consideration of Specific Nonaudit Services

3.85 By their nature, certain nonaudit services directly support an entity's operations and, if provided to an audited entity, create a threat to the auditors' ability to maintain independence in mind and appearance. Some aspects of these services will impair auditors' ability to conduct GAGAS engagements for the entities to which the services are provided.

3.86 Auditors may be able to provide nonaudit services in the broad areas indicated in paragraphs 3.87 through 3.106 without impairing independence if (1) the nonaudit services are not expressly prohibited by GAGAS requirements, (2) the auditors have determined that the requirements for providing nonaudit services in paragraphs 3.73 through 3.78 and paragraph 3.83 have been met, and (3) any significant threats to

independence have been eliminated or reduced to an acceptable level through the application of safeguards. The conceptual framework enables auditors to evaluate independence given the facts and circumstances of individual services that are not specifically prohibited.

Requirements: Preparing Accounting Records and Financial Statements

3.87 Auditors should conclude that the following services involving preparation of accounting records impair independence with respect to an audited entity:

- a. determining or changing journal entries, account codes or classifications for transactions, or other accounting records for the entity without obtaining management's approval;
- b. authorizing or approving the entity's transactions; and
- c. preparing or making changes to source documents without management approval.

3.88 Auditors should conclude that preparing financial statements in their entirety from a client-provided trial balance or underlying accounting records creates significant threats to auditors' independence, and should document the threats and safeguards applied to eliminate and reduce threats to an acceptable level in accordance with paragraph 3.33 or decline to provide the services.¹⁸

3.89 Auditors should identify as threats to independence any services related to preparing accounting records and financial statements, other than those defined as impairments to independence in paragraph 3.87 and significant threats in paragraph 3.88. These services include

- a. recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an audited entity's general ledger;

¹⁸See fig. 2 at the end of ch. 3 for a flowchart on independence considerations for preparing accounting records and financial statements.

- b. preparing certain line items or sections of the financial statements based on information in the trial balance;
- c. posting entries that an audited entity's management has approved to the entity's trial balance; and
- d. preparing account reconciliations that identify reconciling items for the audited entity management's evaluation.

3.90 Auditors should evaluate the significance of threats to independence created by providing any services discussed in paragraph 3.89 and should document the evaluation of the significance of such threats.¹⁹

Application Guidance: Preparing Accounting Records and Financial Statements

3.91 Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, even if the auditor assisted in drafting those financial statements. Consequently, an auditor accepting responsibility for the preparation and fair presentation of financial statements that the auditor will subsequently audit or that will otherwise be the subject matter of an engagement would impair the auditor's independence.

3.92 Source documents include those providing evidence that transactions have occurred (for example, purchase orders, payroll time records, customer orders, and contracts). Such records also include an audited entity's general ledger and subsidiary records or equivalent.

3.93 Determining whether services, as discussed in paragraph 3.89, are significant threats and require safeguards is a matter of professional judgment.

3.94 Factors that are relevant in evaluating the significance of any threats created by providing services as discussed in paragraph 3.89 include

¹⁹See para. 3.33 for additional requirements related to documenting threats identified and safeguards applied to eliminate or reduce threats to an acceptable level.

- a. the extent to which the outcome of the service could have a material effect on the financial statements,
- b. the degree of subjectivity involved in determining the appropriate amounts or treatment for those matters reflected in the financial statements, and
- c. the extent of the audited entity's involvement in determining significant matters of judgment.

3.95 Providing clerical assistance, such as typing, formatting, printing, and binding financial statements, is unlikely to be a significant threat.

Requirement: Internal Audit Assistance Services Provided by External Auditors

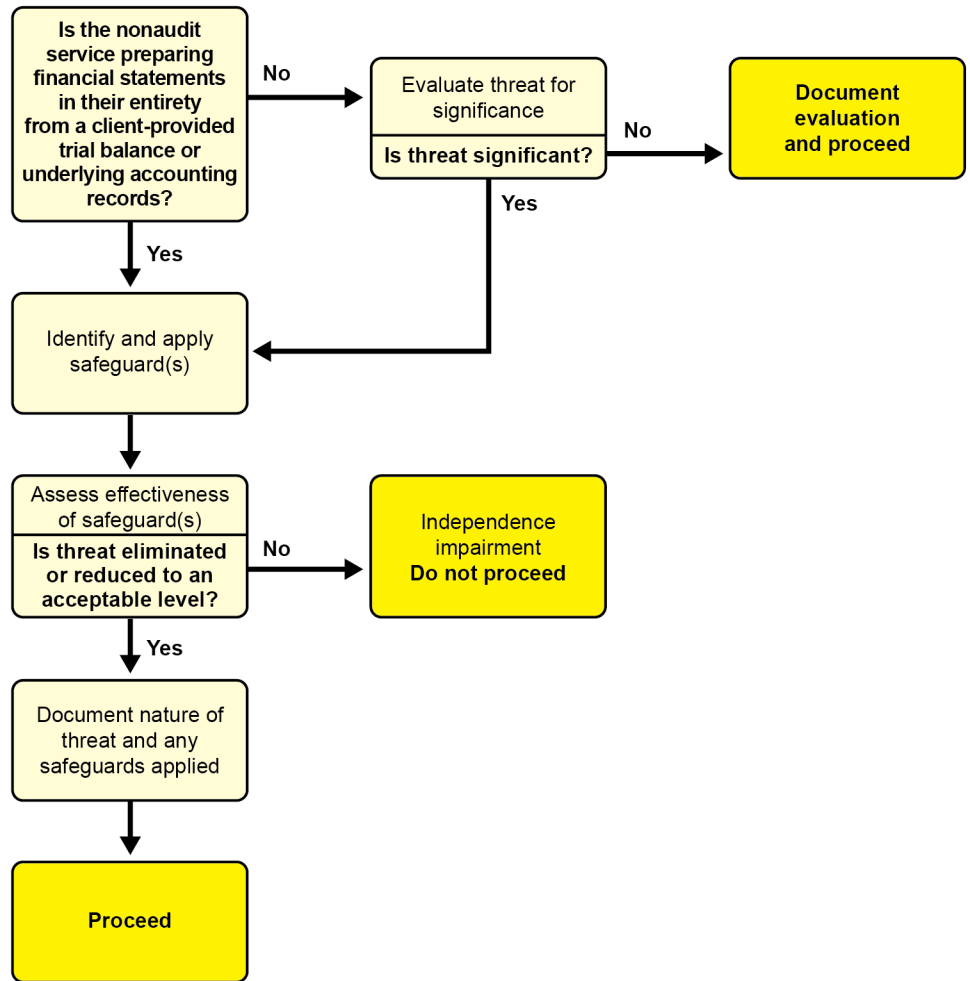
3.96 Internal audit assistance services involve assisting an entity in performing its internal audit activities. Auditors should conclude that the following internal audit assistance activities impair an external auditor's independence with respect to an audited entity:

- a. setting internal audit policies or the strategic direction of internal audit activities;
- b. performing procedures that form part of the internal control, such as reviewing and approving changes to employee data access privileges; and
- c. determining the scope of the internal audit function and resulting work.

Requirements: Internal Control Evaluation as a Nonaudit Service

3.97 Auditors should conclude that providing or supervising ongoing monitoring procedures over an entity's system of internal control impairs independence because the management participation threat created is so significant that no safeguards could reduce the threat to an acceptable level.

Figure 2: Independence Considerations for Preparing Accounting Records and Financial Statements



Source: GAO. | GAO-24-106786