



Freed Maxick & Battaglia, PC
Certified Public Accountants



Audit Committee Guide for State and Local Government Units

Public Sector Practice

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theMax.

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Freed Maxick's Governmental Services Group is comprised of professionals who understand the unique environment in which municipal organizations operate and the compliance issues they face. All members of our Governmental Services Group are experienced in audits in accordance with *Government Auditing Standards*, the provisions of the Single Audit Act Amendments of 1996, and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

The contents of this guide are not intended, and cannot be considered, as legal advice or a legal opinion.

Introduction

Dear clients and friends of the firm,

Public confidence in the financial reporting process has eroded over the past couple of years. That loss of confidence was caused by the recent wave of accounting irregularities, corporate scandals and business failures.

The environment created by these high-profile events has caused an increasing wave of scrutiny of the auditing profession, the relationships between auditors and their audit clients, and the activities of the audit committee.

In 1999, the Blue Ribbon Committee on Improving the Effectiveness of the Corporate Audit Committee issued its recommendations to empower the audit committee to function as the guardian of investor interest and corporate accountability. The Sarbanes-Oxley Act of 2002 codified several of these recommendations, which represent business practices some companies were applying in the marketplace. But the new law, designed for public companies, added some stringent new guidelines aimed at protecting the public. The Sarbanes-Oxley Act also provided a new framework aimed at strengthening corporate governance and restoring public confidence. Although this framework was not specifically designed for state and local governments, it is frequently being cited and applied.

Audit committees play an important role in the governance of public sector entities in the United States. The public as well as oversight agencies and funding sources continue to place greater importance on the integrity of financial and compliance reporting by the public sector. Governing board members typically possess neither the expertise nor the time to function as an effective alternative to an audit committee.

The role of the audit committee is one of proactive oversight of the financial and compliance reporting and disclosure process and the results of that process. Management has the responsibility to ensure the accuracy of the financial statements and compliance with laws, regulations and agreements. It is the audit committee's function to carry out due diligence by evaluating information from the chief financial officer, program administrator, the internal auditor, and the external auditors and to form conclusions. The audit committee discharges its responsibilities for the benefit of funding sources, bondholders, oversight agencies, and the public at large. Duties of the audit committee may differ based on the type of public sector entity. This guide focuses on the duties of the audit committee who are responsible for the public reporting of results.

Audit committees are of particular importance to the external auditors, governing boards, management, oversight agencies and regulators since all of these parties have a common interest in and dedication to the quality of the entity's financial and compliance reporting. We publish this guide to share with our clients and associates our views on the evolution of these committees, their value to the entity, and their present and future functions.

Sincerely,

Freed Maxick & Battaglia, CPAs

April 2004



Executive summary

The loss of public confidence in the financial and compliance reporting process has caused organizations to review their governance procedures. The responsibilities of the audit committee are a major focus in these reviews since the audit committee must provide oversight to the financial and compliance reporting process, the external audit process, and the control environment. The media attention given to the failure of large businesses and the role that the financial reporting process had in those failures has created an environment that has heightened public interest in a more robust external reporting process.

The roles and responsibilities of the audit committee received considerable attention prior to the recent accounting irregularities and corporate misdeeds. The Securities Exchange Commission (SEC), the securities exchanges and the Auditing Standards Board (ASB) have developed more comprehensive rules to improve disclosure related to the business practices of the audit committee and enhance the integrity and reliability of the financial statements. Additionally, many federal agencies have taken steps to improve the effectiveness of their oversight of the use of and accountability for federal awards.

The independent auditor must look to the audit committee and the governing board as the client to be served. While the independent auditor may develop business relationships with members of management, the audit committee is responsible for hiring, evaluating and retaining the independent auditor.

To accomplish their responsibilities, audit committee members must be informed and vigilant overseers of the financial and compliance reporting process and the other participants in that process. The audit committee must understand the government's programs and operations, the risk of the business model and the interrelationship of operations with financial and compliance reporting.

The audit committee must be willing to ask tough questions of management, the internal auditor and the independent auditor. But asking the tough questions is only half the process. Understanding the answer is just as important. The audit committee must understand the operating risks and rewards that the management team presents to the governing board.

The audit committee and governing board must establish a "tone at the top" that insists on integrity and accuracy in financial reporting and compliance with laws and regulations. As a check and balance over management, the tone at the top is set by:

- Requiring accurate and clear reporting
- Insisting that the numbers and financial statement disclosures reflect the risks that are being managed
- Challenging management perspective about the "why" and "what" behind the numbers and the operation of programs

Each governmental unit is unique in its organization and management style. The governing board and audit committee should reflect the entity's unique aspects and its governance policies. One size does not fit all when it comes to audit committee composition or structure. The important aspect is that the audit committee must have the resources and capacity to be diligent and spend the time necessary to understand and manage the financial and compliance reporting process.



Historical and regulatory perspectives

Historical

The genesis of state and local government audit committees is different from general corporate audit committees because of the nature and sources of funding and the number of regulatory agencies providing oversight. As the public sector environment has evolved, as the regulators' emphasis has changed, and as the requirements for public accountability have changed, these differences have become fewer with respect to functional responsibilities. Yet state and local government audit committees and governing board members face special challenges because public sector entities are different from commercial enterprises. Government directors are responsible not only to debt holder's and the public's interests, but also to regulatory authorities.

Regulatory

With the increasing reliance on various sources of public funding, regulators look to the entity's governing board as being ultimately responsible for the control of these resources and compliance with program requirements and objectives.

These changes have caused the role of the audit committee to become more diverse. Regulators now often require that governmental units have external auditors conduct an audit of the financial statements and compliance with applicable laws and regulations. Regulators believe that, as one of the most important board committees, the audit committee can assist the board in monitoring compliance with board policies and applicable laws and regulations, in ensuring comprehensive audit coverage by both internal and external auditors, and in overseeing the external financial and compliance reporting process.



The audit committee charter

Audit committees should operate with a written charter that provides a clear understanding of the committee's roles and responsibilities. A well-written, detailed charter will provide a framework of the committee's organization and responsibilities that can be referred to by the governing board, committee members, management and internal and external auditors.

The audit committee charter should address best practices and should also define:

- Overall purpose, responsibility and authority
- Composition of the committee
- Frequency of meetings
- Scope of responsibilities (including qualifications and terms of office)
- Relationship with independent auditors, including pre-approval of services provided
- Relationship with the internal audit function
- Oversight of corporate compliance function
- Reporting responsibilities
- Authority to conduct special investigations
- Authority to engage experts as needed

The governing board should review, approve and revise the charter as necessary. In developing a charter, it is important that the committee's activities are not unduly restricted. The committee's duties and responsibilities need to be flexible enough to allow it to operate effectively. The board should ensure that the charter responds to the governmental unit's changing needs.

The charter should:

- Serve as a guide in planning the committee's meeting agendas
- Be reviewed annually by the governing board to ensure that the committee's objectives are met
- Provide a framework for reporting the committee's activities to the governing board
- Serve as a basis for the audit committee self-evaluation

While no sample charter can encompass all of the activities that an audit committee could be assigned, an illustration of an audit committee charter is included in Appendix I. The charter should set forth governing board expectations of the performance of the audit committee. Those expectations will vary from organization to organization based on types of activities or programs.

Duties assigned to the audit committee

Audit committee charters assign several responsibilities to the audit committee. Principal audit committee responsibilities include:

- Understanding the governmental unit's operations, activities and programs
- Understanding the governmental unit's control environment and risk management systems
- Understanding and overseeing the financial and compliance reporting process
- Understanding and overseeing the audit processes
- Selecting the independent audit firm



Audit committee responsibilities

Audit committee activities have evolved as the business and regulatory environment has changed. Activities that have been identified and held out as “best practices” will also evolve. As the business and regulatory environment continues to change, audit committees should monitor the changes in best practices.

The audit committee’s central focus should be on protecting the general public’s and constituents’ interests. A principal activity that assists these groups in understanding the financial results is the transparent reporting and disclosure of the risks that the organization is managing and the impact those risks have on performance. The financial and compliance disclosures of an organization, which include financial statements, single audit reports, official statements, information returns and press releases, are the primary means for disclosure of the “what” and “why” behind the numbers.

Most governmental units maintain an accounting system designed to accurately gather and record transactions. Most organizations also maintain a system of internal controls to ensure the system as designed is operated to provide reliable financial statements, financial disclosure and compliance with material laws and regulations.

The audit committee can ensure that there are processes in place to monitor the internal control over financial reporting, comply with laws and regulations, and conform to policy and procedure statements established by the governing board.

The specific responsibilities assigned to each audit committee will vary with the circumstances, activities and programs of each state and local government. The audit committee charter will assign those responsibilities.

In general, audit committee responsibilities will include:

- Assessing the adequacy of internal controls and risk management systems
- Overseeing the financial and compliance reporting at interim dates and year end
- Overseeing the audit process
- Selecting the independent auditor

To accomplish the responsibilities assigned, the audit committee must understand the government industry and external factors that drive change in the industry – issues such as legislation, the regulatory environment, legal actions and consolidation/combination should provide a framework for understanding how the governmental unit’s operations are affected. Industry studies and surveys from the Government Finance Officers Association as well as oversight agencies and/or applicable trade associations provide a perspective regarding markets, technology developments and human resources.

With that perspective, the audit committee should obtain an understanding of the governmental unit’s:

- Structure and legal organization
- Accountability to oversight governments
- Major activities, programs and services
- Constituency
- Net asset base and financing
- Accounting system
- Compliance administrative system
- Financial reporting system
- Significant funding sources and recipients
- Management structure
- Internal audit capabilities
- Attorneys and consultants
- Types of transactions – normal and non-recurring
- Off-balance-sheet activities

With this understanding, audit committee members will have an informed perspective to discharge their principal responsibilities as discussed on the following pages.



Understanding the overall control environment and risk management systems

Control environment
Risk management systems
Monitoring
Fraud risk

The audit committee should understand the key components of internal controls and areas where fraud may occur.

Control environment

The control environment provides a key element of the governmental unit's internal control system and establishes the tone at the top of the organization. The control environment includes factors such as:

- Organizational structure
- Management philosophy and operating style
- Integrity of the employees
- Corporate culture
- Organizational values

This tone sets the climate for high-quality financial reporting and addressing issues in internal controls. The audit committee should review policy statements and procedures manuals and have discussions with management to develop an understanding of the government's control environment.

Risk management systems

The risk assessment of an organization relates to the identification, analysis and monitoring of risks that could impact the financial data and/or financial disclosures. The senior management team typically evaluates the enterprise risks of internal and external factors that relate to broad categories of operations and programs as well as specific situations.

Risks that are relevant to the financial reporting process may affect the organization's ability to estimate, record, process and report financial and compliance-related data reliably. Risks can arise or change due to:

- The degree to which operations are decentralized
- Changes in the operating environment
- New personnel
- New or revamped information systems
- Rapid growth
- New technology
- New operating model, program or activity
- Organizational restructuring
- Changes in statutes, laws or regulations
- New accounting standards or changes in accounting principles

With the changes taking place in the current business environment, the audit committee must be informed about risks that can impact the financial and compliance reporting process as well as the controls that management has established to respond to those risks. In addition, the audit committee has to be informed about changes, either external or internal, that could bring new risks to light.

Monitoring

Monitoring involves assessing the quality of the internal control system's performance over time and taking necessary corrective action when required. Monitoring activities include:

- Comparison of actual results to prior periods, budgets or forecasts
- Internal audit testing of process controls
- Independent auditor evaluation of internal controls
- Information from external parties
- Communication from regulators and major funding sources

The Committee of Sponsoring Organizations of the Treadway Commission issued the COSO Report in 1992. The report defined internal controls as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in effectiveness and efficiency of operations, reliability of financial reporting [and] compliance with applicable laws and regulations." The report's definition of internal control provides a standard against which the audit committee can assess the governmental unit's control systems so that, when necessary, they can be improved.

The governmental unit's management should provide to the audit committee an overview of the organization's risk and control environment being managed and its policies, procedures and controls surrounding the integrity of financial and compliance reporting.

COSO Internal Control - Integrated Framework

COSO describes five interrelated components of internal control. The audit committee's thorough understanding of these components will facilitate its evaluation of the organization's controls against the COSO benchmark. The five components are:

Control Environment. The control environment sets the tone of an organization. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's personnel.

Risk Assessment. Risk assessment is the identification and analysis of relevant risks to the achievement of the entity's objectives and forms a basis for determining how those risks should be managed.

Control Activities. Control activities are the policies and procedures that help ensure that the necessary actions are taken to address risks to the achievement of the entity's objectives.

Information and Communication. Pertinent information must be identified, captured and communicated in a form and timeframe that enables personnel to carry out their responsibilities. All personnel must receive a clear message that control responsibilities must be taken seriously.

Monitoring. The internal control system needs to be monitored to assess its performance over time.

Fraud risk

The tone set by senior management is the most important factor contributing to the integrity of the financial and compliance reporting process, because it becomes a core value of the organization and a model of appropriate conduct for every level. To achieve a strong tone at the top, management should:

- Identify and understand the factors that can lead to fraudulent financial reporting
- Assess the risk of fraudulent financial reporting that these factors create within the governmental unit
- Design and implement the necessary internal controls for prevention or detection

The Statement on Auditing Standards No. 99, *Consideration of Fraud in a Financial Statement Audit*, replaces Statement on Auditing Standards No. 82. This statement establishes standards and provides guidance to auditors in fulfilling the responsibility that the financial statements are not materially misstated due to error or fraud.

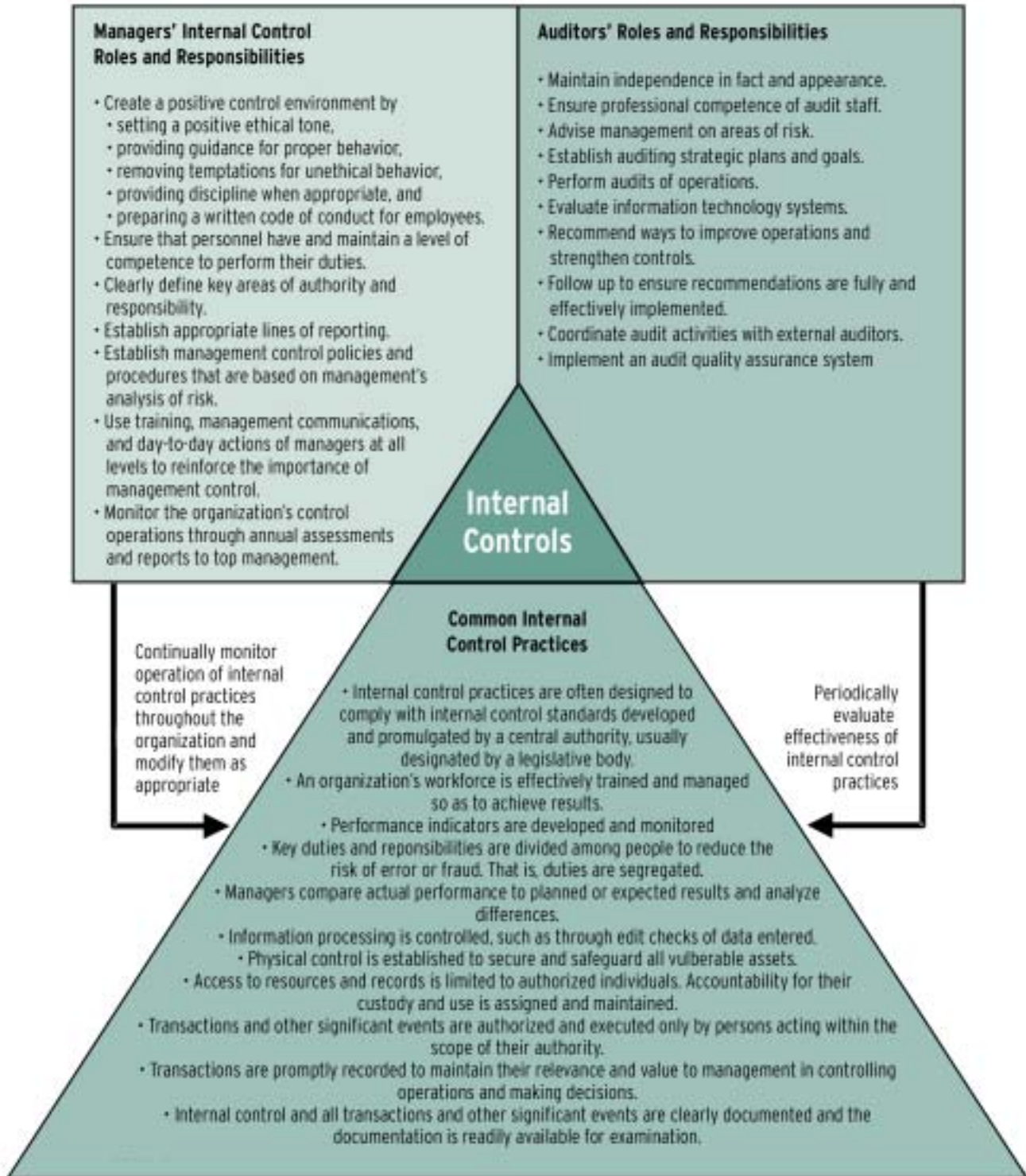
The Statement on Auditing Standards No. 99 provides:

- Description and characteristics of fraud
- Importance of professional skepticism
- Discussions among engagement personnel regarding the risks of material misstatements due to fraud
- Obtaining information needed to identify risks of material misstatement due to fraud
- Identifying risks that may result in material misstatement due to fraud
- Assessing the identified risks
- Auditor's response to the assessment of risks
- Evaluating audit evidence
- Communication about fraud to management, the audit committee and others
- Documentation of the auditor's considerations of fraud

It is important to remember that the governmental unit's management has the responsibility to implement systems to prevent or deter the occurrence of fraud.

Framework for Establishing and Maintaining Effective Internal Control

The Internal Control Standards Committee of the International Organization of Supreme Audit Institutions published the document "Internal Control: Providing a Foundation for Accountability in Government,"¹ in which the following Framework for Establishing and Maintaining Effective Internal Control can be found:



¹The entire document can be found at www.intosai.org/3_INT_Ae.pdf.

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Budget and financing considerations

Budgeting is an important element of the financial planning, control and evaluation processes for most state and local governments. Most states have enacted legislation that requires political subdivisions to adopt a budget for at least their general operating fund and various other funds, activities and/or programs. The budgetary practices of public sector entities vary greatly, and the audit committee as well as its external auditor should be knowledgeable about any laws, regulations, or administrative policies governing the budgetary requirements of the entity and its related organizational units.

Some audit committees are requested to assess and approve the annual budgets prepared by management prior to its presentation to the governing board. There are many ways to approach this topic; the discussion of which would fill many more pages than this publication is intended to cover. However, listed below are a few ideas on how to assess the proposed budget:

- Assess the quality and accuracy of the governmental unit's previous budgets. Is the organization usually able to achieve budgeted results? If not, where are the problem areas and why are these a problem?
- Obtain a thorough understanding of the governmental unit's process to develop its annual budget. The audit committee can gain much insight by understanding the quality and thoroughness of the organization's process. The best way to obtain this understanding is to have the CFO/controller/administrator/etc. walk the audit committee through the process.
- Obtain an understanding of the methodology used to project the significant cost items in the budget. These usually include fixed facilities costs and head counts. In particular, it is important to see that there is an appropriate level of research, detail and assessment regarding these numbers. For example, the revenue budget should be based upon a detailed analysis of grants, entitlements, contribution sources, operating revenues, etc. The revenue budget should also be based on some research regarding the expected growth or decline of the constituency base, allowed or planned participation in federal or state programs, the state of the economy and its effect on property taxes, fees, etc. The audit committee will usually be able to determine if there is an appropriate level of analysis in projecting these numbers.
- Obtain an understanding from management of the most difficult estimates in the budget and the process used to make such estimates. Usually, revenues are the most difficult numbers to budget. As a result, it may be useful to understand the range of possible projected revenues and why management has chosen a particular point in that range. It may also be useful to understand if management has any back-up plans for cost reductions in the event budgeted revenues are not achieved.
- Determine that the governmental unit has obtained industry/operating/program information to benchmark its key performance indicators against, and has identified and implemented plans to make improvements where necessary.

- Obtain an understanding of the key objectives and new initiatives or programs of the governmental unit for the year and the related costs to develop and implement those items.
- Obtain an understanding of planned efficiencies and other cost cuts. It is important that the process include a periodic reevaluation of activities and programs so that low value and inefficient activities or programs can be addressed or eliminated on a timely basis.
- Obtain a reconciliation of the major changes between last year's actual (or forecasted) results and the new year's budgeted results.
- Obtain an understanding of the capital budget items, including considering any alternatives to construction or purchase.
- Obtain an understanding of management's process to monitor actual vs. budgeted results and how corrective action is identified and implemented.
- Obtain an understanding of any regulatory or contractual requirements concerning the preparation, submission, monitoring and compliance with the annual budget.

Additionally, it may be appropriate for the audit committee to assess the governmental unit's short- and long-term financing plan. Obviously, financing is the lifeblood of the organization's ability to operate in the months and years ahead. However, frequently we find that state and local governments do not have a financing plan that extends beyond the current year. The audit committee should consider gaining an understanding of the following from the CFO/controller/administrator/etc.:

- Does the governmental unit have a short- and long-term cash flow forecast that demonstrates the adequacy of the organization's debt financing currently in place? The forecast should typically include both an expected case and a worst case so that adequate cushion exists in the governmental unit's financing capacity.
- Does the governmental unit have an understanding of its current cost of debt?
- Does the governmental unit have a strategic plan and a related three to five year forecast that identifies the financing needs of the organization? Has the governmental unit identified likely alternative sources for its additional financing needs and the steps that will be needed to secure this financing?



Understanding and overseeing the financial reporting process

The Sarbanes-Oxley Act established reforms aimed at clear, complete and accurate financial information. While Sarbanes-Oxley impacts a public company and continues as long as the company maintains its public status, the concepts apply to all organizations that have stakeholders who are not active in managing the business. Management, of course, is responsible for seeing that this information is collected and reported. Implicit in this responsibility is management's assurance that the information is complete, accurate and reliable. This assurance must now go beyond printed financial statements. Today's state and local governments are using the Internet to disseminate financial information, which should be subjected to the same degree of management oversight and control as information distributed using more traditional means.

The recent publicity concerning a number of high-profile accounting irregularities has intensified both the regulators' and the public's interest in the propriety of an organization's financial reporting process. Today's business environment and the lack of stakeholders' confidence in financial reporting create a situation where inaccurate financial and compliance reporting can significantly impact the availability of future resources to the organization. As a result, audit committees should focus on current and emerging issues and the potential impact on financial reporting and disclosure.

The audit committee is responsible for understanding:

- The clarity and completeness of financial statements and financial and compliance disclosures
- Management's selection and application of significant accounting principles
- Critical accounting policies
- Significant or unusual transactions and accounting judgments and estimates
- The Statement of Auditing Standards No. 61, *Communications with Audit Committees* (SAS 61 as amended by SAS 90), communications received from the independent auditor, including its responsibilities under generally accepted auditing standards as well as Government Audit Standards issued by the GAO, significant accounting policies, audit adjustments, uncorrected misstatements, and management's judgments and accounting estimates
- Whether the financial statements present a complete and accurate picture of the financial results
- Whether the financial statements, footnotes and related management discussion provide the reader with a clear understanding of the organizational and program risks being managed
- The impact of management's assertion on the controls over financial and compliance reporting and disclosure

The audit committee's review of the financial statements is done to enhance the quality of communication from management to third parties. In addition to analyzing what is in the financial statements, the committee should also explore what is not there, such as disclosures omitted because of immateriality or because they are not explicitly required by generally accepted accounting principles. The audit committee should pay particular attention to any items that seem unclear and items where there is subjective judgment. The best attitude for every audit committee member to exhibit is one of healthy skepticism accompanied by due diligence.

The Blue Ribbon Committee suggested that the audit committee prepare a report to stakeholders to include disclosures that the audit committee has:

- Discussed the financial statements with management. This discussion should include the quality of the accounting principles as applied and significant judgments affecting the organization's financial statements
- Discussed with the independent auditor their judgments regarding the quality of the accounting principles as applied and significant judgments
- Discussed the independence of the independent auditor
- Recommended to the governing board that the organization's financial statements be included in the annual report

To assist the audit committee, the independent auditor should discuss the audit partner's subjective judgments on the quality and acceptability of the governmental unit's accounting principles with the audit committee. The discussion can assist the audit committee in drawing its conclusions about the quality of the accounting principles selected by management.

The committee can develop an understanding of the degree of aggressiveness or conservatism of the governmental unit's accounting principles and underlying estimates and the transparency of the financial disclosures in reflecting financial performance.

With an understanding of the governmental unit's internal controls, the independent auditor can apply knowledge of the organization's financial reporting practices to significant matters identified during the performance of preliminary or even interim financial and compliance procedures.



Understanding and overseeing the compliance reporting process

Because governmental units often depend on the public, federal government, states and other agencies for a substantial portion of their funding, they are often subject to laws, regulations and contracts that require them to submit compliance audit reports. A number of options exist for meeting compliance requirements, which range from simple tests of specific transactions by the funding source to single audits which encompass the entire operations of the entity including compliance requirements material to the financial statements and major federal and/or state programs. Single audits are typically performed in conjunction with and by the same external auditor hired to audit the financial statements, and many of the thoughts presented above should also go into the audit committee's assessment of the quality and timeliness of compliance information provided by the entity. Additionally, it is particularly important in addressing compliance reporting requirements that the audit committee consider the following:

- What specific compliance audit requirements exist, and who is responsible for meeting them? This publication cannot begin to identify all of the situations that give rise to compliance audit requirements nor all of the options that exist to meet those requirements. However, most oversight agency requirements can be met through the completion and submission of a single audit. Although the external auditor can help the entity meet its audit requirements, the external auditor cannot be expected to determine for the entity or the audit committee what those requirements are. These are normally identified in laws, regulations and agreements between the entity and its funding source. Management should be responsible for determining compliance requirements including those associated with audit reporting. The audit committee should verify that management has a system in place to do so.
- Compliance audit reporting is time sensitive. A funding source wants to know that a recipient is complying with applicable requirements if it is to continue to provide funding. In some cases, funding will be withheld or cut off completely if reporting is not submitted in a timely manner. The audit committee should oversee the timely completion and submission of compliance audit reports.
- The external auditor should include internal administrative control reportable conditions as well as known and projected compliance findings in his or her discussion with the audit committee. We suggest the audit committee request this information in writing. Additionally, we recommend the audit committee obtain and review a copy of management's corrective action plan before it is submitted to applicable oversight agencies. The audit committee might also desire some input from the external auditors concerning the adequacy of management's planned actions.



Understanding and overseeing the audit process

Internal audit process Independent audit process

The audit committee should provide oversight to both the internal and external audit processes. The committee will have to develop communication processes that minimize the duplication of effort between the audit processes and maximize the audit coverage. This is a delicate balance to maintain for the allocation of organization resources.

Internal audit process

Not all governmental units are large enough to justify the cost of an internal audit department. However, a comprehensive audit program typically consists of both internal and external audit processes. The internal auditor monitors processes and controls; the independent auditor provides an opinion on the fairness of the financial statements in accordance with generally accepted accounting principles and the organization's compliance with laws and regulations that are material to the financial statements or major federal programs. The internal audit process usually focuses on compliance with established policy statements and procedures and regulatory guidelines. The purpose of the internal audit function is to provide a broad range of audit coverage and feedback on risk assessments, operations and internal control processes.

In reporting to the audit committee, the internal audit function identifies compliance issues, operational issues, financial issues and control issues that management should address to provide a strong control environment.

The internal audit coverage could include:

- Review of internal controls
- Compliance testing of the internal control processes
- Assessing compliance with board policy statements
- Completing operational audits that could improve business processes
- Special audit coverage for high-risk areas, suspected fraud and special projects requested by the audit committee

The internal audit function should have a charter that is reviewed and approved by the audit committee. The internal audit charter provides the internal auditors with an understanding of the audit committee's expectations for their performance. Internal audit charters will vary from organization to organization because of the unique nature of each organization's business process, programs and organizational structure. The internal audit charter has to change as the governmental unit grows and becomes involved in new activities, programs or new types of transactions.

The audit committee should discuss with the lead internal auditor:

- The planned scope of internal audit work for the upcoming year
- Areas of planned audit coverage in the prior year that were deferred and why they were deferred
- The time budget to accomplish the audit plan
- How the scope of the internal audit plan was determined
- Areas that require follow-up based on the previous internal audit results and indicate a follow-up audit would be appropriate
- Qualification and training for the internal auditors
- Internal audit coverage of Internet activities and information systems
- Internal audit coverage of activities not reported on the statement of financial position

With the focus of attention from regulators and the stakeholding public on control systems, the internal audit function should provide a more consultative service to the governmental unit to ensure that risks are identified and controlled.

Given the growing complexity of activity transactions, programs and business models, some questions that the audit committee might consider to determine if adequate resources are allocated to the audit process include:

- Is internal audit a place to train future organization leaders?
- Does internal audit have the necessary resources to meet the audit committee expectations?
- Does outsourcing of internal audit impact the audit committee's communication process?
- With the focus on strong control systems, should internal audit perform operational audits to identify profit improvement opportunities?
- Do the internal auditors have the experience and training to provide consultative advice to the department heads or program administrators regarding internal controls?

The audit committee's responses to these questions will help determine the long-term direction for internal audit.

Independent audit process

The independent auditor provides the governmental unit and its stakeholders an opinion on the fairness of the organization's financial statements and financial disclosures. These financial statements provide the public with an understanding of the financial results of the risks the organization is managing. The financial statement opinion and compliance reporting provides regulatory agencies with some level of assurance regarding the reliability of the financial reporting process and the organization's compliance with applicable laws and regulations.

The independent auditor provides the audit committee access to a neutral source of information regarding:

- Emerging accounting issues
- Emerging industry trends and risks
- Tax and information reporting issues
- Regulatory issues
- General business advice

The audit committee should expect the independent auditor to:

- Recognize that they are accountable to the governing board and that the audit committee, as the board's representative, is their client
- Maintain open communications with the audit committee and provide timely, open and candid discussions with the committee
- Understand the committee's expectations and design their communications to be responsive to those expectations
- Meet privately with the audit committee on a periodic basis, without the presence of management or internal auditors, to provide the audit committee input on matters relating to management or the internal auditors
- Discuss any concerns about financial reporting or organizational performance promptly with the audit committee

- Communicate significant issues to the audit committee that have been communicated to management, but have not been adequately addressed
- Advise the audit committee about areas believed to require special attention in order to carry out the committee's oversight responsibilities
- Inform the audit committee about any time pressures exerted by management and the degree of management's cooperation in the audit and their potential effects on the effectiveness of the audit
- Meet with the audit committee for an "exit" conference regarding the audit requests and to discuss the contents of the required communications with the audit committee often referred to as the SAS 61 communication

During the executive session with the independent auditor, the audit committee has an opportunity to discuss the independent auditor's assessment of personnel in the organization, including number, experience and capabilities for the size and complexity of the governmental unit. The audit committee can also discuss the independent auditor's assessment of whether management is actively addressing issues of concern that could have an adverse effect on the financial or operational stability of the governmental unit or its compliance with applicable laws and regulations.

In addition to the SAS 61 communications, generally accepted auditing standards, Government Auditing Standards and the Single Audit Act require the auditor to communicate to the audit committee certain matters that come to the independent auditor's attention, such as:

- Internal control reportable conditions and material weaknesses
- Evidence that fraud may exist
- Information about possible illegal acts
- Information about probable material misstatements of information filed or to be filed with regulators

Communications with audit committees

Statement on Accounting Standards No. 61 (SAS 61) as amended by SAS 90, *Communications with Audit Committees*, requires auditors to communicate to the audit committee matters in the following areas:

- Auditor's responsibility under generally accepted auditing standards
- Significant accounting policies
- Management's judgments and accounting estimates
- Significant audit adjustments and uncorrected adjustments
- Auditors' responsibility for other information in documents containing audited financial statements
- Disagreements with management
- Management's consultation with other auditors, if any
- Major issues discussed with management prior to retention
- Difficulties encountered in performing the audit
- For public reporting clients the auditor should discuss their judgments about the quality, not just the acceptability of the organization's accounting principles

Additionally, the Government Auditing Standards (GAS) issued by the General Accounting Office (GAO) require the auditor to communicate information regarding the nature, timing and extent of planned testing and reporting and the level of assurance provided to officials of the audited entity and to the individuals contracting for or requesting the audit.



Selection of an independent audit firm

With audit committees being held more accountable for their role as protector of the public's interest, the responsibility to select and retain the independent audit firm becomes an important role.

The audit committee should be directly responsible for the selection of the governmental unit's independent audit firm. Similarly, the audit committee should have the authority and responsibility to evaluate and dismiss the independent audit firm.

To ensure that the audit committee chooses its independent auditor on an informed basis, the audit committee should develop a list of criteria and expectations that they feel the independent auditor should meet.

The following matters should be considered when selecting or evaluating the independent audit firm. Answering questions such as these may provide a framework for the selection process:

- What is the independent audit firm's audit process and how do they determine areas that are considered to be a higher audit risk?
- How will the audit firm handle the unique and difficult aspects of the engagement?
- Is the audit firm independent with respect to the governmental unit? How does the firm monitor independence?
- What quality-control policies and procedures does the independent audit firm have in place?
- What is the audit firm's relevant experience? What is the expertise of the local office that will be responsible for the engagement, including:
 - The importance of the client and industry to the firm and the local office
 - The audit firm's technical and industry resources
 - The availability of other relevant technical expertise locally and nationally
- What is the quality of the firm's audit practice? This effort will require requesting and calling references.
 - Ask references about staff turnover, responsiveness on issues, proactivity in providing ideas and advice and meeting engagement deadlines.
 - Ask what they like most and least about the firm and the partners.
 - When applicable, inquire of the firm's approach for compliance with GAS independence requirements
 - Obtain a copy of the audit firm's latest peer review report as well as any related letter of comment.
 - Inquire of the firm's approach for maintaining technical competency and complying with applicable state licensing requirements.
- Which partners will be assigned to the client service team?
 - What is their assessment of their ability to develop a working relationship with the proposed engagement partners?
 - What is the relevant and current industry experience of the client service team on similar clients?
 - What level of involvement will the partners have with the engagement?
 - How does the audit firm share knowledge and expertise within the firm?
- What are the estimated fees, what is the basis for determining them and how will differences between actual and estimated fees be handled?
- What technology tools are available and how will they be used in the audit process?
- How will weaknesses in the internal control process and/or any management advice suggestions be communicated?



Considering the requirements of the Sarbanes-Oxley Act of 2002

Although the far-reaching Sarbanes-Oxley Act of 2002 currently applies to public companies only, components exist that may be appropriate for adoption by many governmental units as well.

Generally, Sarbanes-Oxley seeks to:

- Increase investor and shareholder confidence in public reporting and reduce aggressive financial reporting
- Ensure effective internal controls surrounding financial reporting
- Reduce fraud and increase accountability for expenses
- Ensure the board of directors is independent from the company
- Increase accountability of the executive team for financial reporting and information disclosed to the market

Currently, SEC reporting companies are undergoing intensive internal scrutiny and analysis, reviewing internal controls and methods of recording transactions. They're looking at the composition of their boards and examining auditor relationships for independence issues.

However, none of this happens in a vacuum. Investors, donors, politicians and boards of directors realize that effective internal controls, competent governance and auditor independence is healthy for all businesses – not just public companies.

Reduce fraud and increase accountability

State and local governments, especially those funded with public taxes, contributions and government grants, are stewards of public trust – the public entrusts these governmental units to provide essential services and carry out specific missions. So, they have a right to expect these organizations to implement controls surrounding financial reporting, reduce the chance of fraud and increase accountability for expenses.

Many mission-minded board members have become more focused on the fiscal responsibility that comes with board membership. A renewed interest in financial reporting and internal controls within governmental units has led many boards to question their composition and structure: "Is our board comprised of members who can support effective oversight of our organization? Do we need a separate finance or audit committee to meet these needs?"

Citizens, donors and other funding sources are asking tough questions, too. They want to make sure governmental units are good stewards of their resources and they're spending money for intended purposes.

Several states have already introduced legislation that brings components of Sarbanes-Oxley to organizations other than publicly held corporations. You can find provisions such as intensive internal control documentation, financial officer certification of financial and compliance reporting and audit partner rotation being debated in various state legislatures.

Sarbanes-Oxley has undoubtedly thrust auditor independence issues to the front page of newspapers, but less heralded changes in the Government Auditing Standards (GAS) have had an even more direct impact on governmental units and their relationships with audit and nonaudit service providers.

How? Auditors of organizations subject to GAS are prohibited from providing certain management services or from being involved in the creation or presentation of amounts they will later audit. That may seem like common-sense, but this means CPA firms can no longer offer services like certain kinds of accounting assistance, payroll processing and information systems implementations if they audit the organization's financial statements.

Tighten up financial reporting processes

The Sarbanes-Oxley Act may not directly apply to not-for-profit organizations, but certain provisions in the Act can provide these entities an opportunity to take a closer look at the effectiveness of their financial reporting processes.

A thorough understanding of how internal controls and transparent financial reporting can create value for your organization is critical. It's the responsibility of the organization's committee members, governing board members and management to effectively govern risk – and an effective system of internal controls forms one of the foundations necessary to help build transparent financials.

Along with reducing risk, transparent financial reporting helps instill confidence in the various funding sources and constituency groups. It also builds trust by reducing the risk of fraud or misallocation of funds.

Consider these questions as you determine the strength of your financial reporting process:

- Do you have an effective audit or finance committee?
- Do you have financial expertise on the audit committee?
- Do you have a code of ethics?
- Do you have an effective and documented system of internal controls? Are you monitoring this system?
- Do you certify your financial reports?

An overriding spirit of the Sarbanes-Oxley Act is to ensure true independence exists between the various functionalities that are entwined in the financial reporting process. True independence eliminates conflicts of interests and instills confidence that accurate and ethical financial reporting exists. While Sarbanes-Oxley addresses independence issues that frequently occur in the public realm, many not-for-profit organizations have been maintaining such independence for years.

Additionally, the revised Government Auditing Standards noted above that became effective in 2003 also address external auditor independence for not-for-profit organizations by significantly limiting the non-audit work audit firms can perform for clients that use their services.

Entities that oversee the activities of state and local government units will continue to establish and enforce meaningful alternatives to Sarbanes-Oxley.



Resources for the audit committee

The following resources may help members of the audit committee better understand their roles and responsibilities, changes in corporate governance, and how those changes affect their duties.

The AICPA Audit Committee Toolkit

The AICPA has developed an extensive Audit Committee Toolkit to help audit committees do the job they need to do as effectively and efficiently as possible. Providing these tools “in the public interest,” the AICPA endeavors to help audit committees, internal auditors, and management execute corporate governance. You can order or download a copy of the Toolkit from the AICPA Web site at <http://www.aicpa.org/Audcommctr/toolkits/homepage.htm>.

Following is a list of the tools available in the AICPA Audit Committee Toolkit:

- Audit Committee Charter Matrix
- Financial Expert Decision Tree
- Conducting an Executive Session
- Engaging Independent Counsel
- Hiring the Chief Audit Executive
- Sample RFP: Public Companies
- Sample RFP: Non-Public Organizations
- Peer Review of CPA Firms
- Internal Control: a Primer & Tool
- Fraud and the Audit Committee
- Off-Balance Sheet Transactions
- Issues Report from Management
- Discussions with Independent Auditors
- Tracking Report (Whistleblowers)
- Evaluating Internal Audit Team
- Evaluating Independent Auditors
- Audit Committee Self Evaluation
- Common SEC Filings
- SEC Final Rule: Financial Experts
- Resources for Audit Committees

Publications

American Institute of Certified Public Accountants, Statement on Auditing Standards No. 61, *Communications with Audit Committees*, April 1998.

Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework*, 1994.

Government Finance Officers Association Recommended Practices, *Establishment of Audit Committees*, 1997 and 2002.

National Commission on Fraudulent Financial Reporting, *Report of the National Commission on Fraudulent Financial Reporting*, 1987.

Web sites for information

www.theiia.org/iia/index.cfm?doc_id=1203 is the Institute of Internal Auditors Government Auditors' Resource Center.

www.gfoa.org/services/rp/ leads to Government Finance Officers Association Recommended Practices.

www.nacdonline.org provides answers to questions asked by directors, publications, surveys and research.

www.boardmember.com provides information for board members and audit committee members.

www.realcorporatelawyer.com/secreformportal.html provides links to legal interpretations of the various provisions of Sarbanes-Oxley Act of 2002.

www.conference-board.org provides information on corporate governance.

Regulatory agency and trade association Web sites

U.S. Government's Official Web Portal

www.firstgov.gov

Department of Housing and Urban Development (HUD)

Office of Inspector General

Real Estate Assessment Center

www.hud.gov/offices/oig/

www.hud.gov/offices/real

Fed World.Gov (Commerce)

www.fedworld.gov

American Association of Fundraising Counsel

www.aafrc.org

General Accounting Office

www.gao.gov

Independent Sector

www.indepsec.org

National Association of College and University Business Officers

www.nacubo.org

U.S. Department of Education

www.ed.gov

U.S. Office of Management and Budget (OMB)

www.whitehouse.gov/omb/

State and Local Government on the Net

www.statelocalgov.net

Federal Agency Statistics

www.fedstats.gov

National Association of Local Government Auditors (NALGA)

www.nalga.org

The National Association of State Auditors,
Comptrollers and Treasurers

www.nasact.org



Freed Maxick & Battaglia, CPAs

We are often asked to provide advice on the appropriate roles and responsibilities of audit committees and governance and management issues. In our role as the independent auditor for state and local government units, we work closely with audit committees and have assisted them in implementing governance practices that suit their circumstances.

We have provided education programs aimed at enhancing an organization's understanding of risk management and financial reporting. Through our alternative practice structure with RSM McGladrey, Inc., we can introduce you to governance professionals who can assist your governmental unit in assessing its governance practices and developing an action plan to strengthen the effectiveness of those practices.

We welcome the opportunity to help you and your organization in developing and maintaining an effective audit committee. We would be happy to meet with you to discuss how we can assist you.

Appendices

Appendix I. Audit committee charter

This audit committee charter should be tailored to fit the unique needs of each organization. This sample is not a form that can be copied and applied to every situation. The AICPA has included a matrix for preparing an audit committee charter in their Audit Committee Toolkit that is available at the Web site listed on our Resources page. Prior to adopting an audit committee charter, your organization should gather input and advice from its legal counsel and independent auditor. The audit committee charter is a “living document” that will need to be revised as external factors change.

Membership

All members of the audit committee shall be independent of the management of the governmental unit and free of any relationship that, in the judgment of the board, would interfere with their exercise of independent judgment as audit committee members. Each member of the audit committee must satisfy all applicable membership and independence requirements set forth in any rules or regulations issued by regulatory bodies. The board must make any affirmative determinations concerning the issue of independence of any director required under any applicable rules and regulations.

Audit committee members will not have an interest in the organization or engage in related party transactions that would have a material adverse effect on their independence or ability to act in the best interest of the stakeholders.

If there is any basis for believing an audit committee member is not independent, the facts and circumstances should be reported to the general counsel and the board, and no action should be taken until the board, or the nominating/governance committee thereof, has determined that the audit committee member is truly independent.

Audit committee members cannot vote on any matter in which they, directly or indirectly, have a material interest.

Frequency of meetings

The committee shall meet as frequently as circumstances dictate, but no less than four times annually. The board shall name a chairperson of the committee, who shall prepare and/or approve an agenda in advance of each meeting. A majority of the members of the committee shall constitute a quorum. The committee shall maintain minutes or other records of meetings and activities of the committee.

The committee shall, through its chairperson, report regularly to the board following the meetings of the committee, addressing such matters as the quality of the governmental unit’s financial statements, compliance with legal or regulatory requirements, the performance and independence of the external auditors, the performance of the internal audit function or other matters related to the committee’s functions and responsibilities.

Responsibilities of the audit committee

The audit committee shall be directly responsible for the appointment and dismissal, compensation, and oversight of the governmental unit’s independent auditor(s), and may not delegate any of such responsibilities to others. The audit committee shall assist the board in its oversight of:

- The integrity of the organization’s financial statements
- The organization’s compliance with legal and regulatory requirements
- The independent auditor’s qualifications and independence
- The performance of the organization’s internal audit function and the organization’s independent auditor(s)

The audit committee shall assist the board in fulfilling its oversight responsibilities by:

- Reviewing the organization's financial information that will be made public
- Working with management to establish, subject to the approval of the board, the systems of internal controls
- Reviewing the systems of internal controls and reports of variance from those controls
- Reviewing all audit processes and results of internal audits
- Reviewing the organization's accounting, reporting, financial and program compliance practices

The responsibilities of a member of the audit committee are in addition to responsibilities as a member of the board. The audit committee shall direct the organization's general counsel to prepare or obtain from the organization's outside counsel a memorandum on a regular basis setting forth the standards applicable to the members of the audit committee under applicable laws and regulations.

The audit committee does not prepare financial statements on behalf of governmental units or perform the organization's audits, and its members are not the organization's auditors and do not certify the governmental unit's financial statements. These functions are performed by the organization's management and independent auditor(s).

The audit committee shall perform such other functions as are required by law, the government's charter, resolutions, regulations, or the governing board.

Responsibilities and duties

The audit committee:

- Shall meet at the request of the chief financial officer or the independent auditor at least once every quarter in regular session, or more frequently as circumstances dictate
- Shall meet with the chief financial officer separately at least once every quarter to review the accounts of the governmental unit
- Shall meet with the internal audit leader at least once every quarter
- Shall recommend to the board whether the audited financial statements should be released
- Shall oversee annual compliance audit requirements
- May conduct or authorize investigations into any matters within its scope of responsibilities
- Shall review and discuss financial-related press releases and financial information provided to analysts and ratings agencies
- Shall review and discuss with management the policies and guidelines for risk assessment and management
- May take any other action permitted by applicable laws, rules and regulations necessary to accomplish any action authorized by this charter or to further the goals of the audit committee as set forth in their charter
- Shall report its actions and budget to the board

All meetings of the audit committee required by this charter shall be held without any other members of the board present. Portions of all meetings with independent accountants and internal audit officers shall be held without any other members of management present. Meetings may be held in person or by telephone at the discretion of the chair of the audit committee.

Assistance from others

The audit committee may request reports from the chief executive officer, superintendent, director, etc., or the governmental unit's chief financial officer. The audit committee may retain (and determine the funding for) experts to advise or assist it, including outside counsel, accountants, financial analysts or others, and the organization shall provide sufficient funding therefore.

Relationships with independent auditors

In order to retain independent auditors to review the records and accounts of the governmental unit, the audit committee shall:

- Have the sole authority to appoint (and dismiss) independent auditors to conduct governmental unit audits or to perform permissible non-audit services, with the independent auditor ultimately accountable to the audit committee with respect to audit and related work and to oversee the performance of services by the independent auditor
- Review the independent auditor's scope and audit plan prior to the commencement of the audit
- Determine the scope of the audit and the associated fees to be paid to the independent auditor (for both audit and permissible non-audit work)
- Discuss with the independent auditor any relationships that may affect the auditor's independence
- Confirm and oversee the independence of the auditor
- Establish policies for the governmental unit's hiring of employees or former employees for the auditor

In its review of the independent auditor, the audit committee shall:

- Review the qualifications and experience of senior members of the audit team
- Ensure that the independent auditor provides the audit committee (for their review) with timely reports of (1) all critical accounting policies and practices, (2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, effects of using such alternatives, and the treatment preferred by the independent auditing firm, and (3) other material written communications between the independent auditor and management
- Review the independent auditor's reports on the adequacy of the governmental unit's internal controls, including computerized information system controls and security and its compliance with laws and regulations
- Obtain and review annually a report by the independent auditor describing (1) the auditing firm's internal quality control procedures, (2) any material issues raised by its most recent quality control review or investigation within the preceding five years and steps taken to resolve those issues, and (3) all relationships between the independent auditor and the governmental unit

Prior to the release or filing thereof, the audit committee shall review documents containing any of the governmental unit's financial statements, including any filings with regulators. The audit committee shall specifically review:

- With the independent auditor and management, their processes for assessment of material misstatements, identification of the notable risk areas, and their response to those risks
- With management and the independent auditor, the governmental unit's annual and any interim financial statements and related footnotes
- The independent auditor's audit of and report on the financial statements and compliance with laws and regulations
- With the independent auditor, any additions or changes in auditing or accounting principles suggested by the independent auditor, management or the internal auditor
- With the independent auditor, the internal control, compliance and management letters provided by the independent auditor and the organization's response
- The independent auditor's qualitative judgment about the appropriateness, and not just the acceptability, of accounting principles, use of estimates, basis for determining the amounts of estimates, and financial disclosures
- With the independent auditor, any significant difficulties or disputes with management encountered during the course of the audit
- Any material financial or non-financial arrangements of the organization that do not appear on the financial statements of the governmental unit and their related risks

- With management and the independent auditor, the effect of regulatory and accounting initiatives as well as accounting principles and their alternatives that have a significant effect on the governmental unit's financial statements
- Any transactions or courses of dealing with parties related to the governmental unit that are significant in size or involve terms or other aspects that differ from those that would likely be negotiated with independent parties, or that are relevant to an understanding of the organization's financial statements
- Any other matters related to the annual governmental unit audit(s), including those matters that are required to be communicated to the audit committee under applicable law, generally accepted auditing standards and government audit standards

Approval of services provided by independent auditors

The audit committee shall approve any audit services and any permissible non-audit services prior to the commencement of the services. In making its pre-approval determination, the audit committee shall consider whether providing the non-audit services is compatible with maintaining the independent auditor's independence. If this pre-approval is delegated to an independent audit committee member or members, such member or members shall present a report of actions or decisions at the next scheduled audit committee meeting.

Prohibited non-audit services

The following services may not be provided by the independent auditor contemporaneously with the audit:

- Bookkeeping or other services related to the accounting records or financial statements of the governmental unit
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Certain actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer, investment adviser, or investment banking services
- Legal services and expert services unrelated to the audit
- Any other service that regulatory or oversight agencies have determined to be impermissible

Relationships with the internal audit function

The audit committee shall:

- Be solely and directly responsible for the appointment, replacement, reassignment or dismissal of the governmental unit's internal auditors
- Establish procedures to assess the effectiveness and performance of the internal auditors
- Establish and control the compensation and benefits of organization employees who report directly to the audit committee
- Take steps that are, in the sole judgment of the audit committee, reasonable or necessary to ensure that the internal auditors are independent and the compensation and benefits allocated to the internal auditors are not subject to review or termination without the consent of the audit committee

The audit committee shall consider and review with management and the internal audit leader:

- The governmental unit's internal control structure and procedures for financial reporting and disclosure
- The results of internal audits, management recommendation letters, reports of variance from the organization's internal controls and report of the internal auditor
- Significant findings during the year and management's responses to them
- Significant difficulties encountered during the course of their audits, including any restrictions on the scope of their work or access to required information
- Changes required in the planned scope of their audit plan
- The internal auditing department's compliance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing*

Oversight of corporate compliance function

The audit committee shall:

- Discuss significant risk exposures periodically with the independent auditor, management and internal auditors
- Review the steps and programs that management and the internal auditors have taken to identify, monitor, control and report such exposures
- Establish procedures whereby employees can confidentially and anonymously submit to the audit committee concerns or issues regarding the governmental unit's accounting, compliance or auditing matters
- Establish procedures for the receipt, retention and treatment of complaints regarding accounting, compliance or auditing matters, including their controls
- Review any transactions with related parties and the procedures used to identify related parties
- Periodically require management, the internal auditor and the independent auditor to review, report and comment on significant governmental unit risks or exposures and actions needed to minimize such risks or exposures
- Review the governmental unit's code of ethics and recommend any changes or additions
- Discuss periodically with management and evaluate the effectiveness of the program that management establishes to monitor compliance with the governmental unit's code of ethics and laws and regulations
- Review with management the governmental unit's policies to encourage the reporting of potential illegalities and questionable accounting, compliance or auditing matters
- Review management recommendations to the board for changes that reflect changes in law or policy
- Review with the governmental unit's outside legal counsel any legal matters that may materially affect the organization
- Consider any emerging issues that the audit committee should become involved with in the future

Audit committee formalities and charter

The audit committee shall:

- Review and reassess annually the adequacy of this audit committee charter and recommend any changes to the board
- Report periodically to the board on the audit committee's activities and findings, including any issues regarding the quality or integrity of the governmental unit's financial statements, compliance with legal or regulatory requirements, the performance and independence of the organization's independent auditor, or the performance of the internal auditors
- Keep appropriate minutes, with the advice of counsel
- Take action to assess its performance on an annual basis, such as retaining counsel, the independent auditor or other consultants for the purpose of reviewing its performance

Appendix II. Items to consider in planning the audit committee agenda

In planning the audit committee meeting agenda, consideration should be given to the unique needs of the audit committee members. In some circumstances, background information may need to be furnished to assist the audit committee members in understanding the risks involved.

**Quarterly:
Discussions**

Planned Completed Action

		Discuss with management any changes in the internal control systems, accounting principles, major programs or business activities
		Discuss any changes in applicable laws and regulations with management and the board
		Discuss any changes in internal controls with the internal auditor and independent auditor
		Discuss the financial statement impact of any changes in accounting principles or in the application of accounting principles with the independent auditor
		Discuss with senior management any significant variances from the budget
		Report any significant findings to the board

**Annually:
Internal audit**

Planned Completed Action

		Review and revise internal audit charter, if necessary
		Review and approve scope of internal audit coverage
		Discuss staffing levels of internal audit with lead internal auditor
		Discuss compliance with rules, laws and regulations with lead compliance officer
		Discuss assistance/coordination of internal audit efforts with the audit process of the independent auditor
		Discuss participation in documenting, evaluating and testing internal control processes

Independent audit

Planned Completed Action

Planned	Completed	Action
		Discuss with engagement partner the capabilities of the client service team assigned to the annual audit
		Discuss with engagement partner the process used by the independent audit firm to ensure the independence of the firm and all client service team members
		Discuss with engagement partner the scope and timing of any interim procedures and the annual audit
		Discuss with engagement partner the coordination of internal audit and any oversight agency reviews with the annual audit
		Review and sign the engagement letter for the annual audit and, if applicable, non-audit services
		Discuss the annual audit plan and areas the independent auditor has identified as critical
		Discuss the process for the attestation regarding internal controls over financial reporting and financial disclosure
		Discuss with engagement partner the process for pre-approval of non-audit related services
		Discuss results of the annual audit, where there were variances from the audit plan, and why those variances occurred
		Discuss critical accounting estimates and accounting policies
		If a single-audit engagement, discuss the contents of the required internal control and compliance letters and schedule of findings and questioned costs
		Discuss the contents of the SAS 61 communication, including communications required by GAS
		Discuss passed audit adjustments resulting from the annual audit
		Discuss contents of the letter to management
		Discuss any other issues that arise from the annual report, including:
		Quality of accounting practices
		Assistance of financial personnel
		Condition of records
		Process control issues
		Business/program process improvement opportunities

Management

Planned Completed Action

		Discuss with senior management the governmental unit's risk profile and how risks are managed
		Discuss with senior management the monitoring system in place to ensure all risks are being identified
		Discuss significant accounting estimates, unusual major accounting transactions, related party transactions, and off-balance-sheet activities
		Discuss critical accounting estimates and accounting policies with management including the MD&A prior to the release of the annual report
		Discuss management's response to the internal control, compliance and management letters from the independent auditor
		Discuss changes in accounting principles, policies or practices to understand the reason and preferability of the change

Audit committee activities

Planned Completed Action

		Prepare a report on the annual audit for the board, including SAS 61 communication and letter to management
		Prepare a report for the board regarding internal controls over financial reporting and compliance
		Discuss with the board a recommendation for retention (or selection) of the independent auditor
		Prepare a report for the board regarding internal audit coverage and activity
		Prepare an evaluation of the internal audit function
		Prepare a self-evaluation of the audit committee effectiveness
		Obtain an understanding from the board regarding their expectations of the audit committee

Executive sessions

The audit committee should have executive sessions as circumstances require with:

Planned Completed Action

		Management
		CEO, executive director, superintendent, city manager, etc.
		CFO
		CIO
		Internal auditor
		Independent auditor

Appendix III. An illustration of a report of the audit committee

Report from the audit committee

The audit committee provides foresight of the organization's financial reporting process on behalf of the governing board. Management is responsible for the financial statements and the financial reporting process, including the system of internal control. In fulfilling its oversight responsibilities, the committee discussed the financial statements in the annual report with management, including a discussion of the quality, not just the acceptability, of the accounting principles; the reasonableness of significant judgments; and the clarity of disclosures in the financial statements.

The audit committee discussed with the independent auditors, who are responsible for expressing an opinion on the conformity of those audited financial statements with generally accepted accounting principles, their judgments as to the quality, not just the acceptability, of the organization's accounting principles and such other matters as are required to be discussed with the committee under generally accepted auditing standards including *Statement on Auditing Standards No. 61* [and government auditing standards]. In addition, the committee has discussed with the independent auditors the auditors' independence from management and the organization, including the compatibility of non-audit services with the auditors' independence.

The audit committee discussed with the organization's internal and independent auditors the overall scope and plans for their respective audits. The committee meets with the internal and independent auditors, with and without management present, to discuss the results of their examinations, their evaluations of the organization's internal control, compliance with laws and regulations, and the overall quality of the organization's financial reporting.

Based on the discussions referred to above, the audit committee has recommended to the governing board (and the board has approved) the audited financial statements as of and for the year ended December 31, 20XX. The committee and the board have also recommended, subject to stakeholder approval, the retention of _____ as the organization's independent auditors.

March 1, 20XY

/s/ This report should be signed by all members of the audit committee.

Appendix IV. Example questions for audit committee members

Financial reporting

What are the most critical accounting policies (i.e., most complex, subjective, or ambiguous decisions or assessments) that have the greatest effect on the governmental unit's financial position? Was the accounting treatment conservative or aggressive, and how does it compare to previous periods?

When identifying unusual or nonrecurring items for disclosure, are both gains and losses given equal prominence?

To what extent was the timing of transactions managed in order to occur (or not occur) in the period being reported upon? What was the purpose of managing that timing? How did it affect reported results?

Do reported results provide a view to stakeholders of how market events and significant transactions affected the governmental unit?

How much information about management's previous expectations, results that confirm those previous expectations, and reasons for expectation not being met is being provided?

What areas of the financial reporting, activities or programs are most influenced by management judgment? How does the information in the financial statements allow the reader to understand those aspects and management's assumptions?

What information in the financial statements communicates the significant estimates and assumptions used to develop the financial information? What is the range of possible outcomes, and how is that range communicated to the stakeholders?

What were the most significant events of the past year and how are these communicated to stakeholders? Are both positive and negative events presented?

How does management assess whether the accounting principles it has selected will appropriately convey the economics of the transaction? What accounting principles changed during this past year and how were they assessed?

What changes have there been in accounting policies or in management's application of the policies and the use of estimates and judgments?

Do the disclosures go beyond complying with minimum generally accepted accounting principles requirements?

Do the financial statements and other disclosures form a clear, comprehensive, complete story?

Did you identify any weaknesses in the governmental unit's information technology systems?

Did you use specialists or consult with your firm's experts on all significant issues?

Are there any other risks and uncertainties that have not been disclosed?

What is your overall evaluation of the degree of comparability of this year's financial statements with prior years? What were the causes of significant differences? What reclassifications, if any, were made to prior years' reported amounts?

Were there any unusual unexplained budget to actual relationships?

Oversight of internal accounting controls

Do the internal control processes provide reasonable assurance that fraudulent financial reporting will be prevented or subject to early detection?

Are the internal control processes periodically reviewed?
By whom?

How are controls over computer-generated financial information tested?

Have the firewalls surrounding the Internet site been subjected to testing?

Have any material weaknesses been identified in the internal accounting controls?

What audit tests were performed to compensate for the absence of these controls?

Have the department heads evaluated their department's compliance with the organization's policy statements and control processes? How has that evaluation been documented?

How are changes in the internal control processes made? Is internal audit involved in the process?

How do we put controls and policies in place over new services/products?

Review of internal audit department

Does the internal audit department have a written charter? When was it last evaluated?

Does the internal audit department have the resources to accomplish its objectives?

Does the department appear to be using its time and resources effectively and efficiently?

Are the internal audit personnel well-trained in application of audit procedures in the government environment? Do they understand day-to-day operating and program activities?

Is the experience level of the internal auditors adequate?

Does the internal audit department have a continuing education program?

Does the internal audit department have a risk-based focus in its frequency schedule?

Does the internal audit department use written audit plans?

Does the internal audit department conduct its work in an objective and independent manner?

Does the internal audit department perform any operational duties that would impair its objectivity?

Does the internal audit department reporting process provide for independent reporting?

What types of reports are issued by the internal audit department, and to whom?

Are the internal audit reports issued on a timely basis? Do these reports include sufficient detail for effective action by management and/or the audit committee?

Does management respond appropriately and in a timely manner to significant recommendations and comments made by the internal auditors?

Are there department members with sufficient information systems auditing expertise to address the level of technology used by the governmental unit?

Was the department's involvement in the annual audit effective? What could be done in the future to maximize its effectiveness and efficiency?

Selection of the independent auditor

Is the firm independent relative to the governmental unit?

What are the firm's independence policies? How is adherence to that policy determined?

What are the firm's quality-control practices?

What is the firm's level of specialization in the state and local government industry?

How are members of the audit team selected? Who are the members and what is their experience level?

How does the firm monitor the professional proficiency of audit team members?

How much partner attention is focused on client service?

What other services could the firm provide without affecting its independence?

What level of communication will the firm have with management, the governing board and the audit committee?

What is the audit process and what areas receive primary emphasis?

How does the audit team determine the critical audit areas?

What level of reliance will the firm have on the internal audit functions or the results of any oversight agency reviews?

What steps does the audit team follow if there are problems identified in the audit process?

How does the firm use technology in its audit process?

Does the firm have a peer review? What was the result of the latest review?

Have any sanctions been placed on the firm by any regulatory or oversight agencies?

Review of the audit plan with independent auditors

What are the critical audit areas this year? How does that compare to prior years?

Have any changes been made in your understanding or application of auditing standards that will significantly impact the scope of your audit?

What is the process you used to determine our exposure to fraud risk?

What do you consider to be our high-risk areas?

How are the data processing, wire transfer, ACH and Internet activities included in the audit process?

Which departments, agencies or locations will the audit team be visiting this year?

What audit work will they do at each department, agency or location?

How was the audit work coordinated with internal audit, internal loan review and the CFO?

What are your plans to identify and report on reportable conditions? How will you address general comments to management?

Will you have an exit conference before your audit team leaves?

Will your audit team be able to meet our deadlines for the financial statements and single audit, if applicable?

What changes in accounting rules and regulations have occurred and how does that impact the financial statements, GAS and single audit?

What is the process for discussing issues that might require potential adjusting entries?

Executive session with the independent auditor

Were personnel cooperative (e.g., did they answer your questions; did you have to push for answers)? Were any other difficulties encountered during your audit?

Were there time pressures on your work, including pressures on the timing of the audit procedures? If so, what was the effect on your audit?

Are the internal auditors or financial management – at both the organization-wide and division levels – qualified for what we are asking them to do? Do we need to hire any specialists, such as an information systems auditor for the internal audit department?

Do you have any other concerns about financial management or grant administrators?

Did management adequately respond to your suggestions for improvement in operations and controls?

Does financial management have adequate resources (e.g., experienced personnel and technology resources)?

Does program management have the competency and adequate resources to address compliance with applicable laws, regulations and agreements?

For any proposed adjustments that were not recorded this year by management, does management have a reasonable plan to record those adjustments in subsequent periods?

Does management have adequate policies and practices for communication with analysts?

What is your assessment of the risks of material financial statement fraud and your understanding of the controls designed to mitigate such risks?

What is (are) the area(s) of greatest concern to you? And, has (have) the area(s) been sufficiently covered with the committee in another context (e.g., audit committee meeting and/or written materials)?

Were any changes made in your scope or in planned procedures because of changes in your risk assessments? If so, why did they occur?

Review of regulatory reporting

Were there any significant violations of regulations or statutes?

Were there any repeat violations that needed to have immediate attention?

Does management agree with the results of any regulatory or oversight agency reviews?

Did the examination process identify any issues that may impact the entity's ability to participate in any major programs in the future?

Appendix V. Questionnaire for assessing audit committee effectiveness

A. Understanding the structure, roles and responsibilities of the audit committee

	Effective	Needs improvement	Suggestions for improvement
The responsibilities of the audit committee are set forth in an audit committee charter which is approved by the board.			
The audit committee annually reviews the charter and suggests changes to the governing board.			
The experience and qualifications of audit committee members are compatible with the duties of the committee, including the ability to understand financial reporting and compliance requirements.			
The size of the audit committee is appropriate for the complexity and operations of the governmental unit.			
The members of the audit committee are independent of management.			
The audit committee completes a self-evaluation on its performance and recommends changes to the board.			
The audit committee plans an agenda for each meeting to ensure that it addresses:			
Matters to be discussed at each meeting during the annual cycle			
Communication between the audit committee (or chair) and the independent auditors before the release of financial information			
General topics to be discussed each meeting			
Meeting agendas are prepared and distributed in advance together with sufficient background information to allow the committee members to prepare for meetings.			
Minutes of meetings are taken and circulated to members after the meeting.			
The audit committee members attend training sessions on accounting, auditing and financial reporting developments and current business and industry issues.			
Audit committee members ask tough questions, listen to answers and challenge responses to ensure that they understand the business and financial impact.			
The audit committee encourages a "tone at the top" that conveys basic values of ethical integrity as well as legal compliance and strong financial reporting and control.			
The audit committee obtains information on leading practices and other developments in organizational/corporate governance and considers ways to improve.			

B. Understanding the business operations

	Effective	Needs improvement	Suggestions for improvement
The audit committee understands the organizational structure/programs and the revenue drivers of the government's activities and programs.			
The audit committee discusses their evaluation of the controls over the financial reporting and disclosure process with management, the internal auditors and independent auditors.			
The audit committee evaluates whether management exhibits the proper "tone at the top" and fosters a culture and environment that promotes high-quality financial reporting, including appropriate attention to internal control issues and compliance with laws and regulations.			
The audit committee evaluates management's procedures for monitoring compliance with the governmental unit's code of ethics.			
The audit committee discusses with the internal auditors their adequacy of the governmental unit's regulatory compliance programs.			
The audit committee receives the internal and independent auditors' assessments of the risks of fraud and is alert for risk factors that lead to potential fraudulent financial reporting.			
The audit committee is made aware of reports or other communications received from regulators, and updates from the general counsel on legal and regulatory matters, that may have a material effect on the financial statements, or that may affect related organization compliance policies, or the financial stability or profitability of the organization.			

C. Understanding risk management

The audit committee receives regular updates from management on operating risks and is involved in risk management by being an advocate for the adoption of a risk and control system for effective risk management.			
The audit committee has discussions with the CIO to understand the organization's technology strategy, information systems and measures taken to protect resources devoted to information technology.			
The audit committee has discussions with the senior management team to understand emerging business risks.			

D. Understanding financial reporting

	Effective	Needs improvement	Suggestions for improvement
The audit committee reviews financial statements with senior management and discusses the transparency and clarity of the financial reporting and disclosures with the governmental unit's internal and independent auditors.			
The audit committee develops an understanding of the business purpose and economic substance of major or unusual transactions.			
The audit committee evaluates the quality of activity reporting and considers any "red flags" that may indicate that net assets are being managed.			
The audit committee discusses the selection, application and disclosure of the governmental unit's critical accounting policies with management, the internal auditor and the independent auditor before releasing the annual report.			
The audit committee reviews the financial statement disclosures to determine that the information is not inconsistent and that the disclosure provides the reader a concise understanding of the risks being managed.			
The audit committee discusses any passed audit adjustments with management and the auditors, determines why they were not recorded, and evaluates the impact on the financial statements and stakeholders if all differences were recorded.			

E. Understanding interim financial reporting

The audit committee is provided with material to review prior to release of interim reporting package.			
The audit committee (or the committee chairperson) discusses and reviews any interim financial statements with management.			
The audit committee is briefed by management on how management develops and summarizes interim financial information and how the interim financial close process may differ from the annual financial close process.			
The audit committee reviews with management any significant year-end issues that may impact the financial integrity of interim accounting and reporting practices.			

F. Understanding the audit process

	Effective	Needs improvement	Suggestions for improvement
The audit committee understands how an internal audit is conducted and understands the independent audit process.			
The audit committee reviews any significant control deficiencies identified by the internal or independent auditors, as well as management's corrective action plan and timetable to address those recommendations.			
The audit committee reviews the internal audit charter on an annual basis and evaluates it against the current expectations and needs.			
The internal audit function reports to the audit committee.			
The audit committee reviews the quality, experience and objectivity of the internal auditors.			
The audit committee annually reviews the performance of the independent auditor, including the auditor's responsiveness to the audit committee's expectations and recommends to the governing board the retention (selection) of the organization's independent auditor.			
The audit committee discusses audit plans and scopes of internal and independent auditors, the results of their work, any changes in the plans, the extent of control testing to be performed, and the extent of the coordination of their activities to ascertain if the audit coverage is adequate.			
The audit committee reviews the independence of the independent auditor and discusses the processes used by the audit firm to monitor its independence and the independence of the members of the client service team.			
The audit committee approves and signs the engagement letter for the annual audit and approves the audit fee.			
The audit committee has a process to identify and approve non-audit services to be delivered by the independent audit firm.			

G. Development of a communication process

	Effective	Needs improvement	Suggestions for improvement
The audit committee provides a report to the governing board after each committee meeting.			
The audit committee meets in an executive session, as circumstances require, with the senior management team members.			
The audit committee obtains a written report from management on the effectiveness of internal control over financial reporting, or written representations from management regarding management's responsibility for integrity of internal control and the financial reporting systems and processes, and management's beliefs about the quality of controls, financial reports and compliance with applicable laws and regulations.			
The audit committee has executive sessions with the internal and independent auditors as circumstances require.			
The audit committee reviews management's response to audit recommendations and whether follow-up audits indicate that corrective action is timely and effective.			
The independent auditor provides to the audit committee their assessment of the personnel in the organization, including the number, experience and capabilities of such personnel for the size and complexity of the governmental unit.			

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