

*Characteristics
of Effective Audit
Committees in
Federal, State
and Local
Governments*

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CHARACTERISTICS OF EFFECTIVE AUDIT COMMITTEES

Executive Summary

The private sector financial debacles of the early 21st century (Enron, World Com, Tyco, Health South and others) resulted in sweeping corporate governance legislation known as the Sarbanes-Oxley Act of 2002 (SOX). SOX places significant new responsibilities on the board of directors of publicly traded companies, including expansion of audit committee responsibilities. The audit committees of all publicly traded companies are responsible for all aspects of the audit for the company, including hiring, compensating, monitoring, evaluating and, if necessary, firing the external auditor and closely monitoring and evaluating the internal auditor.

Governments are not subject to the provisions of SOX. Unlike the private sector, there are no national legislative or regulatory requirements for governmental audit committees. Even without such overall requirements, many governments have effectively implemented audit committees and several governments or governmental units (for example, the U.S. Department of Defense, the state of New York and the state of Oregon) have mandated audit committees for specific entities or agencies under their jurisdiction.

Even though there is significant government interest in audit committees, little information is available on how governments use audit committees. Thus, the objective of this research was to identify the characteristics of effective, mature audit committees at all levels of government—local, state and federal.

The research was performed by interviews with numerous individuals knowledgeable in government audit committees, reviews of documents from over 30 audit committees and on-site visits with several governments. There was no attempt to identify all governmental audit committees among the 90,000 or so government entities in the U.S. Nor was the research meant to evaluate actual performance of the committees; we depended on what we were told or read in published documents.

Audit committees can improve the financial management and overall governance of government entities of all types—general and special purpose governments—at all levels. Thus, we recommend that each government entity consider and examine whether an audit committee can improve the operations of that entity. The research also demonstrated that governments have a great deal of flexibility and many choices as to the mission, structure, responsibilities, membership, operations and activities of an audit committee. Therefore, in performing an evaluation, each government should look at several potential models to select the mission, structure, responsibilities, membership, operations and activities most suitable for its needs.

Several organizations have also published guidance useful to governments in establishing audit committees—the American Institute of Certified Public Accountants (AICPA, for all government entities), Deloitte & Touche, LLP (for state and local governments), the Department of Defense Inspector General (for DoD entities), the Government Finance Officers Association (GFO, for local entities) and KPMG, LLP (one publication for state and local governments and a more recent publication for federal entities). Several of these

guidance publications also provide excellent checklists, sample charters, sample evaluation questionnaires and suggested questions for the committee to ask the CEO, CFO, the Audit Executive and the external auditor.

These guidance publications are similar in many ways, but there are significant differences in several areas. The differences are partially explained by the levels of governments to which the guidance is directed. For example, significant differences relate to the mission of the audit committee, the committee membership and committee relations with external and internal auditors. These differences were also noted in practice among the audit committees reviewed, reflecting the flexibility available to governments in establishing their own audit committees.

Governments establish audit committees for a variety of missions, among them to improve audit capabilities, improve internal controls, minimize future fraud and implement “best practices.” The perceived benefits of governmental audit committees are many and varied, including improved accountability and transparency, quality advice on many topics, “clout,” an independent forum for resolving issues, extension of the governing board, “a third set of eyes,” insulating the internal auditor from undue pressure, increased credibility for the internal audit and finance department, and improved communications of financial information.

The diversity of practice noted in the research provides a number of government audit committee best practices and good ideas, which are transferrable to other governments. Perhaps the most important best practice is that governments adopt a well-thought out, complete charter for its audit committee. Unfortunately, we talked with several governments that either had no charter or a sketchy one. While the charter has several elements, the most important relate to a clearly defined committee mission or objective, committee responsibilities and committee membership, as outlined below.

- Generally, the mission or objective of government audit committees falls into one or more of the following categories—Responsibility for, oversight of or advice relating to the external audit; responsibility for, oversight of or advice relating to the internal auditor; and/or advice for ensuring and/or maintaining auditable financial statements. Responsibility for internal controls and risk management is included with each of these potential committee missions. The key is that each government clearly defines the mission of its audit committee.
- The charter must also define the responsibilities or activities that the audit committee should undertake in fulfilling its mission. Often the responsibilities are included in the charter as a coordinated list of tasks or steps. Such an articulation of responsibilities provides the committee with guidance for its activities and also provides a basis for self-evaluation.
- Recommended committee membership varies among the guidance documents and in practice. It is critical to understand the skills and capabilities required for an effective committee and recruit or appoint individuals with those skills. Each committee should include at least one

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financial expert and at least one individual who understands the audit process. Other skills may relate to particular industry or technical skills, understanding of the entity and/or presence in the community.

Committee membership varies widely in practice. For some committees, members are all members of the governing board; for others, members are independent outsiders; other committees include members of management, and yet other committees represent combinations. Each structure has its advantages and disadvantages. While each government must carefully make its own decisions, we suggest that an audit committee with one or more outside members may be optimal, particularly if the outsider is a financial expert.

In the government, the independence of committee members is less critical than in the private sector. That is demonstrated by the number of committees that include members of entity management or management of a closely related entity among the members.

Audit committee members must receive orientation and education as they assume their responsibilities. We found relatively few committees that provide sufficient initial orientation. Several committees, however, provide ongoing education for committee members on the activities of the entity and on professional developments. Some committee members told us that they would like to understand more about the entity's activities and operations.

Top management support is critical to the success of the audit committee. The CEO can demonstrate his or her support in many ways, including his or her presence (or that of a key aide) on the committee or as an invited guest at each meeting. The CEO also demonstrates his or her support by the qualifications and expertise of personnel appointed to the committee, by providing the committee with adequate resources and by implementing its recommendations.

Audit committees also vary in their relationship with the external and internal auditors. We found, however, no matter whether the committee hires, compensates, monitors, evaluates and/or fires the auditors, other areas of "best practice" are similar. The committee should meet at least three times a year with the external auditor—at audit planning time, while the audit is being performed and at the conclusion of the audit. During those meetings, the committee should identify areas they would like to have covered during the audit, question the findings and obtain the auditor's view of the overall internal controls and financial viability of the entity. The committee should also assure the continued independence of the external auditor and review the external auditor's peer review report.

The committee should review the annual audit plan of the internal audit department. In practice, several audit committees participate in the internal audit department's risk assessment, which leads to the annual audit plan. The audit committee should also review audit reports with each, or selected, auditee. (Some audit committees receive information that audits have been performed without seeing the report itself. We were told by one committee member that the committee would like to see more reports and better understand the entity.) Each auditee should commit to

corrective actions, completion of which should be monitored by the committee. The committee should receive periodic reports of the status of agreed-upon corrective actions and require any manager who has not successfully completed the actions to appear before the committee. The report of the status of corrective actions should encompass findings and corrective actions from the internal audits, corrective actions from external audits and corrective actions resulting from a peer review of the internal audit department. Several audit committees have implemented innovative techniques to ensure that corrective action plans are accomplished as per auditee commitment.

Audit committees also approach responsibility for internal controls in various ways. Some committees rely on the annual external audit and internal audits to test the adequacy of internal controls. Other committees are more proactive. These committees require internal control reviews by entity staff agencies, either as an overall government-wide internal control evaluation program or on a department-by-department basis. Audit committees may also participate in annual internal control, fraud or risk management workshops for the entity and require that the audit plan be focused on areas of greatest risk.

The research identified many other areas of best practice, including member and chairperson recruitment, committee self-evaluation, a committee annual report, member compensation, committee letter in the entity's annual report, fraud and ethics hot lines, enterprise risk management, access to people and data, outside consultants, executive sessions, the Annual Financial Report, the Federal Advisory Committee Act for federal executive agencies, visibility for the committee and committee meetings, among others.

We also offer an additional word to all governments with audit committees. Service on an audit committee requires a great deal of time and effort. Remember to thank to your committee members. As one audit committee member told us, "I have been a volunteer member of this audit committee for many years. In that time no one has ever said 'thank you' to me." Perhaps the members do not want or need monetary compensation, but a show of thanks is always appreciated.

The message from the overall research is that government audit committees provide valuable contributions to improving a government entity's financial management and overall governance. Not all best practices or good ideas are applicable to or useful to every audit committee. Each government should evaluate the potential role of an audit committee in its environment and determine which practices and ideas may apply. To the extent that such a committee would be of value, the research shows that each government has wide flexibility in establishing such a committee. Many potential characteristics of effective committees are presented in this report. The challenge for a government is to combine those characteristics in a way that works best for it.

CHARACTERISTICS OF EFFECTIVE AUDIT COMMITTEES

Introduction

The private sector financial debacles of the early 21st century (Enron, World Com, Tyco and Health South among others) resulted in sweeping corporate governance legislation known as the Sarbanes-Oxley Act of 2002 (SOX). SOX places significant new responsibilities on the board of directors of publicly traded companies, such as for risk management and internal controls. It also significantly expands the responsibilities of audit committees of publicly traded companies. SOX requires that all audit committees of publicly traded companies be made up of independent board members, with direct responsibility for financial statements, financial reporting and audits (and auditors). Thus, the audit committee is responsible for hiring, compensating, monitoring, evaluating and, if necessary, firing the external auditor. Audit committees of publicly traded companies are also responsible to monitor and evaluate the internal auditor and to concur in the hiring or firing of the internal auditor.

In addition, such corporate audit committees are taking on additional responsibilities such as for the corporation's ethics program and for enterprise risk management. Corporate audit committees of publicly traded companies are subject not only to SOX legislation, but also to regulations of the U.S. Securities and Exchange Commission (SEC) and U.S. stock exchanges. Further, the Public Company Accounting Oversight Board (PCAOB) oversees the auditors of publicly traded companies and their relations with the audit committee, and the American Institute of Certified Public Accountants (AICPA) has established new professional guidance and standards for auditors of private companies and not-for-profit and government entities (non-SEC registrants).

Privately owned companies, governments and non-profit organizations are not subject to SOX. However, the federal government has adopted some SOX-like concepts. For example, the Office of Management and Budget has mandated that large federal executive branch agencies (the so-called CFO Act agencies) undertake a complete review of their internal controls and business risks (known as OMB Circular No. A-123, Appendix A). While only mandated for CFO Act agencies, other executive branch and several federal legislative branch agencies have also implemented A-123, Appendix A. In addition, other federal, state and local governments have placed additional focus on risk management and internal controls.

Many governments—local, state and federal—have had audit committees for many years. Others have expressed interest in, initiated, expanded, modified and/or strengthened their audit committees since the passage of SOX (and many not-for-profit entities have also taken an interest in establishing audit committees as a way of ensuring better governance). In addition, several professional organizations and federal oversight agencies support the concept of audit committees for governmental entities. However, even though there is renewed interest in government audit committees, there is little information about the characteristics of such committees.

Thus, to provide improved information on government audit committees, the objective of this research was to “identify the characteristics of effective, mature audit committees at all levels of government—local, state and federal.” Since the U.S. has 90,000 or so governmental entities, this research is not an attempt to identify all governments with such committees nor is it an audit of whether committees actually perform as they say they perform. Rather the research identifies best practices and good ideas of current audit committees which we contacted during the research. The best practices and good ideas identified in this report are representative of practices that may be applicable to most governments, but in no way should they be viewed as all inclusive or the only practices that will work. They should, however, be considered by all governments with an audit committee or contemplating establishing one.

The research was performed by discussion and interviews with individuals knowledgeable about government audit committees, reviews of documentation of specific government audit committees at all levels and on-site visits to several governments. We talked with more than 135 knowledgeable individuals—elected and appointed officials, chief executive officers (CEOs), chief financial officers (CFOs) and other financial and budget personnel, chief audit executives (CAEs) and other audit personnel, audit committee chairs and members, external auditors, representatives of professional organizations and oversight organizations, and others. We gathered information on 35 audit committees (Appendix I) – 12 federal, 14 state and nine local. We also visited seven governments to talk directly with participants interested in the audit committee process and to sit in on several audit committee meetings. In addition, we reviewed available audit committee guidance, both private sector and governmental, and many articles and publications that focused on audit committees. We also attempted to contact representatives of the three major bond-rating agencies; these agencies did not participate in the research project.

One word about terminology used in this report. Governments use different terms to describe their governing boards and their top management officials. For example, governing boards may be city councils, county commissions, and state legislatures, appointed or elected boards of directors, the U.S. Congress, etc. Likewise, the top operating official may be a mayor, city manager, executive director, county commissioner, department head, board chairman. The top audit executive may be called internal auditor, inspector general or auditor general. The top financial official may be the controller, chief financial officer or accounting manager. For ease of reference we will refer to these positions as CEO, CAE and CFO unless there is a reason to use another term.

Similarly, we found that audit (or similar) committees in government have different titles, such as audit committee, audit advisory committee, financial management advisory committee or financial and audit advisory committee. In addition, some committees that perform audit committee activities may include other responsibilities, such as finance, budget or oversight. We will refer to these committees as audit committees, even though they may be different in

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scope and responsibility than private sector audit committees. Finally, we found that annual financial reports have different titles, such as the Comprehensive Annual Financial Report (CAFR), Performance and Accountability Report (PAR) or Annual Report. We will refer to these reports as Annual Financial Reports, unless there is a reason to call them otherwise.

What We Found

Government entities have multiple responsibilities ranging from general governance (cities, counties, states, federal agencies) to special-purpose governments responsible for a single function (such as transportation, student loans, pensions, health care, education, etc.). Each government operates in its own culture with its own population and constituency base and each government is subject to a wide variety of laws and regulations. Thus, we found that government audit committees have many different responsibilities, membership, functions, structures and operations. These differences provided a number of excellent practices and good ideas that may be transferrable, but also highlighted some very poor practices, a few of which we will mention. Many governments, but by no means a majority, are interested in and have established audit committees.

As expected, we found that there are no all-encompassing legal or regulatory requirements for audit committees in governmental entities. Many governments implemented and have successfully used audit committees for many years, well before SOX legislation (for example, New York City, Dallas Area Rapid Transit). Other government audit committees were established more recently to address specific local issues or as a “best management practice.” Passage of SOX encouraged some governments to investigate (and form) audit committees and prompted other governments to reevaluate, and perhaps restructure, their audit committees. We also found that specific governments have mandated audit committees for certain entities under their jurisdiction. For example, the state of New York State requires audit committees for all public authorities in the state; the state of Oregon requires an internal audit department and an audit committee for each department in the state with expenditures in excess of \$100 million and over 400 full-time employees; and DoD requires audit committees for more than 20 DoD entities.

Several professional organizations recommend that their members implement audit committees, most notably the Government Finance Officers Association (GFOA), which has issued its *Recommended Practice on Audit Committees and its Elected Officials Guide to Audit Committees*. The National Association of College and University Business Officials (NACUBO), the Institute of Internal Auditors (IIA) and the Association of Local Government Auditors identify audit committees as a best practice for their members. The Government Accountability Office (GAO) and the Office of Management and Budget (OMB) encourage audit committees for governmental entities, though neither requires audit committees.¹

The bottom line appears to be that, even though there are no all-encompassing legal or regulatory requirements for governmental audit committees, many governmental entities have implemented audit committees to support and strengthen their internal and external audit functions, internal controls, and financial management and financial reporting functions.² Further, the absence of overall requirements has enabled each government to tailor, shape and structure its audit committee to meet its individual needs.

With a few exceptions each government we talked to believed that its audit committee was effective, since it accomplished the purposes for which it was established. The differences in committee missions, structure, responsibilities, membership, activities and operations provide a number of characteristics and best practices, which may be transferrable to other jurisdictions.

Several Potential Sources of Guidance

While there are no requirements for governmental audit committees, the following organizations have published guidance for the mission, structure, responsibilities, membership, activities and operations of governmental audit committees, focused on different levels of government.

- American Institute of Certified Public Accountants (AICPA)—all governments³ (The AICPA offers similar guidance for private and not-for-profit organizations audit committees.)
- Deloitte & Touche LLP (D & T)—state and local governments⁴
- Department of Defense Inspector General—DoD entities⁵
- Government Finance Officers Association (GFOA)—local and state governments⁶
- KPMG Peat Marwick (1989)—local and state governments⁷
- KPMG LLP (2003)—federal entities⁸

While the guidance is meant to be advisory for governments in establishing such committees, the GFOA recommends that all governments establish an audit committee and DoD requires audit committees for selected DoD entities. The other organizations do not address whether governments must or should have such committees, but by implication encourage consideration of audit committees.

The chart in Appendix II compares the key features of the guidance offered in the several documents. As noted, the guidance is similar on many subjects, including:

- Need for a charter
- Need for executive sessions
- Number of meetings
- Need to prepare an annual report of committee activities
- Need to prepare an annual plan for the committee
- Need for committee to evaluate its own performance

However, the guidance also differs in many respects, partially due to the nature of the target audience (that is,

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level of government). Selected differences, in addition to the target governments, relate to the following.

- **Committee Title**—Reflecting the nature of the responsibilities, the AICPA, D&T and GFOA refer to “audit committees.” Other guidance refers to financial management advisory committees or audit and financial advisory committees. These differences are reflected in the titles of the committees that we contacted. The title of the committee often reflects the scope and responsibilities of the committee.
 - **Mission of the Committee**—Each guidance publication defines the committee mission somewhat differently, depending on the level of government to which the guidance is directed.
 - **Committee Membership**—An area of great variety among the guidance documents as they relate to the backgrounds of the committee members.
 - ✓GFOA advocates that all audit committee members be members of the entity’s governing board who are independent of the financial management activity of the entity.
 - ✓KPMG recommends that the committee be made up of independent outsiders— individuals independent of the entity and of the federal government. Members should be respected members of the community.
 - ✓D&T takes the view that the committee can include both independent outsiders and members of the governing board.
 - ✓DoD IG guidance provides for independent outsiders, representatives of other DoD entities, employees of other federal agencies and/or members of management of the entity itself.
 - ✓The AICPA does not directly address this issue, but implies that members can be from the governing board or independent outsiders.
- We found a wide variety of membership in practice in entities that have audit committees.
- **Characteristics of Members and Leader**—The DoD IG guidance (and to some extent the D&T guidance) provides extensive discussion of the characteristics of audit committee members, such as the ability to act independently and to ask relevant questions. DoD IG also provides guidance as to selection of committee members and guidance on characteristics of the committee chair, such as an individual who is strong and independent with the ability to lead.
 - **Relations with External Auditor**—The AICPA and the GFOA suggest that the audit committee hire, negotiate with, evaluate and, if necessary, fire the external auditor. D&T suggest that the committee can directly hire the external auditor or recommend a selection to the governing board. The DoD IG and KPMG, reflecting the federal environment, suggest that the committee receive reports and information from the external auditor, but not be involved in the auditor engagement process. The differ-

ences in approach to the external audit function were in evidence in the audit committees covered in the research, depending on the needs of the government.

- **Relations with Internal Auditor**—The AICPA recommends that the audit committee review and concur on the appointment, replacement, reassignment or dismissal of the internal auditor while D&T recommends that the committee provide oversight of and evaluate the internal audit function, including review and approval of the annual audit plan. The DoD IG and KPMG guidance suggests that the committee receive periodic updates from the internal auditor and review the annual audit plan (again reflecting the federal environment) while the GFOA discusses alternative approaches but does not recommend a specific structure. The differences in approach to the internal audit function were again in evidence in the audit committees covered in the research.
- **Orientation for Committee Members**—All guidance, except the AICPA which does not address the issue, recommend orientation for committee members to their responsibilities and, if necessary, to government accounting and financial management. The DoD IG guidance notes that the chairperson should have a solid financial background. Without this type of experience, the chairperson will require a great deal of training and the time and effort required to complete training could potentially reduce the effectiveness of the chairperson.
- **Educating Entity Staff**—DoD IG guidance suggests that the audit committee should take the lead in educating agency financial and program staff as to the importance of financial statements and of the external audit. Other guidance refers to educating the governing board, but does not deal with other entity staff. In practice, we found only DoD entities provided training to agency staff, but audit committees provide education programs for the governing body.
- **Compensation**—Only the KPMG guidance suggests that compensation for committee members may be considered because of the time required to perform audit committee responsibilities. (Our interviews backed up this observation. Members devote significant time to committee activities.)
- **Internal Control and Risk Management**—Each guidance publication recommended some level of involvement for the committee in internal controls and risk management of the entity. The D&T guidance provided the most extensive discussion of the committee’s responsibilities in these areas.

Guidance publications from the AICPA, D&T, the DoD IG and KPMG include very helpful checklists, sample charters, sample questions to ask the CEO, the CAE, the external auditor and others, evaluation check lists, internal control check lists, annual planning documents and other useful guides.

In general, we found all guidance helpful in structuring a governmental audit committee. However, the differences in

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the guidance serve to emphasize that each government is different with different legislative and regulatory requirements, histories and cultures. Thus, the nature of government audit committees demonstrate significant differences, tailored to the needs of the government.

Several CPA firms and the AICPA have websites devoted to corporate governance, including audit committees.⁹ These sites are updated frequently and provide links to other valuable information for audit committee members. While these websites are focused on private-sector corporate governance and audit committees, the information can be useful for governments to stay up-to-date on audit committee-related issues and best practices.

Are the Committees Effective? Do They Add Value?

We attempted to determine if government audit committees are “effective”—that is, if they add value to the financial management and/or the overall governance of the government. No government audit committee has quantitative performance metrics that would make answering such a question straightforward. Further, few committees have directly measurable goals, such as to reduce material weaknesses or significant deficiencies, to judge performance. Therefore, to address the question of “value-added” we asked the people to whom we talked whether they thought their audit committee was effective and “adds value” to the government.

Not surprisingly, most people to whom we spoke think that their audit committee is effective, meets the goals for which it was established, and improves the financial and the overall management of the government. We did, however, identify a few instances where the committee did not improve overall management and/or governance. In one instance, an audit committee was disbanded when the CEO and the CAE were not satisfied with the results and the advice coming from the committee. In another instance, the CFO and the CAE were constantly “at odds”; each viewed the audit committee as a group to support his views. When the committee did not “take sides,” its value lessened in the eyes of the CEO, CFO and CAE and the audit committee was reorganized. (The committee was chartered by the CEO and reorganized by the CEO.)

In several cases we were told that the committee effectiveness varied, depending directly on the capabilities of the committee chair (and/or the committee members). This was most often the case when the committee members were drawn from the governing board and the board did not include individuals who were financially literate (nor interested in becoming financially literate). In one instance, we were informed that the committee chair (who was a senior member of management) did not believe he was the right person for the job. When the new CFO assumed responsibility for the audit committee, the effectiveness of the committee significantly improved.

Despite a few anomalies, the people to whom we spoke identified a number of ways in which their audit committee improved the financial management, audits and overall

governance of their governmental unit. Some of the more frequently mentioned “values added” included:

A Best Management Practice—Several respondents told us that a strong audit committee is a best practice to improve the governance and financial management of the entity. The concept of the audit committee as best management practice is supported by the National Association of College and University Business Officials and the Institute of Internal Auditors.

Accountability and Transparency—These are, of course, a major reason for establishing audit committees. Government officials and others to whom we spoke indicated that the presence of an audit committee encouraged staff to increase the level of care in preparing financial statements, ensured that the statements were viewed by key individuals in and out of the government, ensured that financial information was presented so that it was understandable to the public, highlighted internal control weaknesses and provided an opportunity for employees to identify potential financial issues without fear of reprisal. Thus, management accountability was enhanced by the presence of an audit committee that “paid attention,” with the information available and usable by a larger portion of the public.

Several individuals told us that the presence of the audit committee resulted in staff being more attentive and careful to how money was spent. The committee was able to achieve a government-wide overview of spending patterns. Similarly, the committee was able to challenge and question management, which in turn ensures that management has “thought through” its decisions and rationale. The committee can also put more focus on risk management and internal controls. One individual commented that his government’s audit committee had “lengthy discussions” of risk management. As a sub-set of risk management, at least one audit committee focuses on the risks inherent in information systems and devoted significant attention to that aspect of risk.

We had many comments that audit committees provide “a third set of eyes” to identify issues that might slip by staff too involved with preparing or auditing financial statements or reviewing internal controls. That “third set of eyes” can also assist with ensuring the reports, such as annual financial reports, are understandable to the governing board, top management officials and the public, moving the reports from “jargon” to information.

Audit committees also provide more accountability and transparency for subordinate governments within an overall government. For example, New York City has more than 20 component units included in its annual financial report, each of which has a separate external audit. Each of these audits is reviewed by the NYC audit committee; the CEO and CFO of the component unit are required to appear before the NYC audit committee. In another instance, a local government includes 18 fire districts, each with a separate audit. These audits are also subject to the scrutiny of the local government’s audit committee. In yet another case, a university has a university hospital and a medical group

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each with its own audit committee and audited financial statements. A member of the university's audit committee is chair of one of the subordinate audit committees and the university's internal auditor participates in the audit committee meetings of the other entity. Thus, the financial information of these subordinate entities is subject to increased emphasis on accountability and transparency.

Credibility—One of the most frequently mentioned benefits of an audit committee is the concept of credibility. In several instances, the presence of an audit committee with well-credentialed and well-known members of stature in the community improved the credibility of the entity's financial statements. This was particularly true of entities that had only recently initiated issuance of audited financial statements, but not limited to such entities.

Audit committees also have credibility with entity top management. Several individuals told us that their audit committee, particularly the chair, "has the ear of the CEO who values the opinions of the committee" and assists financial management in accomplishing its objectives. In several instances the audit committee was very helpful in getting additional staff and other resources for the finance and/or internal audit departments or getting budget requests adopted and/or obtaining the appropriate allocation of resources. In another instance, the audit committee provided input to the CEO in helping him deal with financial issues. In yet another instance, the committee supported an organization change designed to improve internal controls. In another, the audit committee proposed an expansion in the scope of the internal audit function, which was adopted by the governing board.

One audit committee, by charter, meets with the CEO privately twice a year and other committees meet with the CEO in executive session from time to time. In a number of instances, the CEO or the governing board used audit committee recommendations to his/her advantage, for example in obtaining additional resources or in dealing with citizen groups. Of course, the opposite can be true—the CEO does not have confidence in the committee. We identified only one such instance; the result was the committee was disbanded.

Other individuals informed us the presence of an audit committee increased the credibility of the internal audit function within the entity. For example, two internal auditors told us that their departments were ineffective and were not able to get the "attention" of operating departments until an audit committee started demanding that operating department auditees appear before the audit committee to discuss audit findings and corrective action plans. Another internal audit department was "bogged down" in small audits until the newly formed audit committee changed the focus of the internal audit department. In another instance, the internal audit function is viewed as helpful to entity managers, not as the "black hat." This reputation is partly a result of the approach and attitudes of the audit committee.

A related benefit is that the audit committee ensures that internal audit recommendations are "taken seriously" and are followed up. One CAE told us of an internal audit recommendation relating to investments of entity funds that was not followed up. It turns out that the investment adviser was running a scam that would have been discovered had the internal audit recommendation been pursued. The result was a significant financial loss for the entity. This instance was very instrumental in establishing a powerful audit committee within the entity.

Other internal auditors and audit committee members attributed new respect for the internal audit function from the presence or formation of an audit committee. Several audit committees also serve as a "buffer" between the internal auditor and "undue pressure" from management and/or the governing board. In fact, we saw charters that specifically state a purpose of the audit committee is to act as a buffer between the CAE and the governing board and/or management. In several cases, the audit committee decides which audits will be performed by the CAE, and their priority, with precise procedures for requesting an audit.

Audit committees also enhance the credibility of the finance department, particularly when the CFO is implementing new internal control procedures, resolving internal control deficiencies or implementing new financial systems. The support of an audit committee for financial statements, in general, also demonstrates top management support for the process. This is particularly important when the entity has not previously prepared financial statements in conformity with GAAP nor been subject to an external audit.

The audit committee also builds credibility within the audit and finance departments. Several individuals told us that the presence of the committee and the time lines established by the committee ensure that material will be prepared in a timely and accurate fashion. In addition, the presence of the committee ensured that audits were completed on time and under budget.

Audit committees can also be used to educate entity staff, including program staff as to the importance of financial statements and of the independent outside audit. This can be particularly important in agencies, especially federal agencies that have never prepared GAAP-based financial statements or been subject to an external audit. (Not all federal government components are subject to an outside audit requirement.)

Clout—Closely related to credibility is the concept of clout or as one CAE put it, "the audit committee is a baseball bat." The presence of the audit committee helps the entity accomplish its objectives, not only in financial areas, but in matters relating to operations, internal control and risk.

Effective audit committees can also ensure that things get done. These "things" can be implementation of new procedures, preparation and retention of financial records and information and information for the governing board and the public, among others. As one CAE told us, "When the audit committee speaks, it gets done."

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For committees that include governing board and/or management representatives, the managers and leaders who are responsible for implementing actions are “at the table.” (In one instance the CEO was a member of the committee.) When the committee agrees on an action, the manager responsible for “making it happen” is “at the table.” Managers do not want to be embarrassed in front of their peers. That becomes a powerful incentive to “get things done.” A perfect example is the audit committees at specific DoD entities. The committees include the managers of each program and financial activity within the entity. When the committee decides to implement a new procedure to fix a weakness, the responsible manager has to make it happen. This also builds recognition that the finance department does not “own” most internal control issues nor own the corrective action plans. These are often programmatic activities. With key programmatic managers on the audit committee, the probability of implementing the changes approaches 100 percent. This is also one way to communicate the importance of financial statements and internal controls to program officials.

One question that kept coming up is, “How can an audit committee of independent members (not aligned with the government) have any real impact on the entity?” How can they get things done? We were told several times that if the committee members are respected by entity managers and have the ear of the CEO, even a committee of outsiders can make change happen. In addition, one audit committee member told us that because of his reputation in the community, if he were to resign in a dispute with the entity, the credibility of the entity and its financial information would suffer.

An Independent Forum—Several individuals lauded the audit committee as an independent forum where the members have “no axe to grind” (particularly when the members are outsiders) and who can look at the facts of an issue and make a recommendation. The members who have knowledge of the issues, of financial management and of the audit process, provide input and oversight as needed. The committee becomes a forum for the “meeting of minds.” For example, one entity had issues with valuing property, plant and equipment (PP&E); the committee, with its experience, was able to assist with resolution of the issue. In another instance, the entity and the CFO were at serious odds with the external auditor. The audit committee was able to mediate the differences so the entity eventually received an unqualified opinion.

One respondent described the audit committee as a deterrent. It forces issues to be resolved before they get to the CEO. The committee also enables both the committee and management to dig into issues and reach resolution.

Committee members also take a broad view of the entity and of the financial reports, looking at them with that critical independent eye. There is a certain synergy that comes from having very smart, knowledgeable, independent people together who can get to the heart of the problem. Several governments commented that their audit committee

helps the government function better. They are part of the “continuous improvement” mentioned by one CEO (see below).

The audit committee can also look at the government from the layman’s point of view. They don’t get bogged down in the jargon and can help the government present itself to the public from a much more “human point of view,” as one CFO put it. Several respondents commented that audit committee comments on the annual financial report helped make it more understandable to the public. One respondent told us that the audit committee took a very “common sense” approach to internal control.

Knowledgeable audit committee members are able to ask *penetrating questions* of management, the external auditor, the internal auditor and department heads whose departments are the subject of internal audits. Committee members are able to inquire in a meaningful way because of the experience and the capabilities of the committee members. As one CAE told us, “The committee can cross-examine the external auditor.” Since most audit committees can call any member of management to a meeting, several committees have asked penetrating questions relating to information technology, human resources and various program managers when those individuals impact financial management and/or agency governance or are subject to audit. In another instance, the committee asks the CAE the right questions; at the same time the committee supports the efforts of the CAE.

The committee is interested in “facts, facts, facts.” They analyze issues independently, each coming from his or her perspective. In addition, the questions cover a wide range of related topics, including program operations, investments and insurance, among others. The questions can result in changes in operations, more complete corrective action plans and improved internal controls.

As one CAE put it, “We never know what questions the committee members will ask. We have to be fully prepared.” And, the committee follows up. “If we are asked to take an action, the committee will not forget. It has to be done.”

An Extension of the Governing Body—Several audit committees were established to take on responsibilities of the governing board, either as advisory to the board or with delegated responsibilities for financial statements or relations with the external or internal auditor. The delegation to a separate committee enables members to devote sufficient time to learn about the intricacies of governmental financial statements, internal controls, audits and/or information technology. Such delegation is often to a committee of governing board members but as often to a committee of independent outsiders. As the chair of one audit committee told us, “The audit committee speaks for the governing board. Certain matters do not have to go to the overall board itself since the committee handles the issues for the board.”

The CAE of a major city told us that the governing board of his city is made up of part-time elected representatives. They are elected to office based on “politics and policy

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matters,” not based on their knowledge of finance and the audit process. In addition, they do not have time, along with their other responsibilities, to devote to audit-related matters. In this case, an audit committee of knowledgeable citizens enables the governing board to fulfill its responsibilities within the time available as part-time board members.

Quality Advice—A frequent benefit of an audit committee is that “they give us good advice.” Since many audit committees are advisory in nature, the quality of the advice is critical. In instances where the audit committee members are outsiders, they may be recruited and selected for their specific expertise. For example, representatives of a government that was undergoing its first audit (and whose CFO had not experienced an audit and had no experience dealing with external auditors) recruited audit committee members who had recently undergone their first audit. The advice was “spot on” in helping the government to prepare for that first audit. The committee focused on “high risk” weaknesses and was able to help the government anticipate issues before they occurred. Agency staff and management paid attention to the committee because of the experience and expertise of the committee members. In other instances, the committee members were recruited for their knowledge of the industry (or appointed to the governing board for that knowledge and hence to the audit committee).

In one specific instance the government had received a clean opinion, which was then withdrawn by the external auditor. The entity needed help in resolving complex accounting problems and resolving differences between the CFO, the CAE and the external auditor. The audit committee, made up of prominent and experienced outsiders, helped to accomplish these goals and enabled the government to receive its unqualified opinion for several consecutive years. Now that “things have settled down,” the government and the audit committee are focused on improving the quality of financial information and of reporting to the public and the governing board.

Similarly, governments have recruited audit committee members with expertise in government and private sector accounting, annual financial reports, information technology, property, plant & equipment (PP&E) accounting or in other areas representing a specific need of the government. In all cases, the benefit was termed as “great advice” and assistance with resolving contentious accounting issues. In other instances, the committee members are able to mediate differences of opinion between the CAE and the CFO or between the CFO and the external auditors.

Many governments have a single-purpose focus, for example, pensions, guaranteed student loans, transit, information technology, health care, education. Audit committee members with specific industry expertise are best able to provide good advice to such agencies.

Even when audit committee members were not recruited for specific expertise or when the members were from the governing board, we repeatedly heard that the committees provide quality advice to the CEO, CFO, CAE and the governing board. The independence of the outside members

together with the knowledge of governing board personnel enable the committee members to step back and look at their assigned responsibility with a broader view. The different backgrounds and perspectives also enable the committee to examine issues and provide advice from a variety of backgrounds. As one respondent told us, the audit committee has had a positive role in the governance and accountability of the entity.

As one government CEO said, the audit committee is part of the process of “continuous improvement.” (His government’s audit committee is made up of governing board members.) The advice and the suggestions for improvements are critical, as the entity continually strives to improve its operations and customer service. This CEO also suggested that audit committee should have performance indicators to evaluate the committee performance, just as management performance is evaluated.

Best Practices in Governmental Audit Committees

Based on the research, we suggest that each governmental entity consider whether an audit committee can add value to the financial management and overall governance of the government. Since there are no national legal or regulatory requirements for government audit committees (although there may be local requirements), governments that desire such a committee have a great deal of discretion in how they structure the committee to fulfill specific entity needs. This is both the good news and the bad news. The good news is that there are no requirements. The bad news is that there are no requirements. Thus, if a government wants/needs an audit committee, the government must clearly think through the type of committee it needs and the characteristics of its committee. There are no rules they can rely on and no single guidance to meet every type of government in the U.S.

While there are no rules or regulations, there are several “starting points.” Many aspects of the Sarbanes-Oxley legislation may be applicable to specific governments. Further, as noted above, several organizations have issued guidance for the mission, structure, responsibilities, membership and operations of government audit committees. (One CAE told us that his entity’s audit committee charter was based on the AICPA guidance.) Much of the guidance includes checklists and examples that may form the basis for the audit committee for a specific government. In addition, as mentioned, several major CPA firms and the AICPA maintain up-to-date websites devoted to audit committees and corporate governance, and numerous articles and other publications focus on the most current thinking in private sector audit committees.

Most important, the governments included in this research have shown a remarkable amount of innovation and creativity in establishing and operating their audit committees. We have distilled their best practices described in the sections below. In addition, many entities included in the research would be pleased to share their experiences with other governments.

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A Well Thought-Out Charter—the Foundation of the Audit Committee

Every audit committee must have a well thought-out charter (or equivalent) to provide direction to the committee and to inform entity officials and the public of the committee's role. The charter is perhaps the most important foundation of an effective audit committee. Many charters are well thought-out and provide the information necessary for the committee to operate effectively. Unfortunately, we saw some very sketchy charters and talked with representatives of committees that had no charters. (In one case, the person we talked to said, "Yeah, I suppose we should have a charter.") As someone once said, "If you don't know where you are going any road will get you there." An audit committee without a charter (or equivalent) does not know where it is going or what it wants to accomplish. In that case, any level of accomplishment looks good.

The charter must be written so that the key characteristics are clear. We examined several charters that were more about the internal audit function than about the committee. (Effective internal audit departments may have their own charter.) Other committee charters were written so that the key characteristics were buried in language that made it difficult to really ascertain the mission and responsibilities of the committee.

Formation of an audit committee may be advocated by different government officials. At times the CFO takes the lead in proposing and forming the committee; at other times it is the CAE. The risk is that the committee can be perceived as "in the pocket" of the official who proposed its formation. We learned of one case in which the CAE led formation of the committee, but a new CAE did not agree and the committee was abandoned. In another case, the CFO led committee formation. However, the CFO and the CAE were such adversaries that the committee was reformed with new members appointed directly by the entity's CEO.

Audit committee charters are usually codified in legislation adopted by a legislative body or resolutions adopted by an appointed or elected governing board. For most general federal entities the committee is chartered by the agency head. In a few instances, the committee may be established by the CFO or the CAE. (This type of committee is probably the most fragile if it is not supported by the governing board and the CEO.) Unfortunately, several committees "just grew" without a well-defined charter.¹⁰ In many cases, the audit committee itself is one of the bodies approving a new or revised charter

Key components of an audit committee charter are the *mission, responsibilities and activities, and membership*. These three critical elements of the charter are discussed in the next three sections. Charters include other important components and sections, several of which are discussed among these best practices and are described in several guidance publications. However, without a well thought-out mission, responsibility and membership, the committee is not off to a good start.

The Committee Mission Must Be Clear—Why Do We Need an Audit Committee? In general, audit committees have one or more of the following three missions or objectives.

- Responsibility for, oversight of, or advice relating to the external audit.
- Responsibility for, oversight of, or advice relating to the internal audits.
- Advice for ensuring and/or maintaining auditable financial statements.

Some level of responsibility for internal controls is included with each of these committee missions. In addition, committees may include responsibilities for ethics and compliance with laws and regulation or other responsibilities. The basic mission, however, revolves around the external audit, the internal audit and/or the financial statements.

Each government must decide why it needs an audit committee and what it wants the committee to do. In the government sphere, audit committees do not neatly fit the mold laid out by SOX and its implementing regulations. (In fact, one respondent objected to the committees being called "audit committees" since they were often different than SOX-mandated audit committees). This creates both challenge and opportunity for government—to mold their audit committees (or audit advisory committees or financial management advisory committees, etc.) to fulfill the specific needs of the community.

Some audit committees are formed as a response to perceived financial or audit need or to a specific precipitating event. One government formed an audit committee to provide more "muscle" to the internal audit department; another because of a recent fraud in the government's investment program that may have been avoided if an internal audit recommendation had been followed up on; another because a breakdown in internal controls resulted in fraud; NYC's committee was a requirement of federal support to resolve the city's fiscal crisis of the 1970s¹¹; one committee was formed as a way to reduce government costs; yet another by the legislation forming the entity (a government authority); other committees are formed specifically to assist a government in obtaining a clean audit opinion, particularly federal committees; other committees are formed to meet regulatory requirements. In other cases audit committees were formed because they are considered a "best management practice" or because the finance (or other committee), which had been overseeing the audit, did not have the time to devote to audit-related activities. In one instance, a new CFO brought the idea for an audit committee with him to his new entity as a best practice. The committee has had a dramatic, positive impact on the government.

The reasons for forming the committee will, of course, determine its mission. Some governments model their audit committees on SOX requirements, with the committee assuming responsibility and/or oversight of external or internal audits as well as financial reporting and internal controls. For others, audit committees are established to

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advise the governing board (or the CEO, CFO or CAE) on financial reports, on dealings with the external auditor or the internal auditor or with risk management. Each of these missions is valid.

The most effective committees had a clear definition of the mission and objective. Some examples (actual examples, but paraphrased) of clearly stated audit committee missions taken from charters that we reviewed include:

- An audit committee provides oversight of auditing and internal control for the agency and helps ensure the independence of the internal audit function. The purpose of an audit committee is to assist agency management in carrying out its oversight responsibilities as they relate to financial and other reporting practices, internal control, compliance with laws, regulations and ethics, and economy and efficiency of operations.
- The entity-wide audit advisory committee is created to promote excellence and professional, standard-based internal auditing services in entity government. The entity-wide Audit Advisory Committee serves in an advisory capacity to the director of Administrative Services.
- Primary function of the internal audit committee is to fulfill its oversight responsibility by reviewing the reports and other information provided by the systems of internal control regarding finance, accounting, legal compliance and ethics that the entity has established and the auditing, accounting and financial reporting processes generally.
- The audit committee is advisory to chief financial executive (CFE) on policy/guidance proposed by the CFE and assists in promulgation and enforcement of policy/guidance. It serves as a forum for raising accounting/auditing implementation issues, assigning responsibilities for resolution and tracking completion.
- Independent audit committee to oversee the annual audit of the financial statements and provide a forum to discuss and resolve a wide variety of government accounting and auditing issues.
- Ensure Internal Audit Department has unrestricted access to all information, ensure Internal Audit Department operates independently, ensure appropriate action on audit findings and promote and enhance mutual cooperation among committee, internal audit and executive management.
- Audit and oversight committee is responsible for overseeing entity's principal administrative processes, financial systems and internal controls. As delegated by the board, the committee provides general supervision of the CAE, who is responsible for all audits and investigations of entity programs, awards and personnel. Committee also reviews and advises the board on issues related to effectiveness, efficiency or integrity of entity operations.
- Council audit and finance committee shall assist the council in oversight of and responsibility for the entity's financial and performance reporting practices, internal controls, compliance with applicable laws and regulations and initiatives to improve service.
- Purpose of the audit committee is to oversee the integrity of the entity financial statements, the entity compliance with legal and regulatory requirements, the independent auditor's qualifications and independence and the performance of the entity's internal auditor and independent auditors. The committee is to be the entity's principal agent in ensuring the integrity of entity management and adequacy of disclosures to the public.
- To assist the board in fulfilling its oversight responsibilities for the financial reporting process, the system of disclosure controls and system of internal control over financial reporting, the independent auditor's qualifications and independence, the internal and external audit processes and the entity's process for monitoring compliance with laws and regulations and the board's ethics code and travel policy (and other duties as assigned).
- The committee is established by the CEO to provide recommendations and advice regarding the entity's financial management, including the financial reporting process, systems of internal controls, audit process and process for monitoring compliance with relevant laws and regulations.
- The audit committee is established to increase the credibility of the financial statement audit process and provide a valuable contribution to the entity's financial management.
- Assist the CEO in fulfilling his/her oversight responsibility by reviewing and discussing the effectiveness of entity's financial reporting process and internal control and determining whether entity's financial management systems substantially comply with the requirements of significant laws and regulations.
- Serve in an advisory capacity to the governing board and the audit department on issues presented to the committee related to the oversight of audit activities (internal and external) for the entity and the entity's audit department. Serve as an intermediary between the governing board and the entity auditor to prevent exertion of any undue pressure on the entity auditor in the selection of audit projects.
- Assist and provide guidance to the board chair and board in monitoring and overseeing the conduct of the entity's financial reporting process, the application of accounting principles and the engagement of outside accountants, the entity internal controls and risk management systems, and general matters relating to legal, regulatory and ethical compliance.
- Assist and advise the board in fulfilling its oversight responsibilities for the entity's financial reporting, internal controls, risk management, performance of external and internal auditors, and compliance with laws and regulations. Committee reviews all contracts for audit and non-audit services provided by independent public accountants and recommend action to the board.
- The audit committee shall exercise full authority over the audit function in accordance with policies and procedures established by the board, including participation in

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selecting the external auditor and oversight of the external auditor and recommending appointment, compensation or removal of the CAE.

In conclusion, it is an important best practice for the committee to have a clearly stated mission and purpose(s).

What are the Committee's Responsibilities?

What Does it Do to Fulfill Its Mission? A second key element of an effective charter includes guidance to the committee as to its responsibilities and activities. The guidance serves to provide additional direction for the committee. The guidance cannot be restrictive; the committee needs flexibility. However, the activities provide a roadmap of what the committee should be considering for fulfilling its responsibilities and objectives. If the guidance proves to be too restrictive or too "loose" the charter can be revised and fine-tuned. As with a mission statement, we found a number of charters that provided no or little guidance for the responsibilities of its audit committee. In such cases, the committee "invented" its own responsibilities, which hopefully contributed to fulfilling the mission (if there was a stated mission).

In addition to guidance, the list of responsibilities and activities serves as a basis for evaluating the committee's performance (see below). The following examples from charters that we reviewed represent examples of clearly stated responsibilities to fulfill the mission of the audit committee to which they apply.

- Twenty specific responsibilities relating to documents and reports review, financial reporting processes, process improvements and ethical and legal compliance. In addition the committee concurs in the appointment or removal of the director of internal auditing to safeguard the independence of the internal audit function in matters falling under the jurisdiction of the internal audit committee.
- Eight specific responsibilities including reviewing and approving internal audit charter, approving internal audit annual plan, receiving and considering requests for special audits by CEO and governing board, review annual external audit plan and results, among others. The committee chair is also responsible to review the charter annually and report to the governing board.
- Eight specific responsibilities including review of internal audit plan, monitor internal audit results, monitor internal controls, provide assurance entity is in compliance with laws and is conducting affairs ethically, review financial reports with CFO, recommend an external auditor and review results of audits, and review outside peer review of internal auditor.
- Approximately 20 specific responsibilities including those related to oversight of the external auditor, financial statements and disclosure matters, communication with auditors, and internal auditors.
- Approximately 30 specific responsibilities relating to financial statements, internal control, internal audit,

external audit, compliance, reporting requirements and other.

- Fifteen responsibilities relating to the financial reporting process, systems of internal controls, process for monitoring compliance with laws and regulations and others.
- Nineteen responsibilities related to engaging the independent public accountant, annual audit and the review of annual financial statements and periodic responsibilities.
- Eleven specific responsibilities relating to implementation of relevant legislation, reviewing changes in GAAP and GAAS, advising and discussing financial audit coverage, advising and discussing the effectiveness of internal controls, reviewing CAE reports, reviewing peer review info, advice on handling unusual transactions, annual review of charter, advice on sensitive matters and reviews on specialist studies. The committee also meets twice a year with the CEO to discuss the status of the committee work.
- Chair and vice-chair specifically have 13 responsibilities relating to auditors, financial statements and accounting policies, internal controls and risk management and miscellaneous. The chair and vice chair report their activities to the entire committee. The committee has 18 specific responsibilities relating to auditors, financial reporting and accounting policies, internal controls and risk management, ethics and conflicts or interests, and miscellaneous.
- Twenty-seven responsibilities relating to financial and other reporting, including monitoring the external auditor, internal control, compliance with laws, regulations, policies and procedures and the internal audit function.

In conclusion, to avoid too restrictive a charter, charters of effective audit committees also state that the committee may take on such other activities that it deems necessary to fulfill its responsibilities.

Committee Members Should Be Matched to Committee Responsibilities—Committee membership must be carefully considered based on purpose and responsibilities. In the private sector, all audit committee members are members of the company's Board of Directors. In government, we see a much wider range of membership. Some committees include only members of the governing board; other are made up entirely of independent outsiders; yet others are composed of internal management; others are made up of delegates of elected government officials and independent outsiders; yet others are composed of internal senior officials; and others are a combination of inside management and outsiders from other departments of the same government. The point is that there are many variants in the membership of government audit committees.

Ideally the backgrounds of the committee members will reflect the specific needs of the government. In all cases, the committee should include at least one member who is a financial expert¹² (unless for some reason the committee does not deal with entity finances) and at least one member who understands the audit process (may be the same indi-

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vidual). The financial expert is critical to ensure that the committee can ask those penetrating questions about the entity's financial position and description and help the committee "get behind" the numbers. Further, the financial expert will help the government "move from jargon to English" in its reports to the governing board and the public.¹³ The member knowledgeable in the audit process will enable the committee to ensure that professional standards are being followed and to question the processes, procedure and reports of the external and the internal auditor. Since many internal auditors perform a wide range of audits (not limited to financial audits), knowledge of the audit process must be applicable to all types of audit projects.

Members may be selected for their understanding and knowledge of the government entity (more on this later), experience with a first audit, the ability to "make things happen," expertise in the industry (particularly for single-purpose governments), knowledge in specific accounting areas (such as credit accounting or complex leases), expertise in information technology, PP&E or other specific needs of the government. One committee includes a representative of the entity's employee union (who we were told is a very effective member). Other members may be smart people who ask challenging questions and are respected by the governing board and/or management.

Examples of charter language on the composition of audit committee members is listed below (not all of which represent a recommended structure).

- One or more board or commission members (if agency has a board or commission) or senior management officials not responsible for internal audit and outside individuals (to enhance accountability and transparency) with qualifications determined by the agency.
- Five or more members as determined by the committee. All members with working familiarity with basic finance and accounting. Members may enhance understanding by participating in educational programs.
- Twenty-six members of agency management.
- Audit committee with five public members, one of whom is a financial expert, one who is active, inactive or retired CPA, one familiar with governmental financial accounting and one who is a representative of the public. The government, financial expert has "an understanding of GAAP and financial statements; ability to assess general application of those principles in connection with accounting for estimates, accruals and reserves; experience in preparing, auditing, analyzing financial statements; understanding of internal controls; and an understanding of audit committee functions."
- Seven members with four appointed by the council and three appointed by the city manager.
- Four members of council.
- The committee shall have at least five members independent of management and of the independent auditor. The entity has a policy (reviewed periodically) for appointing members who have necessary financial

expertise. At least one member of the committee shall qualify as an "audit committee financial expert" (as defined by SEC) and other members shall be familiar with accounting and reporting practices of the entity.

- Committee members must have sufficient financial knowledge and experience to discharge the committee's duties. Each member must be able to understand entity financial statements and recognize factors affecting the quality of the entity's financial reporting to make meaningful recommendations about the entity's audited financial statements and related financial management policy.
- Three independent, non-governmental members who have outstanding reputations in public service or business and have financial and/or legal expertise.
- Three to five members, one of whom may be on governing board. Members must be residents and must be financially literate and at least one member shall have accounting, auditing or related financial management expertise.
- Representatives of each of the three elected entity officials and four private members. Two private members shall be expert in finance and two expert in accounting.
- Three or more members from the governing board. Insofar as practicable, at least one member of the committee shall have financial expertise.
- One member from each of the governing board's standing committees. One member shall be designated as the "financial expert" with financial expertise, including but not limited to understanding of generally accepted accounting principles, financial statements, internal controls and audit functions.
- Three to seven members from the governing board. No special qualifications are required; however, if possible, committee members should possess a basic understanding of operating, financial and budgetary standards and methodologies.

As indicated from these examples, the extent to which committees specify the qualifications of members varies widely. More specificity of qualifications will usually provide for a stronger audit committee.

The need for specific capabilities on the audit committee poses a dilemma for governments that appoint their audit committee members from among governing board members. Whether the governing board is elected or appointed, there is no assurance that they will or can include individuals with the requisite skills. Several charters that require audit committee members to be selected from its governing board include language similar to "one member of the committee should have financial expertise, if possible." They recognize the need for this capability, but cannot guarantee that members of the governing board will have such capability.

If committee members are not familiar with government finances, committee members have the responsibility to learn what they need to know about financial management and internal controls and auditing (or engage outside

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expertise). We found only a few examples where the audit committee members received the type of education that would be required for them to be sufficiently knowledgeable about finances, etc. to fulfill that responsibility (see discussion below).

The GFOA, in its guidance, suggests that if the governing board does not include an individual with financial expertise, the government should engage outside professional support to provide this type of advice to the committee. In our review, we did not find any audit committee that engaged outsiders to provide the financial expertise (although one audit committee reappointed a retiring board member to its committee so that they would be sure to have such capability).

The flip side is that the governing board is responsible for the government's financial management and internal controls. Thus, the board has the responsibility to oversee the financial reporting and the audit processes. Further, as governing board members, they may be in best position to "get things done" in their government. (This very much depends on the characteristics of the governing board and its responsibilities compared with executive management.)

Only a few charters we reviewed stressed independence in committee members. The concept may be implied but if it is important, it should be specified in the charter. This demonstrates, that in government, the independence of audit committee members is less critical than in the private sector. The reduced focus on independence may be because government audit committees often play more of an oversight role for the internal auditor, are often responsible to "make things happen" within the organization or because the opportunities for committee fraud is less than in the private sector. Whatever the reason, the number of government audit committees that include members of management of the entity or of a closely related entity demonstrates the less critical nature of independence for some government audit committees

As noted above, we were told in several instances that the effectiveness of an audit committee consisting of governing board members and/or of specific office holders was very much determined by the capability, energy and expertise of the chair and members of the committee. When the chair and/or members were financial experts, the committee was able to accomplish a lot more than in other years. As one respondent told us, "The quality of the leadership is key to an effective audit committee. Some chairs are better than others."

One other potential risk of an audit committee made up of governing board members is that the committee will tend to be political. In most cases, we were assured that the committee was *not* political, but was able to focus on the committee responsibilities. However, we were told in at least two cases that the committee was politically oriented, to the detriment of fulfilling its responsibilities.

Several committees include insiders based on their position within the organizations (hold specific elective or appointed offices) or in related entities. At times, these individuals possess financial expertise and/or deep knowledge

of the entity. However, they are not independent and there is no assurance that they will be able to make "arms length" decisions. However, for committees that had such membership we found no evidence that the committee was anything but objective.

Devote Appropriate Resources to Recruiting Committee Members

In addition to specific experience, expertise and knowledge, audit committee members also require attributes of curiosity, energy, willingness to devote the time (it can be considerable), tact, people skills, willingness to engage in spirited discussions and an ability to see the "forest for the trees." For example, the DoD IG guidance cites the following qualities of committee members.

- Ability to act independently and be proactive in advising the organization of issues that require further management attention.
- Ability to ask relevant questions, evaluate the answer, and continue to probe for information until completely satisfied with the answers provided.
- Independence of thought.
- Appreciation of the entity's culture and ethical values and a determination to uphold those values.
- Ability to encourage openness and transparency.
- Ability to work with management to achieve improvement in the organization.
- Ability to adequately explain technical matters to other members of the committee where members have been chosen for particular skills.

In addition, DoD IG guidance provides the characteristics of an effective chairperson, starting with, "Lead from the front—decide what the committee is going to achieve, plan a schedule and push it through vigorously, keeping up the momentum."

Recruiting and/or appointing committee members is a critical function of appointing officials, irrespective of whether the members are from the governing board, from management or from outside the entity. One respondent told us that his government is "very selective" in selecting its members. Appointing officials (and/or their staffs) should devote significant energy to finding qualified members for the audit committee. Often the appointing officials will interview candidates to get a sense of how the potential candidate will fit into the government and with existing committee members. Some governments perform a background and credit check on potential candidates. Interviews and background checks may be particularly important for the committee chair. (While in some cases the committee elects its own chair, in most cases the chair is appointed by the appointing authority.) When members are from among the members of the governing board, the board chair (or other appointing official) should match required qualifications with the backgrounds, skills and interest of the members.

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We have heard suggestions that when audit committee members are from outside the entity, it is often difficult to find qualified committee members. However, in no instance were we told of any difficulty in recruiting qualified outside members. Each government develops its own approach to identifying potential members. For example, the city of Tallahassee has a process whereby citizens can sign up to serve on city committees. Audit committee members come from that list or from individuals whose expertise is known to the mayor or the city auditor. In other instances, the appointing official may solicit candidates from other entity officials (for example, the CAE or the CFO). The AICPA also maintains an Audit Committee Matching System where people can search for potential audit committee members.¹⁴

When the members are selected from an elected or appointed governing board or from among specific administrative officials, it is more difficult to ensure that the members will have the personal characteristics or the experience, capabilities and expertise required for the committee. In theory, appointed governing board members can be appointed with audit committee qualifications in mind. In practice, this is rarely done (we did not identify any cases). This is different from a private sector board of directors, where directors can be and are often appointed for their specific qualifications, such as those required for an audit committee. As previously noted, the effectiveness of government audit committees can vary depending on the backgrounds of the selected members.

Orient Committee Members To Their Responsibilities

Audit committee members assume significant responsibilities for decisions and/or advice on the financial management and/or governance of the entity. Most new committee members, irrespective of their experience, background and knowledge, are not versed in the responsibilities of the committee or the legal aspects of their service on the committee. In addition, members must understand the functions and intricacies of the entity and the industry in which it operates, government financial reporting and accounting, external and internal audit functions, prior audit committee actions or other information vital to effective service on the committee. Finally, it is important that audit committee members understand the business of the government for which they have responsibility. Thus, it is critical that new committee members receive a thorough orientation at the beginning of the individual's service on the committee. (Not only a briefing but a thorough orientation). The orientation program must be structured to the needs of the members—some may require better understanding of government financial methods (even individuals with knowledge of private sector accounting), and some may require a better understanding of the business of the government.

Several charters require such an orientation. A few governments we talked with said they have orientation programs for new committee members. Those orientation sessions were provided by a combination of the CFO, the CAE and the external auditor, with the CEO participating in some orientation. However, most governments do not

appear to provide formal orientation and training for new committee members. In some cases, the CFO or the CAE will meet with the new member for an hour or two. At times, all new governing board members are oriented to the government; however, there was no specific orientation or training for audit committee members.

Initial orientation is important. However, no matter how thorough, a single orientation cannot provide a committee member with all he or she needs to know about the entity and about activities of the entity. In addition, ongoing professional activities that affect the committee should be presented. While we did not find a lot of initial orientation, we found that several governments provide ongoing orientation and training for committee members. One government holds its committee meetings at different facilities of the entity and includes a briefing for the audit committee by the manager of that location. For example, one city audit committee held a committee meeting at the offices of the city's electric utility and received a briefing from the utility manager. A federal entity transported its committee members to different cities to see entity activities in different geographic locations.

Other committees receive periodic briefings and discussions of ongoing activities of interest to the committee, such as the progress of implementing a new financial management system or investment activities of the government. Other briefings may relate to new accounting requirements (e.g., GASB 34) or professional requirements (e.g., new Audit Standards) or other educational matters. On an ongoing basis the education programs can be provided by CFO or CAE staff, by the independent auditor, by the IT staff, by the General Counsel or by program managers. Such briefings serve to help the committee members understand the government itself and are vital to the operations of the committee. In a few instances, audit committee members attended educational conferences conducted by the CFO or CAE for their employees or by outside organizations, such as AGA. While this can be an effective method of education, it requires time of very busy people.

An essential best practice for an effective audit committee is to ensure that the committee members understand their responsibilities and the functions and committee activities and that members receive ongoing information about the government. Without understanding the business of the government as well as the uniqueness of government finance and reporting and the audit process, the committee will not be able to fulfill its full responsibilities.

The Committee Can Also Provide Training

Another side to orientation and education is the training and education provided by the committee to the governing board and to government staff. Many governing boards are not fully aware of the responsibilities or the activities of their audit committees. In fact, in some cases, the governing board may not even be aware they have such a committee. (One CEO talked a great deal about the internal audit department, but seemed unaware of the contributions of the entity's audit committee.) Thus, it may be worthwhile for the audit committee to periodically brief the governing board on the

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finances of the entity as well as describe the activities of the committee to the board. In addition, some committees prepare annual reports for the governing board (see below).

In some government entities—for example in federal entities that have not previously prepared GAAP-based financial statements or been subject to an external audit—the audit committee takes the lead in educating program and finance staff as to the importance of financial reporting and external audits. The presentations are typically conducted by respected management staff of the agency. These programs serve to educate staff and to rally the staff to perform the difficult tasks involved in fixing the entity's financial systems to obtain a clean audit opinion. In other cases, the committee may sponsor training programs for entity management through the internal audit or the finance departments. The external auditor is often a significant participant in such educational programs.

Ensure Institutional Memory—Continuity of Membership

It can take a year or more for an audit committee member to fully contribute to committee activities. Depending on the background of the individual and the functions of the government, it can take that long for a new member to understand his or her responsibilities, government financial statements, committee operations, the industry and/or the unique aspects of the organization for which they serve. Many audit committees recognize the necessity of having experienced committee members, with their accumulated knowledge, to ensure the ongoing operation of the committee. Several committees include individuals who have been on the committee for many years (in one case more than 20) to provide the institutional memory for the committee.

Most audit committees enable members to serve more than a single term (terms are usually three years). When the members come from the governing board, the membership on the committee will depend somewhat on the election or the appointment cycle. Nonetheless, continuity of membership is a factor in the effectiveness of many audit committees. Of course, there may be a point at which new blood is appropriate, so that term limits may be appropriate. At least one audit committee has a two-term (each for three years) limit for committee membership.

Focus on Audit-Related Activities Only

Many audit committees we reviewed devote all their attention to audit issues only. However, we identified several committees where the audit committee functions were included as part of another committee, often a finance committee or a budget committee or an oversight committee. When the audit committee is part of another committee, the audit-related activities do not seem to get sufficient time or consideration. One individual told us that his finance and audit committee devoted one meeting a year to receive the report of the independent auditor. Except possibly for very small governments, that is insufficient time.

One government recently formed a standalone audit committee, moving those responsibilities from the finance committee. The entity realized that audit requirements could not get sufficient attention as part of another committee. In addition, the entity cited the National Association of College and University Business Officials recommendation that a separate audit committee is a best management practice.

The best practice here is for the audit committee, irrespective of its mission and responsibilities, to devote all of its time to only audit-related issues.

Clearly Identify Committee Reporting Structure

The charter should specify to whom the audit committee reports or whom the committee advises. In most cases the committee reports to or advises the CEO or the governing board, although some committees report to or advise the CFO or the CAE. We found several cases, however, in which the committee was a standalone entity, with no reporting relationships, even a committee that was responsible for the external audit relationships. (One committee member was surprised by the question of reporting relationships; it seemed as if he had not even thought about reporting.) Such a standalone orientation may be deliberate, but should be acknowledged in the charter. Another respondent said that his committee reported to “everyone.” Again, reporting relationships should be clarified.

Top Management Must Support the Committee

Top executive management, most particularly the CEO, CFO and CAE, must support the audit committee for it to be successful and effective. Such support ensures that the committee is taken seriously by all entity staff and that committee recommendations are implemented. As previously discussed, we identified instances where lack of top management support doomed the committee to failure and dissolution.

Top management can demonstrate its support in several ways. For some entities, the CEO or a representative(s) of the CEO is a member of the committee. For example, at the FDIC, the deputy to the chairman is a member of the audit committee; in New York City, senior level representatives of the city's three elected officials are on the committee. In other cases, the CEO or a senior representative attends and participates in every audit committee meeting, even when not a member of the committee. For example at DART, the Government Accountability Office and the Architect of the Capitol, the CEO attends all (or most) committee meetings. In yet other cases, audit committees are mandated by the CEO and senior representatives attend selected meetings, as, for example, at DoD. In yet other instances, the committee consists entirely of senior members of management. In one instance, the CEO and the CAE meet prior to each audit committee meeting so that they can anticipate questions and be best prepared for the meeting. Even if the CEO is not represented at committee meetings, some CEO's require periodic briefings by or about committee activities.

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Top executives also demonstrate their support by the quality of the appointments to the committee, by their timely implementation of committee recommendations and by ensuring that the committee has adequate administrative support and required funds to carry out its mandate.

Top management includes the support of the CFO and the CAE, since these offices are most directly involved in audits and financial reporting. We identified very few instances where the CAE and the CFO were not supportive, although we did find that for most audit committees (depending on its responsibilities), one or the other tended to be more dominating. We also found that committee members and top management were respectful of the legislative responsibilities of the CAE or the CFO. For example, in most federal agencies the CAE (for example, the inspector general) is legislatively responsible for selecting and managing the external auditor and for performing audits of the agency. The audit committee seeks information about these areas and may make recommendations, but does not attempt to impose its recommendations.

Relations with the External Auditor

In the private sector, the audit committee, under SOX, is responsible for hiring, monitoring, evaluating and, if necessary, firing the external auditor. In government, the audit committee relations with the external auditor are much more varied.

Several government audit committees have direct responsibility for the external audit relationship (New York City, for example). In those instances, government staff will take on the administrative effort of selection such as preparing the Request for Proposal (with committee input), performing initial evaluations and presenting summaries of the proposed firms to the committee. Often, the committee will interview the firms, review staff summaries and recommendations, negotiate the terms and fees, make the selection and contract with the external auditor. In other cases, the committee will rely more on staff analyses and recommendations, but will make the selection. In still other instances, the committee will endorse the recommendation of staff. Best practice, when the committee is responsible for relations with the external auditor, is for the committee to participate directly in preparation of the RFP, in interviews with selected firms and in selection of the external auditor.

As part of the selection process, staff and the committee will ensure that the external auditor is truly independent of the entity. Independence is also reviewed periodically thereafter, usually annually. Another best practice is for the committee to review the quality control procedures of the firm by reviewing the audit firm's peer review. Such reviews are required every three years whereby another audit firm will test the quality control procedures of the firm. Peer reviews of the external auditor should be reviewed by the audit committee; the committee should receive an explanation of how any peer review recommendations affect the entity and how the firm is responding to peer review recommendations.

The audit committee may also request the external auditor provide other services to the entity as long as those additional services do not compromise the firm's independence. The committee will also review requests (by the CEO, CAE or the CFO) for the external auditor to provide other services to ensure that such services do not impair the firm's independence.

If the audit committee is responsible for the external audit, the committee will usually meet with the external auditor at least three times per year. Each of these meetings should be an exchange of views and information and, as described by one respondent, a "lively discussion." During the first meeting, the committee will review the auditor's audit plan for the year (one committee does this in executive session). During this meeting the committee may suggest areas of coverage based on prior audits and their own knowledge of the government. In addition, the external auditor will provide the audit committee with the information required by professional standards (SAS 114).¹⁵ The second meeting will usually entail a progress report. During that meeting, the external auditor can convey any problems and concerns, describe any changes in the plan and communicate any preliminary findings.

The third meeting between the committee and the external auditor is to discuss the results of the audit. Usually the audit committee will receive a draft of the audit report, including internal control, compliance and management letters, a week or more in advance of the meeting. It is important that committee members thoroughly review the draft information so that they actively participate in the meeting with the auditors. The auditor will typically make a presentation of the audit results at an audit committee meeting. In the most effective audit committees, this meeting is typically very lively with many questions and comments by the committee. At times, the manager responsible for a department with material weaknesses (such as the director of Information Technology) may also be asked to attend this meeting. Audit committees do not ask the auditors to substantially change their reports (all external auditors we spoke with indicated they would refuse), but the committees may request additional clarification of issues raised by the committee. During this meeting, the external auditors will also update the committee on the government's progress in implementing recommendations from prior years. The audit firm will also present the professional communications required to be presented to the "those charged with governance."

The audit committee should also perform an annual evaluation of the performance of the external auditor and/or of the overall audit for the preceding year. Such an evaluation should be performed in conjunction with the external auditor and the management staff. We found no instances where such a formal evaluation was performed. We suggest that such an evaluation would be an excellent practice to ensure that the committee, auditor and management see "eye to eye" on their expectations for the audit.

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Audit committees may hold private meetings with the external auditors in executive session (where allowed by law) to discuss such areas as relations with management, problems encountered, personnel matters or other sensitive matters. Some audit committees found such executive sessions very useful; other committees did not hold such sessions. As one external auditor said “The executive sessions are for the committee. Anything I have to say, I’ll say in open session.”

In some instances, the external auditor advises the committee on audit and accounting issues that may arise during the year. Often the external audit partner will attend each audit committee meeting to provide such advice on an as-requested basis. His or her advice does not relate to the audit in progress. In some instances, audit committee members and the external auditors have one-on-one conversations outside of the formal meetings. Such conversations are usually so that the auditor can answer a question of the committee member or so that one party or the other can provide a “heads up” of an upcoming issue. In addition, the external auditor will often present educational programs for the audit committee of upcoming professional issues.

For audit committees that do not engage the external auditors, the relations between the committee and the auditors vary widely. Most committees are notified of who the external auditor is when the auditor is changed. For some their charter may require them to monitor the external auditor, even though they are not responsible for hiring, evaluating or firing the auditor. These committees have the same three meetings a year with the external auditor to satisfy their responsibilities (even though they may not receive the professionally required communications). Other committees may have the same meetings to stay informed even though they are not responsible for hiring, evaluating or firing the auditor. Yet other committees may meet periodically with the external auditor for updates on progress. Some financial management advisory committees, which have no responsibility for the external auditor, nonetheless meet with the external auditor to assist the committee in performing its role—very often to prepare the entity for outside audit.

We found a few committees with some responsibility for the external audit who merely “receive the report” of the external auditor with little discussion or questioning. We suggest that “just receiving the report” is a “non-best practice.” Quite often this occurs when the audit committee has no members who understand the audit process. Other committees have no responsibility or contact with the external auditor. These are the committees focused strictly on the internal audit function or focused on the financial statements.

For those committees with any type of external audit responsibility it is imperative that the committee include individuals with financial expertise as well as knowledge of the audit process. Such expertise will enable the committee to effectively select and monitor the external audit relationship and to ask the types of questions that must be

addressed to ensure that the audit process is as beneficial as possible for the government. Such expertise also provides assurance to the public as to the integrity of the audit.

Relations with Internal Auditors

As with the external auditor, audit committee relations with the internal auditor vary widely as do the reasons for audit committee involvement. Some audit committees are responsible for hiring, monitoring, evaluating and, if necessary, firing the CAE. The committee will review the position specifications; staff of the entity will perform the administrative tasks to identify a pool of candidates. The committee may interview the candidates and make the selection or may rely on a senior official to perform the interviews and make a recommendation to the committee. As with the external auditor, if the committee is responsible for any aspect of hiring, monitoring, evaluating and/or firing the CAE, the committee should participate in preparing the position specifications and interviewing and selecting the internal auditor.

The internal auditor often, but not always, reports directly to the committee, which will recommend compensation changes and, if necessary, relieve the auditor of his/her responsibilities. In some cases, the internal auditor will report functionally to the committee but administratively to the CEO (possibly to the CFO, a “non-best practice”). Having the internal auditor report to the committee ensures that the auditor will be fully independent of the government and will be able to perform his or her responsibilities without pressure from either the governing board or from management. In fact, the charter of several audit committees specifically state that part of the committee’s responsibility is to shield the internal auditor from undue influence in performing his/her job. Even when not directly responsible for hiring the CAE, several audit committees must concur in the hiring or firing of the internal auditor and are asked for input for the individual’s annual evaluation and compensation changes.

Many internal audit departments have a charter for their operations, often tied to the charter of the audit committee. The internal auditors we encountered, collectively, perform a full range of audits, including financial, operational, contract, compliance, IT, performance and agreed-upon procedures. The audits can go well beyond financial areas and look into the programs and the performance of the entity. This emphasizes again the need for a member of the audit committee who understands the audit process as applied to a wide range of audit situations.

Whatever the type of audit, each effective audit committee receives, reviews and possibly changes an annual audit plan from the internal auditor for the specific audits to be performed during the upcoming year. (One internal audit department prepares a five-year audit plan.) At times the committee will participate with the internal auditor in drafting the audit plan (see discussion of risk management below). For example, audit committee members may participate in the internal audit department’s audit planning conference. Often the audit plan is accompanied with a matrix

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of risks being addressed and/or a chart of prior audit coverage to ensure that all risk areas are being reviewed on a timely basis. Substantial changes in the plan (each committee has its own definition of substantial) must be approved by the audit committee. The internal auditor has some flexibility to change the plan based on his/her judgment.

Some audit committees play the very valuable role of “raising” the credibility of the internal audit function. In one instance, the internal audit department was performing a series of small audits, which did not get to the “guts” of the government. The audit committee is eliminating these small, non-essential audits with more substantive and meaningful projects at the same time the audit staff is being expanded and upgraded. In another instance, an internal audit called attention to a potential fraud area. The warnings were ignored by the management and the governing body, until a fraud actually occurred. A new audit committee now assures that all audit recommendations are taken seriously; each recommendation is followed up on and the audit function is an integral part of the risk management of the entity.

In some jurisdictions all requests for audit must come to and through the audit committee, irrespective of who requests the audit. For example, the state of California has specific procedures that must be followed by anyone, even the governor or key legislators, who wants an audit performed of a state entity. Audit requests are reviewed in open meetings and those approved are placed in the queue of audits to be performed.

Audit committees receive audit reports in several different ways. Some committees receive draft audit reports for comment, which are then discussed in open session with the auditee present, often the department head, to respond to questions and to tell the committee how they will respond to the recommendations. (Even though the reports are reviewed by the committee in draft form, the committee does not ask the auditor to change his/her report in any way, except perhaps to expand or clarify a point.) The key best practice here is that the auditee is present and the reports are discussed in open session. However, one government discusses all audit reports with the auditee in executive session. While that may be a good practice if the report is sensitive in nature, most committees find that discussions of reports in open session are useful.

Other models are also used to present reports to the audit committee. Some committees receive final audit reports and hold meetings similar to those described above with the auditee. One committee votes to accept each audit report. This demonstrates to management and the auditee that the audit committee has reviewed the report and expects the auditee to complete the corrective actions on the agreed-upon timetable. Other audit committees receive periodic information of audits performed and corrective actions without necessarily seeing the reports, except perhaps for particularly sensitive audit reports. Other committees see reports “as appropriate.” One audit committee member told us that members of that committee really desired to see and

discuss more audit reports, in depth, so that the committee can get a better understanding of the operations of the entity.

While most internal auditors seek comments and corrective action plans from the auditee, one government routes all audit reports to the auditee organization and to the CEO’s office. The corrective action plans come back through the CEO. If responses are not received, the CEO’s office follows up to ensure that responses are received. In another government, an auditee (department head) is not allowed to disagree with the internal auditor’s findings and recommendations unless the disagreement has been approved by the CEO. In this way the CEO is kept aware of what is happening in the government and the CEO adds “clout” to the internal audit function.

Audit committees have also gone outside their own internal audit departments (at times at the suggestion of the internal audit department) to engage specialists for audits such as those related to information technology. The major reason to use outside specialists is because the internal audit department cannot afford the wide range of IT specialists it would need for its own staff. In one instance, the audit committee engaged an outside firm to perform IT audits for a single year. The committee then engaged an outside firm to perform IT audits (based on competitive bids) for a multiple-year contract. Another audit committee routinely uses an outside firm to perform IT audits. Some audit committees may contract out part of or the entire internal audit function to an outside firm. (Of course, the firm performing the independent audit is not eligible for such as assignment.) Another committee engaged an outside contractor to audit long-range construction plans of the entity.

A few audit committees we encountered perform an annual evaluation of the internal auditor (a best practice). However, most audit committees do not formally perform such an evaluation. In several instances the internal auditor prepares a summary of his/her performance for the year, which is shared with the audit committee and appropriate government management.

To comply with Institute of Internal Audit standards, internal audit departments are required to have an “internal audit quality assessment” (that is, peer review) every five years, performed by an external organization or a self assessment verified by an outside party. Best practice is to have the results of the peer review presented to the audit committee by the organization performing the peer review. Any corrective actions resulting from the peer review should then be added to the list of open audit recommendations (see below).

As noted previously, some audit committees are not involved with internal auditing, particularly when those audits are performed by an elected official or appointed official (for example, elected state auditor, federal inspector general). In those cases, the committee may get a periodic update from the internal auditor or the IG, or the committee may receive a copy of the annual report of the elected or

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appointed auditor. However, one audit committee that we talked with has recently requested the audit plan from the elected official responsible for internal audits.

In cases where the audit committee is responsible for internal audits, the committee members must understand the audit process and have a good understanding of the programmatic functions of the government. The understanding of the “business” of the government is critical when the CAE performs audits outside of the financial arena. In addition, specialized knowledge among the audit committee may be a real plus, such as IT capabilities. If the internal audit does not deal with financial audits and if the committee has no financial responsibilities, financial expertise may be less necessary for such a committee.

As above, a “non-best practice” is for the audit committee to receive reports with no discussion or dialog among themselves or with the auditee.

Innovative Methods to Follow Up on Corrective Action Plans

Most audit committees with any responsibility for the internal audit and/or the external audit monitor timely implementation of corrective action plans. Some committees rely on the internal auditor for periodic reports of the status of recommendations or for the annual report from the independent auditor as to whether prior year recommendations were put into place. However, more proactive audit committees use innovative techniques to ensure that internal and external audit recommendations are implemented.

For some committees, the practice of discussing the reports and the corrective actions in open (or closed) sessions is the beginning of ensuring that the audit recommendations are implemented. Auditees know they will be called back to explain why the recommendations have not been implemented; most managers do not like to be embarrassed in open sessions. Similarly, having the CEO involved with corrective action responses (or ensuring that department managers respond) is an effective way to get the attention of the department managers.

Other audit committees receive monthly or quarterly reports from the internal auditor of the status of open recommendations. (As one department head noted, “Being on the past due list is a pain.”) The committee has the right to call department managers to an audit committee meeting to understand the reason corrective action implementation is falling behind. One innovative government carries that a step further. At the beginning of a quarter the list of open recommendations is sent to the CEO with those due to be completed in the next quarter highlighted. The CEO is responsible for ensuring that the appropriate department manager responds with the status of the corrective action. At the end of the quarter the open recommendation list is updated and presented to the audit committee. We are told that there has been a significant reduction in the number of past due open recommendations since this procedure was implemented. The past due list, combined with the involve-

ment of the CEO is an effective incentive to implement the corrective actions. On the other hand, one CAE told us that the follow-up at his entity was “informal” and “they have to do a better job.”

Many audit committees receive lists of open and/or past due recommendations. In some cases, the list only includes the open internal audit recommendations; the status of open external audit recommendations is not included on the list, at times because another department of the government tracks those recommendations. A best practice is to include *all* open recommendations on the list of open and/or past due audit recommendations that goes to the audit committee. In that way, the committee “sees the entire picture.” In fact, if appropriate, the list can include open and past due peer review recommendations for the internal audit department.

Internal Control, Risk Management and Fraud Prevention

Most audit committees have some level of responsibility to monitor the entity’s internal control, fraud prevention and/or risk management activities. When audit committees are responsible for internal controls, fraud and risk management, it is important that they take an entity-wide view. Internal control is not only a financial issue; program managers must assume responsibilities for internal controls since the risks occur in operations as well as in finance.

Many audit committee charters speak of internal controls, risk management and fraud prevention. Sample language from entity charters includes the following.

- Focus on monitoring and risk assessments to ensure internal controls underlying the financial statements are both in place and working.
- Internal audit committee can request special projects relating to investigation of potential or suspected fraud or other irregularities. Upon detection, Internal Audit will promptly notify the IG for follow up.
- Audit and oversight committee is responsible for overseeing entity’s principal administrative processes, financial systems and internal controls.
- Consider the effectiveness of the entity’s internal control over annual and interim financial reporting, including information technology security and control.
- Review the entity’s process for assessing the effectiveness or internal controls, the adequacy of management’s assessment and the progress in resolving material weaknesses, audit follow up actions and other management challenges and control issues.

When the committee has internal control, fraud prevention and/or risk management responsibilities, many audit committee members require additional education in the concepts of internal control and risk management. The guidance from D&T includes a great deal of insights into the responsibilities of the audit committee for internal controls and risk management.

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Some audit committees rely on internal control reviews by the outside auditor and audits performed by the internal auditor to satisfy their objectives to monitor the entity's internal control systems. Several internal audit plans include a systematic effort to examine selected internal control modules over several years based on a complete risk assessment (see below). Some committees are more proactive, understanding that internal controls examined during external audits are limited and internal audits may not cover all aspects of internal controls. They go beyond relying on the auditors for internal control information. As one audit committee member told us, "We press hard on internal controls." One CAE also commented that his audit committee takes a "common sense" approach to internal controls.

Several governments, on their own or at the request of the audit committee, perform more complete internal control reviews, perhaps following the pattern of OMB Circular 123, Appendix A, which is mandatory for all so-called CFO Act agencies of the federal executive branch. (This methodology is, in turn, based on SOX requirements.) Other governments perform internal reviews of internal controls on a more complete basis. Several audit committees request presentations of such internal control reviews and tracks recommendations coming from such reviews. Even if the entity does not perform formal internal control reviews, the audit committee may request self-assessments by department managers and/or may request briefings on issues that they perceive as subject to risk.

Unfortunately, when fraud is discovered this becomes the impetus to initiate a complete internal control review (perhaps locking the barn after the horse has left). One government told us they had just uncovered a major fraud and were bringing in an outside firm to perform a complete internal control review of the entity. The questions are how will the government follow up and to what extent will the audit committee continually monitor internal controls?

Several governments perform formal risk assessments each year, including entity-wide risk management surveys. These assessments are led by the internal auditor and involve managers and board members entity-wide. One government has identified nine categories of risk and 1,500 auditable areas. These assessments are usually part of the audit planning process. In the best practice cases, the audit committee participates in the risk assessment and is able to shape not only the risk assessment but the audit plan for the year. At times risk assessment may be integral to the audit planning conferences; at other times risk assessment becomes an overall entity effort.

A few governments go even further. They hold annual seminars and training for the audit committee and entity staff on risk management and fraud prevention issues. One government not only holds annual fraud prevention training, the government holds an annual "fraud brainstorming" session to identify potential risk areas and determine audit activities that may be required. Such programs are educational for audit committee members and help to shape the

audit agenda for the future. As previously noted, two audit committees to whom we talked engaged outside consultants to perform IT reviews, since their internal audit staff did not have the expertise for such audits.

While the term "enterprise risk management" was not used by any of the audit committees that we talked to, several governments and their audit committees are moving toward an overall assessment of enterprise risk. These entities recognize that enterprise risk is as much, if not more, programmatic than within the bounds of the finance departments. Therefore, they focus on all risks to which the entity is subject and plan their audit program to mitigate such risks. For example, the United States Holocaust Memorial Museum considers the risks inherent in its museum collection. One committee brought in an outside consultant to assist with risk assessment. One CAE indicates that his entity is beginning to perform "enterprise risk management" activities, but has not yet shared the information with the audit committee (it is too preliminary).

Dealing With Component Entities

Several governments include component entities in their reporting entity, many of which have their own external auditors, their own internal audits and/or their own audit committees. For example, New York City has more than 20 component units, several pension plans and a number of Business Improvement Districts which have their own external audits; the University of New Mexico has a University Hospital and a Medical Group each of which have their own external audits and audit committees; and a large local government includes a number of volunteer fire districts, each with its own external audit, included in its annual financial report. Each government has taken an innovative way to monitor the audits and the financial statements of these component entities.

New York City requires each component unit and its outside auditors to appear before the city's audit committee with their annual audit report. The component unit, typically represented by its CEO or CFO and its auditor, are subject to penetrating questioning, particularly relating to internal controls, material weaknesses, significant deficiencies or management letter comments that have not been corrected or changes in accounting policies. In addition, the component unit may be questioned about other areas, such as investment policies or contribution rates of pension systems. The requirement for the component units to appear before the city's audit committee ensures accountability and transparency and that the CEO of the component unit is "on top of" the finances of the organization. In addition, since New York City has a number of very small Business Improvement Districts, the city holds seminars on financial reporting for these small districts and their similarly small audit firms.

At the University of New Mexico, a member of the University's audit committee chairs the audit committee of the Medical Group. The chief internal auditor of the University participates in audit committee meetings of the University

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Hospital. Even though not a member of the audit committee, the University internal auditor provides input and guidance for the committee.

For the large local government, the audit committee reviews the annual financial report of each fire district.

Each Audit Committee Requires an Annual Plan

Several audit committees prepare an annual plan for committee activities. The plan identifies for each meeting what topics will be covered (for example, entrance conference with the external auditor, briefing on specific IT controls, etc.). The advantages of an annual plan are that it engages the audit committee in “thinking through” what it wants to accomplish in the upcoming year, it alerts participants to when they must appear before the committee and it ensures that all committee business will be accomplished during the year.

Sample annual plans from the Metropolitan Transportation Authority and of the United States Holocaust Memorial Museum are attached as Appendices III and IV.

Each Committee Should Perform a Self-Evaluation

Most audit committee charters do not include measurable goals or targets for the committee. One very knowledgeable respondent suggested that perhaps audit committees should have measurable targets such as reduction in material weaknesses and significant deficiencies, achieving a “clean” opinion or receiving a particular award (such as the GFOA Certificate of Excellence or the AGA CEAR award). One CEO suggested that the committee should have “key performance indicators or KPIs” just as his operating departments do. Very few committee charters, however, include such measurable goals (although in some instances they may be implicit goals).

The lack of specific evaluation criteria is understandable. The responsibilities of an audit committee are often so broad that it is difficult to include specific measurable goals into the charter, or any other document. And, specific goals may change annually depending on events of the current year.

Even without measurable performance metrics, it is critical that each audit committee evaluate its performance annually and use the result of the evaluation to shape its program for the following year(s). Several charters include the requirement for an annual evaluation. However, we found that only a few committees actually perform such self-evaluations. One or two individuals told us that the governing board may orally evaluate the audit committee’s performance at the governing board’s annual retreat, but no evaluation report was prepared or used. In several instances we were told that the governing board performed at least an informal evaluation of its own performance, but not of the audit committee.

One effective basis for committee evaluation is the specification of committee responsibilities and activities in the committee charter (hence the importance of a complete

charter). Using the committee responsibilities as a starting point, the committee can evaluate its performance, usually starting with a written questionnaire. The questionnaire may include the list of committee responsibilities and ask members to address questions such as:

- Did the committee perform each activity identified in the charter and how well were they performed?
- What is the opinion of committee members about the performance of the committee in the past year?
- What changes should be made for the following year?

The self-assessment questionnaire used by the Illinois Municipal Retirement Fund is included as Appendix V of this Report.

One audit committee asks the CEO, CFO or CAE and other staff to participate in the evaluation process, by responding to the written questionnaire. Several guidance documents previously cited, as well as several corporate governance websites, include sample committee evaluation forms and protocols. A summary of the responses to written questionnaires can be used by the committee for discussion of performance and to develop plans for the following year(s). Such a process is recommended by several guidance publications cited earlier in this report as well as for private sector audit committees. For one audit committee, the chair is charged with the responsibility to perform an assessment of the charter and report to the governing board.

Such a self-evaluation caused one government audit committee to realize that it was not devoting sufficient time to risk assessment, which in turn resulted in changes in the plans for the following year. Another committee focused on committee member turnover as a result of the evaluation. Yet another committee used the evaluation to focus on the fact that the committee’s “financial expert” was at the end of his term on the governing board. (In this case the individual was asked to stay on the audit committee even though no longer on the board.)

Part of the self-evaluation should include an assessment of the charter and potential charter changes to be recommended to the governing board. Staff of one entity suggested a change in the charter in mid-year, which was acted on at the end of the year. Assessment of the charter is required by several charters we examined. We identified several governments that review and modify their charters every few years or as circumstances change. With rapid changes in governmental financial management, in the world of auditing and/or in the industry in which governmental authorities operate, a periodic charter assessment is a best practice. In addition, we talked with several audit committees who are not performing all of the responsibilities assigned to them in their charter. If certain responsibilities are not important they should be dropped from the charter; otherwise the committee should perform those activities.

One other area that should be considered as part of the self-evaluation is whether the committee requires new skills and capabilities. For example, when an entity goes from

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preparing for audit to maintaining a clean opinion or when risk management becomes a dominant issue, the committee might require new (or additional) expertise among the committee members. We found no audit committee that evaluated its own membership qualifications, but in this rapidly changing world, this evaluation should be performed periodically.

Several websites, sponsored by the major CPA firms and the AICPA, track changes in corporate governance practices, which could affect government audit committees. While not encountered, it would be an excellent practice for staff of an entity to monitor the literature and websites of corporate governance to identify issues that might be appropriate for their entity's audit committee.

Fraud or Ethics Hot Lines

Several guidance publications suggest that the audit committee should be responsible for procedures for the "receipt, retention, treatment of complaints received by the issuer regarding accounting, internal controls and auditing." These guidance publications also suggest that the audit committee should monitor adherence of employees to a code of ethics. In addition, several charters specify ethics and code of conduct as responsibilities of the audit committee, for example:

- Provide reasonable assurance to the council that the entity is in compliance with applicable law and regulation, is conducting its affairs ethically and is maintaining effective internal controls against a conflict of interest or fraud.
- Review the process for communicating the Ethics Code and Travel Policy to entity personnel and for monitoring compliance therewith.
- Establish procedures for the receipt, retention and treatment by the director of Internal Audit of complaints from the entity's employees on accounting policies, internal accounting controls or auditing matters and shall protect from retaliation those who make such complaints in good faith.

Several committees have established hot lines into the office of the CAE for accounting, internal control and auditing complaints where the whistle blower is guaranteed certain protections. Unfortunately, in one instance we found that the internal audit department devoted a great deal of effort to performing internal audits to follow up on each complaint. This emphasis on small audits prevented the internal auditors from addressing more pressing needs of the government. A newly formed audit committee changed the focus of internal audit and added credibility to the internal audit process.

In one government, complaints go to the chief legal counsel. Each complaint is discussed by the CEO, CAE and legal counsel (unless one of them is the subject of the complaint) and then directed to the correct department for resolution. The internal audit department is only involved in those issues that appear substantive either before or after review by the proper department head.

An internal audit hot line for financial issues is appropriate, so long as there is a process for review that does not require an inordinate amount of audit time. We are not sure if the government audit committee is the proper forum for monitoring the code of ethics. Each government should make that decision based on how its code is implemented and monitored.

Some guidance also suggests that the audit committee should review spending by entity officials, particularly related to expense accounts. We found only a few committees that perform this function. Again, each government should determine if this is the proper role for the audit committee.

The Annual Financial Report

Several audit committees receive a draft of the entity's annual financial report for review and comment. The review usually encompasses both the financial portion as well as the management discussion and performance evaluation portions of the report. (One committee only reviews the financial portion of the annual financial report but is contemplating expanding the review to encompass the entire report.) For the most part, editing by committee members is focused on making the report more readable and understandable by the target audience (the public and their representatives). This in turn aids in the accountability and the transparency of the government's finances. At times, the financial expert(s) on the committee may comment on the form and content of the report.

We encountered several committees that reviewed and provided (we are told) excellent comments on the entity's annual financial report. In each of these cases, the audit committee included members quite knowledgeable in government finance and/or knowledgeable about the programs and functions of the government.

Committee Annual Report and Letter

Several audit committees prepared an annual report of committee activities addressed to the governing board and to the public. Perhaps the most extensive is the report prepared by the New York City audit committee. It covers:

- Responsibilities and Operations of the Committee.
- Relationship with the Independent Public Accountants.
- Review of the Annual Financial Statements.
- Review of Accounting Issues.
- Review of the Independent Auditors Management Report.
- Review of Component Units and Fiduciary Funds Included in the City's Reporting Entity, Covered Organizations and Bids.
- A copy of the Audit Committee Schedule.

Several other committees, particularly those consisting of governing board members, present a report on committee activities at each meeting of the governing board in lieu of an annual report. In some instances, the audit committee chair may make a verbal report at an annual governing

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board planning retreat. However, we suggest that an annual written report may be useful to communicate fully committee activities to the governing board and the public.

We also identified one audit committee, made up of outside members, which makes an oral presentation to the governing board. That seems like a good practice that perhaps should be combined with a written report.

Another best practice was a letter from the audit committee included in the annual financial report of the entity (such as included in the annual financial reports of the Small Business Administration and the Government Accountability Office). This brief (one-page) letter describes the activities of the audit committee and provides assurance that the committee is comfortable with the financial reports of the entity. This does not substitute for the independent auditor's report or any other assurance statement by the CEO or CFO but it does provide an additional level of assurance for the public in the financial statements. An example of the letter from the audit committee included in the GAO Annual Financial Report is attached as Appendix VI.

Compensation

Most audit committee members are not compensated for their committee service, except reimbursement of expenses. For some committees made up of governing board members, the members may get compensated just as they do for service on any committee of the governing board (for example, state legislators may get compensated for each committee meeting they attend). We identified only two committees consisting of outsiders where the committee members received compensation. One other committee charter provides for an honorarium for committee members but no committee member has ever requested the honorarium.

Executive Sessions

Audit committees are encouraged to hold executive sessions with the external auditor, the CAE, the CFO, the CEO or others if the committee thinks it advisable. Often these sessions are held to enable the committee to obtain the views of the external auditor on management cooperation, difficulties encountered, internal control problems or the views of management on auditor performance, etc. As noted, one audit committee reviews all internal audit reports with the internal auditor and the auditee in executive session.

Several committees told us they do not often go into executive session, even though allowed, because of concern about the transparency perception of the committee. In addition, many governments have Open Meetings or similar laws, which require all meetings to be held in public unless the subject relates to personnel matters, legal issues or real estate matters. The GFOA encourages governments to change these laws so that audit committees can use executive session to further their understanding of the government's audit status and/or audit relationship.

While executive sessions may be useful in some instances, each government must make its own decision on whether such sessions are worth the difficulty of changing legislation.

Federal Advisory Committee Act (FACA)

Federal agencies whose committees include non-federal employees are subject to the Federal Advisory Committee Act (FACA). FACA limits the number of federal advisory committees, requires the approval of the General Services Administration and establishes a number of other requirements that the committee must meet (for example, publication in the Federal Register the date, time, location and agenda for each committee meeting). Federal agencies should be aware of FACA requirements, which are very well outlined in the guidance documents prepared by KPMG and the DoD IG.

Engaging Outside Experts

Several audit committee charters include a provision that allows the audit committee to engage outside experts to advise the committee. We identified relatively few examples where the committee unilaterally utilized this capability. In most cases, outside experts were engaged in conjunction with the CAE and/or the CEO. For example, one committee engaged an outside expert to help evaluate the financial implications of long-term construction together with the CAE. As noted earlier, in several instances the CAE and the committee engaged specialist IT auditors. Generally, government audit committees do not have separate budgets. Expenditures typically come from the budgets of the CAE, the CFO or the budgets of committee members (when the members are part of entity management).

Visibility for the Committee/Saying "Thank You"

Some governments ensure that the work of the audit committee is appreciated and recognized within the government and by the public. One government publishes a periodic newsletter to citizens including descriptions of the work of the committee, one government webcasts its audit committee meetings (as it does all its governing board committee meetings), one government posts the committee charter and minutes to its website, several governments post its internal and external audits to its website and several committees made up of outsiders make formal presentations to the governing board. That said, we suggest that even more visibility may be appropriate for some committees, since we found key governing board members who were not aware of the work of their entity's audit committee.

One additional word to all governments with audit committees. Service on an audit committee takes a great deal of time and effort. Remember to say thank you to your committee members. As one audit committee member said to us, "I have been a volunteer member of this audit committee for many years. In that time no one has ever said thank you to me." Perhaps the members do not want or need

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monetary compensation, but a show of thanks is always appreciated.

Access to People and Data

All governments provide their audit committees full access to government personnel. The committee can call upon any entity employee or contractor to appear before the committee. Many committees use this capability to require department heads to appear to explain control weaknesses or explain what action the department head will take to correct audit findings. In addition, committees often consult with the entity general counsel on outstanding litigation, with the chief information officer on IT issues, with the human resources director on personnel matters and with program managers on their areas of responsibility. The corollary is that there must be full and open communications among individuals involved in audit processes.

In addition, many charters provide the committee full access to entity data and information, except perhaps for confidential personnel records. An effective committee requires full access to information.

It Goes Without Saying

Audit committees cover numerous other best practices which appear to be (or should be) common among all committees, including:

- **Open meetings**—All committees hold their meetings open to the public, although we did get one comment that the room in which the meetings were held is too small. Interested members of management often are not able to attend.
- **Regular meetings**—Committees typically hold four to six meetings a year. However, some committees meet monthly and a few (particularly if audit responsibilities are only a portion of what they do) may meet only once a year. Several committees schedule meetings a year in advance so that the committee and attendees can plan their personal schedules
- **Administrative support**—Audit committee administrative support, which can involve significant effort, is assigned to a key member of CFO or CAE management to ensure that the committee receives the support it requires. The office that provides support typically has the budget to provide for the out-of-pocket expenses of the committee and to pay for any outside experts that the committee requires.
- **Agenda with input from committee members**—Often the agenda is developed by the CAE or CFO, possibly with input from the committee chair. Committee members should be encouraged to provide agenda topics. If the committee prepares an annual plan, input from the entire committee to the plan is an effective way to ensure that all important topics are included.
- **Advance materials**—All documents for a meeting are provided to the committee members at least a week in advance. This provides time for the committee members

to digest the material and formulate questions. It also provides time for committee members to consult with the CEO, CAE, CFO or the external auditor prior to the meeting.

- **Prompt minutes**—Minutes should be prepared quickly in draft and then final form. One CFO told us that the entity did not prepare formal minutes of the audit committee meetings. Other respondents reported sketchy minutes, at best. If factual, these are certainly “non-best practices.” On the other hand, one committee’s minutes is a verbatim “play-back” of the committee meeting. That is probably too much for an understanding of the issues discussed and the actions taken.
- **Prepared committee members**—Members must read the advance materials and come to the committee meetings prepared to enter into lively discussions.
- **Assigned “follow-up” items**—One committee reported that each committee meeting results in a “due-out” or “to-do” list. This is a good idea especially since several weeks pass between meetings.
- **One size does not fit all**—This report identifies many best practices and good ideas for government audit committees. Not all practices and ideas are appropriate for every committee. Each government will have to select those practices that work well for them.

In Conclusion

We recommend that each government entity consider an audit (or similar) committee for its government. With the broad scope of government activities and the variety of laws and regulations to which they are subject, there are no standard models for the mission, structure, operations, responsibilities, membership or activities of such committees. However, as demonstrated by the committees included in this project, an audit committee can serve a valuable function for each government.

It is critical that each committee be shaped and formed by the needs of the specific entity. As discussed in this report, many governments have identified new and innovative ways to take advantage of the potential power of an audit committee. Governments have several sources of potential guidance as well as this summary of best practices to design their audit committee. Some governments will decide that they do not require an audit (or similar) committee. However, each government should evaluate whether an audit committee can provide benefits for its constituency.

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End Notes

1. Please note that there may be other entities that require or support audit committees. The entities mentioned in this paragraph are those which came to our attention during this study.

2. No data are available on the number of governmental organizations that have audit committees. Two studies in 2005 (by the Association of Governmental Accountants and the National Association of State Auditors, Comptrollers and Treasurers) provided only partial information.

3. The AICPA Audit Committee Toolkit: Government Organizations, American Institute of CPAs, 2005.

4. *Public Sector Audit Committees Resource Guide*, Deloitte & Touche LLP, May, 2003.

5. *Best Practices for Audit and Financial Advisory Committees Within the Department of Defense*, DoD Inspector General, December, 2007.

6. "Recommended Practice, Audit Committees", Government Finance Officers Association, February 24, 2006, and Stephen J. Gauthier, "An Elected Officials Guide to Audit Committees," Government Finance Officers Association, 2006.

7. *Audit Committees for State and Local Governments*, KPMG Peat Marwick, 1989. (This document is no longer in print.)

8. *Financial Management Advisory Committees for Federal Agencies*, KPMG LLP, March, 2003.

9. See, for example, the AICPA Audit Committee Effectiveness Center at www.aicpa.org/audcommctr.homepage.htm or KPMG Audit Committee Institute at www.kpmg.com/aci or the Deloitte Center for Corporate Governance at www.corp-gov.deloitte.com.

10. Just to be clear, not all charters adopted by legislation were well prepared, but they are probably more effective than a committee chartered by the CFO or CAE or a committee with no charter.

11. NYC represents an interesting example. Its audit committee, which was the result of its fiscal crisis, could have been disbanded recently when all necessary outstanding bonds issued during the crisis were repaid. The city, however, decided to retain the audit committee because of its value to the city.

12. The definition of "financial expert" by GFOA is an individual who meets all of the following qualifications: a thorough understanding of GAAP and financial reporting (for government); experience either preparing or auditing the financial statements of similar entities; experience with the application of GAAP to accounting estimates and accruals; experience with internal accounting control; and understanding the functioning of the audit committee. (See Gauthier, *Audit Committees*, pp. 24-25.)

13. Several committees included financial experts who are CPAs with private sector experience. It would be better if the "financial expert" possessed experience with governmental accounting.

14. See www.aicpa.org/info/committees/index.asp.

15. Statement of Auditing Standards (SAS) 114, "Auditors Communication with Those Charged with Governance."

APPENDIX 1

Audit Committees Included In Research ⁽¹⁾

Local	State	Federal
Austin, TX	California (State of)	Anonymous
Chicago, IL	Illinois Municipal Retirement Fund	Architect of the Capitol ⁽²⁾
Cook County, IL	Kansas (State of)	Corps of Engineers (DoD)
Dallas Area Rapid Transit (DART) ⁽²⁾	Massachusetts (Commonwealth of)	Defense Finance and Accounting Service (DFAS) (DoD) ⁽⁴⁾
Garland, TX	Massachusetts Technical Park Corporation	Defense Information Systems Agency
Henrico County, VA	Metropolitan Transportation Authority (NY State) ⁽²⁾	Department of Defense (DoD)
Montgomery County, MD	Michigan State University	Federal Deposit Insurance Corporation
New York City, NY ⁽²⁾	New York Power Authority ⁽³⁾	Government Accountability Office ⁽²⁾
Tallahassee, FL ⁽²⁾	Ohio (State of)	United States Holocaust Memorial Museum
	Oregon (State of) ⁽³⁾	National Aeronautics and Space Administration (NASA) ⁽⁴⁾
	Oregon Department of Transportation	National Science Foundation (NSF)
	Texas Guaranteed Student Loan Authority	Small Business Administration (SBA)
	Trinity River Authority (TX)	
	University of New Mexico ⁽²⁾	

⁽¹⁾ Except where noted, we either talked to a representative of the entity and reviewed relevant documents or only talked to a representative of the government.

⁽²⁾ Site visit to this government

⁽³⁾ Reviewed documents only

⁽⁴⁾ Personal knowledge of the author

APPENDIX 2

Audit Committee Guidance Documents: Comparison of Selected Characteristics

Characteristic	AICPA	D&T	DoD	GFOA	KPMG (2003)
Target Audience	All Governments	State and Local	DoD Entities	Local Governments	Federal Entities
Type of Committee	Audit Committee	Audit Committee	Audit and Financial Advisory Committee	Audit Committee	Financial Management Advisory Committee
Committee Mission	N/A	Extension of governing body for effective oversight of the audit and internal control functions	Prepare for audit or coordinate audit and ensure continuation of opinion	Independent review and oversight of financial reporting internal controls and Independent auditors	Advice for various purposes depending on needs of entity
All Governments should have an Audit Committee	N/A	N/A	Selected DoD entities	Yes	N/A
Advisory or Decision Making	Decision	Decision or Advisory	Advisory	Decision	Advisory
Committee Must Have a Charter	Yes	Yes	Yes	Yes	Yes
Focus on Audit Issues Only	Yes	Yes	Yes	Yes	Yes
At Least Four Meetings Annually	Yes	Yes	As Required	Yes	Yes
Minimum of Three Committee Members	N/A	Yes	Yes	Yes	Yes
Committee Membership	N/A	Independent governing board and/or independent outsiders	Internal and independent outsiders	Independent governing board	Independent outsiders
Report to	Governing Board	CEO	Agency Head	Governing Board	CEO
Compensation?	N/A	N/A	N/A	N/A	Should be considered
Requires a Member with Financial Expertise	Yes	Yes	Encourages	If possible; if not, hire outside expert; all members should have or obtain basic understanding	Yes
Members Selected Based on Entity Needs	Yes	Yes	Yes (extensive discussion)	N/A	Yes
Suggestions for Recruiting Chair and Members	Identify/solicit interested individuals including governing board members	N/A	Yes (extensive discussion)	N/A	Yes

N/A = Not addressed

APPENDIX 2 (continued)

Characteristic	AICPA	D&T	DoD	GFOA	KPMG (2003)
Members Oriented to Responsibilities and to the Organization	N/A	Yes	Yes	Yes	Yes
FACA Considerations	N/A	N/A	Yes	N/A	Yes
Audit Committee Should Educate Agency Staff	N/A	Communication and education of board	Yes	N/A	N/A
Internal Control and Risk Management	N/A	Yes (significant discussion)	Encouraged as value-added services	Yes	Yes
Relations with External Auditors	Hire, fire, evaluate; reports to AC	Hire, fire, evaluate; reports to AC	Receive regular updates	Hire, fire, evaluate; reports to AC	Receive input and other information
Hold Executive Sessions with IPA, CEO, CFO & CAE	Yes	Yes	Yes; also Chair meets annually with Agency Head	Yes; change legislation if necessary	Yes
Can Committee Engage Outside Advisors	Yes	Works with management	Works with management	Yes	Works with management
Relations with Internal Auditor	Review and concur on the appointment, replacement, reassignment or dismissal; evaluate internal auditor	Direct oversight including evaluation, review of risk assessment and approval of annual audit plan	Periodic updates	Discusses alternative approaches to relations with internal auditor; takes no position; access to annual plan and reports	Access to annual audit plan
Review Audit Plan of Internal Auditor	Yes and conduct ongoing reviews	Approve plan	N/A	Access plan	See plan
Free and Open Communications With All Participants in Audit Process	N/A	Yes	Yes	Yes	Yes
Create Annual Plan for Committee	Yes	Yes	Yes	N/A	Yes
Review Code of Conduct	Yes	Ensure existence	N/A	N/A	N/A
Oversee Spending of Public Officials	Yes	N/A	N/A	N/A	N/A
Evaluate Committee Activities	Yes	Yes	Yes	Yes	Yes
Assess Committee Membership Periodically	N/A	N/A	Yes	N/A	Yes
Prepare Annual Report of its Activities	N/A	Yes	Yes	Yes; should be public	Yes
Report of Committee Activities in Entity's Annual Financial Report	N/A	Yes	Yes; should also endorse response to auditor	N/A	Yes

N/A = Not addressed

APPENDIX 3

Metropolitan Transportation Authority (MTA): 2008–2009 Audit Committee Work Plan

Detailed Summary

I. RECURRING AGENDA ITEMS

Approval of Minutes

Approval of the official proceedings of the previous month's committee meeting

Audit Work Plan

A monthly update of any edits and/or changes in the work plan

Pre-approval of Audit and Non-Auditing Services

As appropriate, all auditing services and non-audit services to be performed by external auditors will be presented to and pre-approved by the committee.

Follow-Up Items

Communications to the committee of the current status of selected open issues, concerns or matters previously brought to the committee's attention or requested by the committee.

Review of Significant Audit Findings/Issues

As appropriate, external auditors, internal auditors, or agency management will discuss with the committee significant findings and/or other issues of the MTA Inspector General, New York State Comptroller's Office, New York City Comptroller's Office, and other outside audit and investigatory bodies.

Executive Sessions

Executive Sessions will be scheduled to provide direct access to the committee, as appropriate.

II. SPECIFIC AGENDA ITEMS

Detailed Summary

JUNE 2008

Quarterly Financial Statements

External auditors, in conjunction with appropriate agency management, will discuss the interim financial statement that was prepared for the first quarter of 2007

Investment Compliance Report

Representatives of the MTA's public accounting firm will provide a review of MTA's compliance with the guidelines governing investment practices.

Management Letter Reports

Reports will be made by the respective independent auditors on the recommendations made in the auditors' Management Letter for improving the accounting and internal control systems of the MTA and its agencies. The report will also include management's response to each Management Letter comment. The response will describe the plan of action and timeframe to address each comment. In addition, the report will contain a follow-up of prior years' open recommendations conducted by the external audit firm.

Review of Inspector General's Office

The MTA's public accounting firm will provide the results of their review of the MTA/IG's operation to ensure compliance with applicable regulations, rules, policies and procedures.

JULY 2008

Report on Compliance with the Requirements of the Internal Control Act

The committee will be briefed by the MTA Chief Compliance Officer and Agency Internal Control Officers on the results of the All-Agency Internal Control Reports issued to the NYS Division of the Budget as required by the Government Accountability, Audit and Internal Control Act.

2008 Audit Plan Status Report

A briefing by Audit Services that will include a status of the work completed as compared to the audits planned for the year, a summary of the more significant audit findings, results of audit followup, and a discussion of the other major activities performed by the department.

AUGUST 2008

No Meeting Scheduled

SEPTEMBER 2008

Quarterly Financial Statements

External auditors, in conjunction with appropriate agency management, will discuss the interim financial statement that was prepared for the second quarter of 2008.

2007 Single Audit Reports

Representatives of the respective public accounting firms will provide the results of their federally mandated single audit reviews at the MTA, NYC Transit and LI Bus.

Re-Appointment of External Auditors

Senior financial management will review with the committee their recommendations whether to re-appoint the two independent public accounting firms which have an annual renewable option for six years (until 2009) as the Independent Auditor for the NYC Transit Group (PwC) and the MTA Group (Deloitte & Touche). As part of this renewal process, the Auditor General has reviewed and provided to the committee, and will retain on file, the latest report of each firm's most recent internal quality control review.

Annual Audit Committee Report

As a non-agenda information item, the audit committee will be provided with a draft report, which outlines the audit committee's activities for the 12 months ended July 2008.

APPENDIX 3 (continued)

This report is prepared in compliance with the audit committee's charter. After committee review and approval, the committee chair will present the report to the full MTA Board.

OCTOBER 2008

No Meeting Scheduled

NOVEMBER 2008

Audit Approach Plans/Coordination With External Auditors

The external audit firms will review their audit approach for the review of the 2008-year end audits. These reviews will describe the process used to assess inherent and internal control risks, the extent of the auditor's coverage, the timing and nature of the procedures to be performed, and the types of statements to be issued.

2007 Pension Audits

Representatives of the respective public accounting firms will provide the results of their reviews of the pension plans that are managed and controlled by the MTA, Metro-North, Long Island Rail Road, and NYC Transit .

Information Technology Reports

The Chief Technology/Information Officers or appropriate management from the respective agencies will review with the committee the actions taken to address issues raised in both internal and external audits concerning system security and control related issues. This will include the status of prior year recommendations that have yet to be implemented and compliance to MTA Agency-wide policies and procedures. As appropriate, the audit committee will be briefed on major Enterprise System Initiatives being undertaken, as well as issues related to the Enterprise Security Infrastructure.

DECEMBER 2008

No Meeting Scheduled

JANUARY 2009

Review of audit committee charter.

The committee chair will report that the committee has reviewed and assessed the adequacy of the audit committee charter and, based on that review, will recommend any changes for 2009 at this time. The review also showed the committee's performance in 2008 adequately complied with the roles and responsibilities outlined in its charter (i.e. monitoring and overseeing the conduct of MTA's financial reporting process; application of accounting principles; engagement of outside auditors; MTA's internal controls; and other matters relative to legal, regulatory and ethical compliance at the MTA).

Quarterly Financial Statements

External auditors, in conjunction with appropriate agency management, will discuss the interim financial statement that was prepared for the third quarter of 2008. Changes in accounting principles, financial reporting and regulatory

matters. In preparation of financial statement review, the external auditor will report on the impact of new or proposed changes in accounting principles, regulations, or financial reporting practices.

2008 Audit Plan Status Report

A briefing by Audit Services that will include a status of the work completed, a summary of the more significant audit findings, and a discussion of the other major activities performed by the department.

2009 Audit Plan

A discussion by Audit Services of the areas scheduled to be reviewed in 2009 as well as the guidelines and policies that were used to assess audit risk and their application in the development of the audit work plan.

FEBRUARY 2009

Financial Interest Reports

The MTA Chief Compliance Officer will brief the committee as to the agencies' compliance with the state law regarding the filing of Financial Interest Reports (FIRs), including any known conflicts of interest.

MTA Ethics Program

The MTA Chief Compliance Officer will brief the committee on selected aspects of the MTA Ethics Program.

MARCH 2009

No Meeting Scheduled

APRIL 2009

2008 Financial Statements and Audit Representation Letters

The agency CFOs/Controllers will be available to the committee to answer any questions regarding the submission of their audit representation letters to the external audit firms.

The respective independent public accounting firms will review the results and conclusions of their examination of the 2008 Financial Statements.

Contingent Liabilities and Status of Third Party Lawsuits

The general counsels from each agency, along with representatives from D&T and PwC, will review in Executive Session the status of major litigation that may have a material effect on the financial position of their agency, or for which a contingency has been or will be established and/or disclosed in a footnote to the financial statements. In addition, the committee will be briefed on the status of third party lawsuits for which there has been minimal or sporadic case activity.

MAY 2009

No Meeting Scheduled

APPENDIX 4

United States Holocaust Memorial Museum: Audit Committee Responsibilities Checklist – CY 2008

Responsibility	Frequency	Jan. – March Quarter	April – June Quarter	July – Sep. Quarter	Oct. – Dec. Quarter
		(4/3/08)	(6/19/08)	(9/25/08)	(11/5/08)
Committee meetings					
1. Schedule meetings for the fiscal year.	Annually				X
2. Review and approve Committee minutes.	Quarterly	X	X	X	X
3. Meet in Executive Session with	Annually				
Museum Director			X		
Chief Financial Officer			X		
Internal Auditor	Semi-annually	X		X	
Partner, independent auditor					X
Audit Committee members	Semi-annually	X		X	
And others, as appropriate.					
Oversight of Independent Auditors					
1. Engage the independent auditors, subject to confirmation by Council.	Annually	X			
2. Meet with independent auditors to obtain an understanding of factors considered by them in determining audit scope.	Annually		X		
3. Determine and approve extent of any nonaudit services.	As necessary				
4. Review with independent auditors the firm's internal quality control procedures, any material issues raised during most recent peer review, and any corrective actions taken.	Annually		X		
5. Review and evaluate external auditor's independence.	Annually	X			
6. Review with the independent auditors any problems or difficulties that they may have encountered in connection with the audit.	Annually				X
7. Discuss with independent auditors and management scope and quality of internal controls in effect.	Annually				X
8. Review any management letter or other material communications from the independent auditors and management's response to that communication.	Annually				X

APPENDIX 4 (continued)

Responsibility	Frequency	Jan. – March Quarter	April – June Quarter	July – Sep. Quarter	Oct. – Dec. Quarter
		(4/3/08)	(6/19/08)	(9/25/08)	(11/5/08)
Oversight of Financial Statements					
1. Obtain DRAFT financial statements for review and approval.	Annually				X
2. Review with management and independent auditors DRAFT financial statements to include –	Annually				X
Significant transactions outside the ordinary operations of the Museum;					
Selection of and changes to Museum’s accounting principles;					
Material correcting accounting adjustments;					
Process in formulating accounting estimates; and					
Risk assessment and risk management.					
3. Review with Council’s General Counsel or Museum’s General Counsel current or pending litigation.	Annually			X	
Oversight of Internal Auditor					
1. Review and approve Annual Internal Audit Plan identifying audit scope and coverage.	Annually			X	
2. Review the performance of the Museum’s Internal Auditor.	Annually			X	
3. Obtain briefings on internal audit activities.	Quarterly	X	X	X	X
Risk Management					
1. Obtain an understanding of Museum’s internal control and risk management policies.	Annually		X		
2. Discuss with management and the Internal Auditor the Museum’s major risk exposures, the adequacy and effectiveness of accounting and financial controls, and steps management has taken to monitor and control such exposures.	Annually		X		
3. Review and approve updated internal audit risk assessment model.	Annually		X		
4. Obtain an understanding of Museum’s physical security over Collections	As necessary	X			

APPENDIX 5

Illinois Municipal Retirement Fund: Audit Committee Self-Assessment Questionnaire

Rank answers from 1 = Needs significant improvement; 2 = Needs improvement; 3 = Consistently good; and 4 = Outstanding. Feel free to include written comments throughout or in the space provided at the end. Of course, any suggestions for improving the Committee's performance and process would be most helpful.

Committee Information				
1. Are you receiving clear and concise background information prior to Committee meetings that helps you understand and evaluate Committee agenda items?	1	2	3	4
2. Has the Committee satisfactorily identified and communicated to management the Committee's informational needs, including identification of potential areas of concern?	1	2	3	4
3. Are you receiving information concerning Committee agenda items in a timely fashion?	1	2	3	4
4. How could the information prepared for the Committee be improved in terms of presentation, level of detail, content, or focus? _____ _____ _____				
Committee Meetings and Accountability				
5. Are Committee meetings productive?	1	2	3	4
6. Are the number of scheduled meetings sufficient? ____ (yes) ____ (no) explain: _____ _____ _____				
7. Is sufficient meeting time devoted to discussion of Committee responsibilities? ____ (yes) ____ (no) explain: _____ _____ _____				
8. Are Committee meetings conducted in a manner that ensures open communication, meaningful participation and timely resolution of issues?	1	2	3	4
9. Are Committee members prepared for meetings?	1	2	3	4
10. Are Committee members knowledgeable about IMRF and the issues it faces?	1	2	3	4

APPENDIX 5 (continued)

11. Does the Committee encourage/ensure an open line of communication:				
A. between the Committee and management?	1	2	3	4
B. among Committee members?	1	2	3	4
C. between the Committee and auditors (internal/external)?	1	2	3	4
12. Does the Committee challenge management when appropriate?	1	2	3	4
13. Are Committee goals, expectations, and concerns openly communicated with the Board?	1	2	3	4
14. Are Committee sessions candid and constructive, and conducted in a manner where there can be civil disagreement and critical questioning?	1	2	3	4
15. Do you believe Committee members ask the appropriate questions of management?	1	2	3	4
Committee Authority and Responsibilities				
16. Has the Committee obtained adequate advice and assistance from internal or external legal, accounting or other advisors? ___ (yes) ___ (no) explain: _____ When necessary we have accessed external parties. _____ _____ _____ _____				
17. Are the frequency and quality of the Committee’s reports to the Board adequate? ___ (yes) ___ (no) explain: _____ _____ _____ _____				
18. How would you rate the Committee’s review and assessment of the Committee charter?	1	2	3	4
19. Is there anything the Committee is not currently doing that it should do to assure effective performance of its duties and responsibilities? Please describe: _____ _____ _____ _____ _____				
20. Do you have any other comments? _____ _____ _____				

Audit Advisory Committee's Report

The Audit Advisory Committee (the Committee) assists the Comptroller General in overseeing the U.S. Government Accountability Office's (GAO) financial operations. As part of that responsibility, the Committee meets with agency management and its internal and external auditors to review and discuss GAO's external financial audit coverage, the effectiveness of GAO's internal controls over its financial operations, and its compliance with certain laws and regulations that could materially impact GAO's financial statements. GAO's external auditors are responsible for expressing an opinion on the conformity of GAO's audited financial statements with the U.S. generally accepted accounting principles. The Committee reviews the findings of the internal and external auditors, and GAO's responses to those findings, to ensure that GAO's plan for corrective action includes appropriate and timely follow-up measures. In addition, the Committee reviews the draft Performance and Accountability Report, including its financial statements, and provides comments to management who has primary responsibility for the Performance and Accountability report. The Committee met three times with respect to its responsibilities as described above. During these sessions, the Committee met with the internal and external auditors without GAO management being present and discussed with the external auditors the matters that are required to be discussed by generally accepted auditing standards. Based on procedures performed as outlined above, we recommend that GAO's audited statements and footnotes be included in the 2006 Performance and Accountability Report.



Sheldon S. Cohen
Chairman
Audit Advisory Committee

AGA CPAG Research Reports Previously Published

- No. 1, March 2005:** *Audit Federal Financial Controls: Sooner Rather than Later?*
- No. 2, July 2005:** *Financial Management Shared Services: A Guide for Federal Users*
- No. 3, November 2005:** *Trends in Technology*
- No. 4, April 2006:** *The Federal Purchase Card: Use, Policy and Practice*
- No. 5, June 2006:** *Challenges in Performance Auditing: How a State Auditor with Intriguing New Performance Authority is Meeting Them*
- No. 6, June 2006:** *PAR—The Report We Hate to Love*
- No. 7, February 2007:** *The State Purchase Card: Uses, Policies and Best Practices*
- No. 8, March 2007:** *Federal Real Property Asset Management*
- No. 9, May 2007:** *Should State and Local Governments Strengthen Financial Controls by Applying SOX-Like Requirements?*
- No. 10, April 2007:** *Process-Based Financial Reporting*
- No. 11, May 2007:** *The State Travel Card—Uses, Policies and Best Practices*
- No. 12, June 2007:** *Trends in Technology—2007 Review*
- No. 13, June 2007:** *The Federal Travel Card—Uses, Policies and Best Practices*
- No. 14, January 2008:** *21st Century Financial Managers—A New Mix of Skills and Educational Levels?*
- No. 15, July 2008:** *SAS 70 Reports: Are they Useful and Can They Be Improved?*
- No. 16, Sept. 2008:** *XBRL and Public Sector Financial Reporting: Standardized Business Reporting: The Oregon CAFR Project*



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