**<u>Item #6:</u>**

**Res. Accepting Proposal From Baker Tilly For Auditing Services**

Baker Tilly Memo Re: Number Of Bank Accounts

03/18/15

## PRIOR YEAR POINTS

### *Internal Control Over Agency Fund Accounting*

The village maintains several agency funds as part of their accounting records. Over the last several years, there has been activity recorded in the Fees Refundable to Others fund that should be reported in other funds, such as the downtown TIF or the general fund. The village also records income statement accounts in this fund, which has resulted in an accumulated balance over the years of approximately $35,000. An agency fund should only be maintaining a balance sheet due to the nature of the fund. Income statement accounts such as bank fees, interest income, etc. should likely be moved to another fund such as the general fund. We recommend the village review prior year transactions to determine where the accumulated balance in the Fees Refundable to Others fund should be recorded, and also enhance controls surrounding the type of activity recorded in this fund going forward.

#### *Status (4/30/14)*

This review has been completed and amounts have been paid over to the general fund. This point is resolved.

### *Numerous Bank Accounts*

The village maintains numerous cash accounts with two of the financial institutions it does business with. At April 30, 2013, the village maintained ten checking accounts and ten savings accounts with a credit union, and twelve accounts with a bank. Maintaining so many accounts results in additional administrative time to reconcile each one each month, additional time to prepare a deposit for each one that receives a portion of village's daily collections, weakens internal controls, greatly increases the need for interfunds (reported as due to/due from as a result of village funds owing each other money) at year end, and possibly additional banking fees. It is our understanding that the general ledger software system, QuickBooks, used by the village's accountants, may have some system limitations that would create additional burdens for reconciling the bank accounts to the financial records if these accounts were consolidated. However, we recommend that village management work with the village's accountants to determine if it is feasible to consolidate these bank accounts into one or two that can then be accounted for separately within the general ledger system.

#### *Status (4/30/14)*

The village continues to maintain the accounts noted above. However, management utilizes each of these accounts as a process to track activities specific to village functions. In addition, utilizing them as part of the village's controls between amounts transacted at the village, and accounted for by the village's outsourced accounting company, establishes important control features that may be jeopardized if the accounts were consolidated. Therefore, this point is considered resolved.

### *Allowance For Doubtful Account*

The village has been reporting $35,550 in this account within the general fund since 2008. It originated from an invoice sent by the village to a citizen for tree replacement costs. Based on the length of this outstanding receivable, its collection appears unlikely. We recommend the village determine if this receivable can be collected, and if not, the allowance and the related receivable should be eliminated during the next fiscal year.

#### *Status (4/30/14)*

Collection of this item did not occur during fiscal 2013-14 and the amount, and related allowance, is still outstanding. It is our understanding that the village will work with their attorney to make a final determination as to whether to pursue collection efforts or not. This point is still valid.

#### *Management's Response (4/30/14)*

The village will request its legal counsel to make a determination of the collectability of this receivable and take any necessary actions to resolve this matter.

BAKER TILLY

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> To Mr. David Lothspeich, Village of Long Grove Manager

> From Thomas Scheidegger, Partner and John Rader, Senior Manager

> Date March 17, 2015

> Re Numerous bank accounts comment and auditor retention

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After your questions regarding the two above-noted items, we wanted to provide you with some further information for the upcoming board meeting.

For the 2012 audit we reported our recommendation to reduce the number of cash and savings accounts maintained by the village. We reported this comment to management and the village board in our Communication to Those Charged with Governance and Management (management letter). The auditing standards as established by the American Institute of Certified Public Accountants (AICPA) requires that we communicate issues to the governing body and management that rise to the level of a material weakness or significant deficiency as defined by those same standards. The comment regarding the numerous checking accounts did not rise to those levels. We considered it to be comment to operate the village's accounting more efficiently. It was reported in the April 30, 2013 and 2014 management letters.

Our primary concern centered on the administrative time to manage the accounts held at the two financial institutions, internal controls that need to be established over all of the accounts, and the additional accounting requirements that are necessary by the village's accountants to report the transactions and manage the accounts. We want to emphasize that our recommendation was not to close the accounts, but rather, to determine if it would be feasible to consolidate some of them at the financial institutions so that fewer accounts would be open, thus reducing the time required each month for bookkeeping.

For the 2014 audit, we worked with village management as well as their accountants to determine if it still made sense to attempt to consolidate some of these accounts. It was determined that the QuickBooks financial accounting system software used does not have any known capabilities to account for cash and investments through the use of pooled (shared) general ledger accounts that many more sophisticated and expensive financial accounting systems do. In addition, we concurred with the village in determining that the checking and savings accounts utilized by the village manager provide a mechanism that allow for verification and assurance between amounts collected at village hall and amounts reported in the general ledger for specific activities. This control utilized by the village manager, and the accountants, is critical in establishing the process being used to track specific funding sources to assure the integrity of funds. It allows for the segregation between maintaining the general ledger and custody of the funds. We therefore reported to the village as part of our 2014 audit, that we considered the issue resolved since it was considered by management and their accountants as we recommended.

It is common to communicate recommendations in one year, and then resolve them in a subsequent year if we are able to determine that management has appropriately assessed the issue and either taken action, or provided evidence to us that allow us to determine that the point has been sufficiently considered and addressed.

It should also be noted that many of the village checking and saving accounts are required to be maintained in separate accounts either by grant agreements, state statutes, village ordinances, or other enabling legislation. In addition, the current structure of the ten checking accounts and ten savings accounts held at the credit union are structured as such so as to adequately insure the funds so as to prevent losses if the credit union were to fail.

The other issue we discussed was related to the costs and benefits associated with mandatory auditor rotation. We have attached a communications from the AICPA that does an excellent assessment of this issue.

Our firm follows the independence requirements of the AICPA, the GAO and the PCAOB which specify that the auditor be independent in face and in appearance. We take these requirements very seriously as they are a cornerstone of our profession. We have developed internal controls and procedures that all staff are required to follow. We maintain auditor skepticism whenever we perform an audit.

Baker Tilly's quality control procedures require an engagement quality review of every audit, financial statement, and management letter issued to our clients. The reviewer is always a highly experienced, usually at the partner level that is independent of the client being audited. Resolution of any matters of disagreement must occur prior to the audit being finalized.

In addition, over the years that we have audited the village, we have had four complete turnovers of audit staff performing the detail audit work. While the partner and senior manager have been consistent over these years, all of the individuals doing the majority of account balance testing, risk assessments, planning, report development, and more have brought a fresh perspective to the audit. We believe this serves the village well by providing a deep understanding of the critical issues faced by the village through partner and manager consistency, while at the same time allowing for rotation of those performing the tests and working with the village's accountants. We have always expressed, and continue to be open to rotation at all levels of the audit for the village, including the senior manager and partner-in-charge. As noted in our proposal, we have a very large public sector group that we could utilize if the village ever desired a change in any level assigned to the audit.

As a firm, we strive to provide quality consistent service to our valued clients. We have public sector clients that we have served for more than 60 years. As partner, I currently am the partner in charge of 24 clients that average 24 years of service. Some I have worked on my entire career of 37 years. This level of longevity is consistent throughout our public sector group and our firm.

We look forward to the opportunity to speak with you about these or any other concerns the village may have relative to the audit process.

American Institute of CPAs
1211 Avenue of the Americas
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December 14, 2011

*VIA ELECTRONIC MAIL*

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington D.C. 20006-2803

**Re: Request for Public Comment: Concept Release on Auditor Independence and Audit Firm Rotation**

Dear Office of the Secretary:

The American Institute of Certified Public Accountants' ("AICPA") is pleased to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Rulemaking Docket Matter No. 037, "Concept Release on Auditor Independence and Audit Firm Rotation" (the "Concept Release"). The AICPA is the largest professional association of certified public accountants in the United States, with over 370,000 members in business, industry, public practice, government, and education. Throughout its history the AICPA has been deeply committed to promoting and strengthening auditor independence and objectivity.

Due to the subject matter of the Concept Release, the AICPA has received input from members of its Professional Ethics Executive Committee (PEEC). Through the PEEC, the AICPA devotes significant resources to independence activities, including evaluating existing standards, proposing new standards, and interpreting and enforcing those standards.

**General comment**

The AICPA supports and shares the PCAOB's overall goal to enhance auditor independence, objectivity and professional skepticism. Clearly, independence, objectivity and professional skepticism serve as the foundation of a high quality audit and we agree that these core values should be continually assessed and enhancements made, where necessary. However, we are concerned that the PCAOB's focus appears to be on mandatory firm rotation as a means to achieve such enhancements. Moreover, it appears that the Board's rationale for pursuing mandatory firm rotation is based on an unsubstantiated presumption that its inspection findings are the result of a lack of auditor objectivity and professional skepticism and that this could be improved through mandatory firm rotation. While auditor objectivity and professional skepticism is one driver of a high quality audit, there are also other important drivers such as the auditor's competence (e.g., industry knowledge and experience), appropriate application of the audit methodology, as well as robust audit and quality control standards.

Indeed, the Board has acknowledged that its preliminary analysis of inspection data appears to show no correlation between auditor tenure and the number of comments in its inspection



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reports. Accordingly, we recommend that the Board further study and analyze the root causes of its inspection findings and for the reasons stated below, refrain from pursuing a mandatory firm rotation requirement.

**Mandatory firm rotation carries costly and unintended consequences**

We believe that mandatory firm rotation carries significant costs and possible unintended consequences that have the potential to hinder audit quality rather than the intended goal of enhancing audit quality. We have provided examples of such costs and unintended consequences below for the Board's consideration.

*Research indicates adverse impact on audit quality*

Research indicates that mandatory firm rotation may have an adverse impact on audit quality;[1] however, we are not aware of any such credible research that exists demonstrating that firm rotation would significantly improve audit quality. In fact, numerous academic studies indicate that audit quality actually increases with audit firm tenure.[2] Experience and knowledge of the company's operations and industry are crucial to a high quality audit and such knowledge and experience increases with audit tenure. Academic research has demonstrated that audit quality "tends to improve rather than worsen with tenure, providing support to the expectation that there is a significant learning process for the auditor, i.e., an auditor needs time to get to know sufficiently well the business of the client and, consequently, audit quality tends to increase over time." [3] Such studies have further concluded that audit quality suffers when the auditor lacks a solid base of experience and understanding of a public company's business.[4]

Mandatory firm rotation may also result in a greater risk of fraud and therefore, adversely impact audit quality. Specifically, academic research indicates that fraudulent financial reporting is more likely to occur in the first three years of the auditor-client relationship. Furthermore, such research concludes that there is no evidence that the risk of fraudulent financial reporting is greater with long audit tenure.[5]

Finally, while some may argue that there is a *perception* that long audit tenure may adversely impact auditor objectivity and professional skepticism and therefore, impair the *appearance* of

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[1] See, *Audit Firm Tenure and Fraudulent Financial Reporting*, Joseph Carcello and Albert Nagy (January 2004); *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?* Mara Cameran, Annalisa Prencipe, and Marco Trombetta (2008)

[2] See, *Mandatory Audit Firm Rotation and Audit Quality*, Andrew B. Jackson, Michael Moldrich and Peter Roebuck (The University of New South Wales) (July 2007)

[3]See, *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?*, Working Paper, Bocconi University (Milan- Italy) and IE Business School (Madrid- Spain), Cameran, M., Prencipe, A., Trombetta, M. (2010).

[4]See, *Earnings Quality: Some Evidence on the Role of Auditor Tenure and Auditors' Industry Expertise*, Ferdinand A. Gul, Simon Yu Kit Fung, and Bikki Jaggi (2007); *A Survey of the Impact of Mandatory Rotation Rule on Audit Quality and Audit Pricing in Italy*, SDA Bocconi University (Milan-Italy) M. Cameran, M. Livatino, N. Pecchiarie A. Viganò (2003); Auditor *Tenure and Audit Quality: The Role of the Demand for Unique Client Specific Knowledge,* Bin Srinidhi, Sidney Leung, and Ferdinand A Gul (April 2010); "*Required Study on the Potential Effects of Mandatory Audit Firm Rotation*" GAO Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services (November 2003).

[5]See, *Audit Firm Tenure and Fraudulent Financial Reporting.* Auditing: A Journal of Practice and Theory, Vol. 23, Issue 2. Carcello, J.V. and Nagy, A.L. Sept. 2004.

independence, research indicates that "investors and information intermediaries perceive auditor tenure as improving audit quality."[6]

Accordingly, extensive research has been conducted that suggests mandatory firm rotation would not achieve the Board's objective of enhancing audit quality but rather, may serve to impair it.

*May limit institutional knowledge, experience, and industry specialization*

As noted, research demonstrates that institutional knowledge and experience are crucial to a high quality audit and increases over time. Mandatory firm rotation would clearly hinder the auditor's ability to accumulate such institutional knowledge and experience and could therefore, adversely impact audit quality. In addition, mandatory firm rotation could result in limiting companies in specialized industries to engage audit firms who have the appropriate skill set and experience to perform the audit. For example, in some geographical areas, companies may be limited in the number of audit firms that specialize in their industry and have the expertise to provide a quality audit. Mandatory firm rotation could have the result of forcing companies to select an auditor who is not as capable with the result of diminishing audit quality. In addition, many firms specialize in certain industries and devote significant resources to training partners and staff in these focused areas. If an audit firm is required to rotate from the engagement and there are few or no other companies who require the same audit specialization, the firm may decide to no longer maintain the industry specialization, even further limiting the number of audit firms with the requisite industry expertise for companies to choose from.

We also believe that mandatory firm rotation could have a severe impact on multi-national audits. Audits of multi-national companies generally involve complex business structures and transactions that require the auditor to develop and maintain expertise in specialized areas. This potential loss of institutional knowledge and experience could be extremely disruptive to multi-national companies and their auditors and result in significant costs. In addition, multi-national audits could be extremely difficult to manage if countries around the world adopted mandatory firm rotation requirements with differing rotation periods. For example, multiple rotation regimes for multi-national companies could result in multiple audit firms and varying audit methodologies used on a particular audit.

*Increased costs and resources*

In the Concept Release, the Board recognizes that "a rotation requirement would significantly change the status quo and accordingly, would risk significant cost and disruption." [7] We agree that these costs would be significant and may cause a major disruption to the capital markets.

As the Board points out, in the Government Accountability Office's (GAO) "Required Study on the Potential Effects of Mandatory Audit Firm Rotation," firms estimate that in the first year, mandatory firm rotation could result in increased audit costs of more than 20 percent[8] The GAO Study also estimated that "Following a change in auditor under mandatory audit firm rotation,

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[6]See, *Auditor Tenure and Perceptions of Audit Quality*, Aloke Ghosh, Doocheol Moon (April 2005).
[7] Concept Release. page 3.
[8] Concept Release, page 14.

the possible additional first year audit-related costs could range from 43 percent to 128 percent higher than the likely recurring audit costs had there been no change in auditor."[9]

In addition to the increase in audit costs, there are other costs that the Board should take into consideration. For example, once a firm is forced to rotate, the company must devote significant resources to identifying and hiring a new audit firm that has the requisite expertise. Such costs include meeting and corresponding with firms regarding the company's business, drafting and responding to proposals, and interviewing the audit firms. Once selected, the company would also need to devote significant time to educating the audit firm on the company's business and operations, internal control systems, accounting and financial reporting systems, and other areas so the firm has the requisite knowledge to perform a quality audit.

In addition to the significant time involved in gaining the necessary understanding of the company's business, operations and systems, the audit firm must also devote considerable time to reviewing the predecessor auditor's working papers, identifying risk areas, understanding complex transactions and other audit planning matters that generally involve significant time commitments as part of the first year's audit. It is likely these additional audit hours would result in an increase in audit fees to the company.

*Undermines role of audit committee*

Mandatory firm rotation may have the unintended consequence of undermining the role of the audit committee. The Sarbanes-Oxley Act ("SOX") assigned responsibility to independent audit committees for overseeing the financial reporting process, including the hiring and firing of the external auditor. However, mandatory rotation could prevent the audit committee from selecting and retaining the most qualified audit firm to perform the company's audit. Since the audit committee is responsible for the selection and oversight of the audit firm, the audit committee should be able to use its discretion and judgment when determining which audit firm is best suited to perform the company's audit. In determining which firm is most capable, the audit committee should consider a number of factors and arguably, firm tenure should be one such factor. Other important factors include the qualifications and reputation of the audit firm, industry experience, and reasonableness of the audit plan. The audit committee is also in the best position to evaluate the quality of the audit and assess the independence and objectivity of the auditor. Clearly, this should be an important factor considered by the audit committee when determining if reappointment of the auditor is appropriate.

Mandatory rotation could limit the audit committee's choice of audit firms and therefore, hinder its ability to select or reappoint the audit firm that can perform the highest quality audit in the most efficient and effective manner. This result could be exacerbated in situations where the company is in a specialized industry with a limited number of firms who have sufficient industry expertise or where the company is located in a geographical area with a limited number of audit firms available to perform the audit.

**Consider impact of recent standards and other potential enhancements**

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[9] GAO Report, page 33.

*Consider impact of SOX and new standards*

In 2002, SOX created significant reforms to restore public trust and investor confidence. Pursuant to SOX, the SEC implemented stringent independence rules to enhance auditor independence, objectivity and professional skepticism. These rules included prohibitions on the provision of certain nonaudit services, prohibitions on hiring former auditors (including a "cooling-off" period), and a requirement for lead and concurring partner rotation every five years and rotation of other audit partners every seven years.

We believe the existing partner rotation requirements are effective and provide the necessary "fresh look" to ensure auditors are exercising objectivity and professional skepticism during the audit. In addition, partner rotation does not carry the same degree of disruption and loss of institutional knowledge that a mandatory firm rotation requirement would have on the company and the audit firm. We also believe that the level of disruption and loss of knowledge would be even worse if the existing partner rotation requirement was coupled with a mandatory firm rotation requirement and question how the partner rotation and firm rotation requirements would be synchronized if the rotation cycles do not coincide. We would also like to point out that when adopting its new rules on partner rotation, the SEC expected the PCAOB to monitor the impact the partner rotation rules would have on audit quality and independence. Specifically, SEC Release No. 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence,* states that, "*In conducting its oversight review of registered public accounting firms, we expect that the Public Company Accounting Oversight Board ("the Board") will monitor the impact of these rules on audit quality and independence.*"[10] We are not aware of the PCAOB having performed such an evaluation of the SEC's partner rotation rules and recommend that the Board consider doing so prior to pursuing further consideration of a firm rotation requirement.

Subsequent to SOX, the PCAOB has also taken measures to enhance audit quality, including a suite of risk assessment standards and a new framework for the engagement quality review. The Board's inspection findings do not reflect the impact that these important standards will have on audit quality and we therefore recommend that the Board not pursue such drastic measures as mandatory firm rotation until it has the opportunity to study the impact of these new standards and how they will enhance audit quality. The Board would then be in a better position to determine if further enhancements, specifically with respect to auditor independence, objectivity and professional skepticism are necessary.

*Other potential audit quality enhancements*

We would support the Board in further analyzing its inspection findings to better understand the underlying reasons for the audit failures that have been observed. If the Board determines that the root cause of such findings were the result of the auditor lacking the requisite independence, objectivity and professional skepticism, then we recommend the Board explore other, more cost-effective enhancements to audit quality. Specifically, we would ask the Board to consider the potential audit quality enhancements described in the Center for Audit Quality's (CAQ)

[10] Section 3.C. *Rotation Period for Partners Other Than The Lead and Concurring Partners*.

comment letter submitted to the Board on this Concept Release. Specifically, the CAQ has offered a number of potential enhancements to audit quality that audit firms, audit committees, and regulators may wish to consider that do not carry the significant costs associated with mandatory firm rotation. We also believe it is important to consider the size of the audit firm in determining the appropriateness of any potential enhancements and that certain enhancements would only be appropriate for annually inspected firms.

*Cost-benefit analysis*

Finally, if the Board determines that it should further pursue a mandatory firm rotation requirement, we would strongly encourage the Board to conduct a cost-benefit analysis to justify that the significant costs associated with mandatory firm rotation do not outweigh any potential benefits. We believe such an analysis is imperative, especially if the Board is unable to demonstrate evidence that mandatory firm rotation will significantly enhance audit quality.

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In closing, we would like to reiterate that we do not believe the PCAOB should proceed with a mandatory firm rotation requirement without evidence that links audit firm tenure to the audit failures noted in the PCAOB inspection findings. Moreover, if further study appears to indicate such a linkage, we would urge the Board to carefully weigh the costs associated with mandatory firm rotation against any potential benefits and consider other potential enhancements that do not result in such a significant level of disruption and costs.

We appreciate the opportunity to comment on the PCAOB's Concept Release and would be happy to meet with the Board to discuss our comments in greater detail.

Sincerely,

Gregory J. Anton, CPA
Chairman of the Board

Barry C. Melancon, CPA
President and CEO