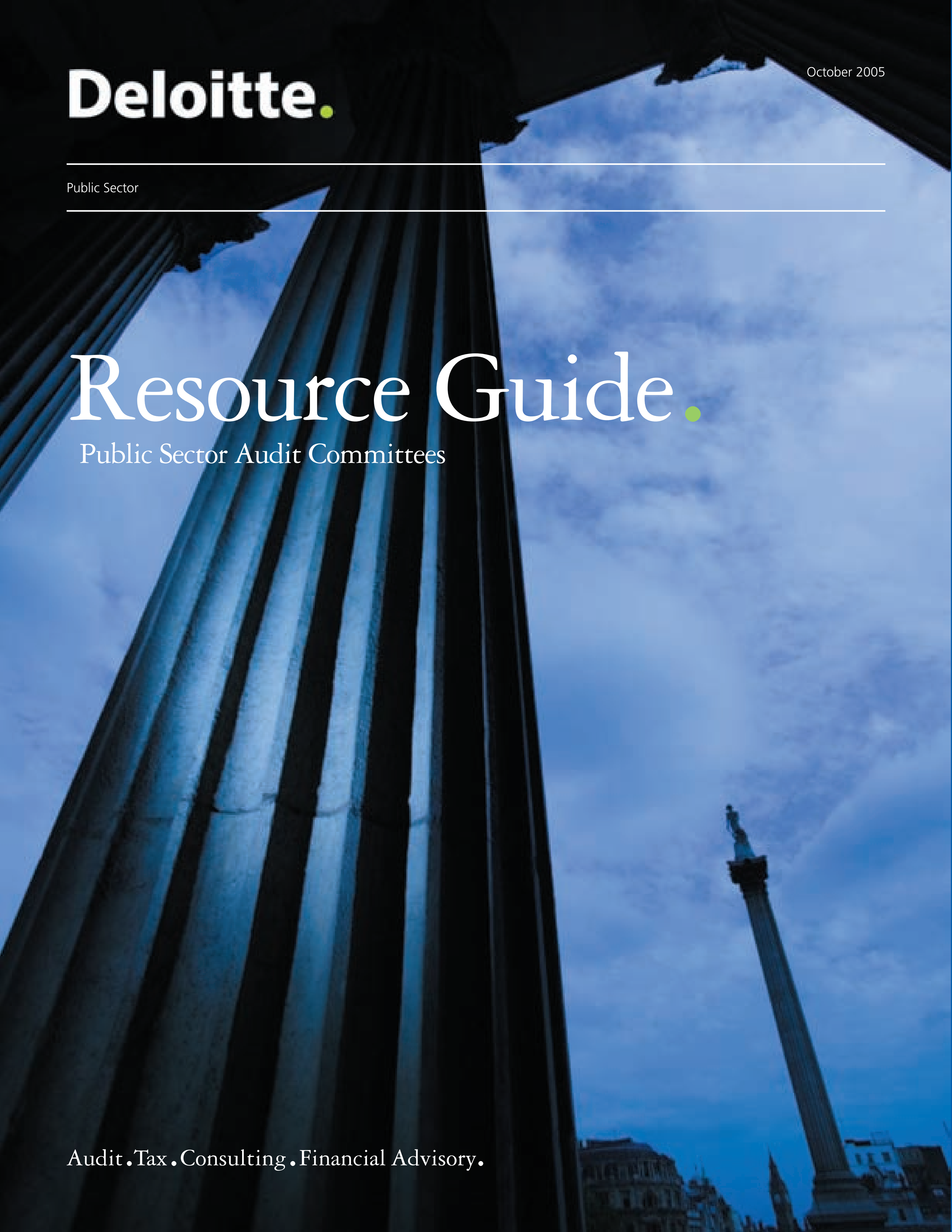

Deloitte.

October 2005

Public Sector

Resource Guide.

Public Sector Audit Committees

Audit. Tax. Consulting. Financial Advisory.

This booklet, *Public Sector Audit Committees*, Resource Guide, is but one indication of our commitment to assist you, our public sector clients and friends, in developing and implementing sound management practices and policies.To learn more about how Deloitte & Touche can help you, please call your Deloitte & Touche office or David Jones,National Managing Partner for Public Assurance Services (973-683-7125); Mike Fritz, Partner (614-229-4806); or Patrick Hardiman, Partner (203-761-3017).

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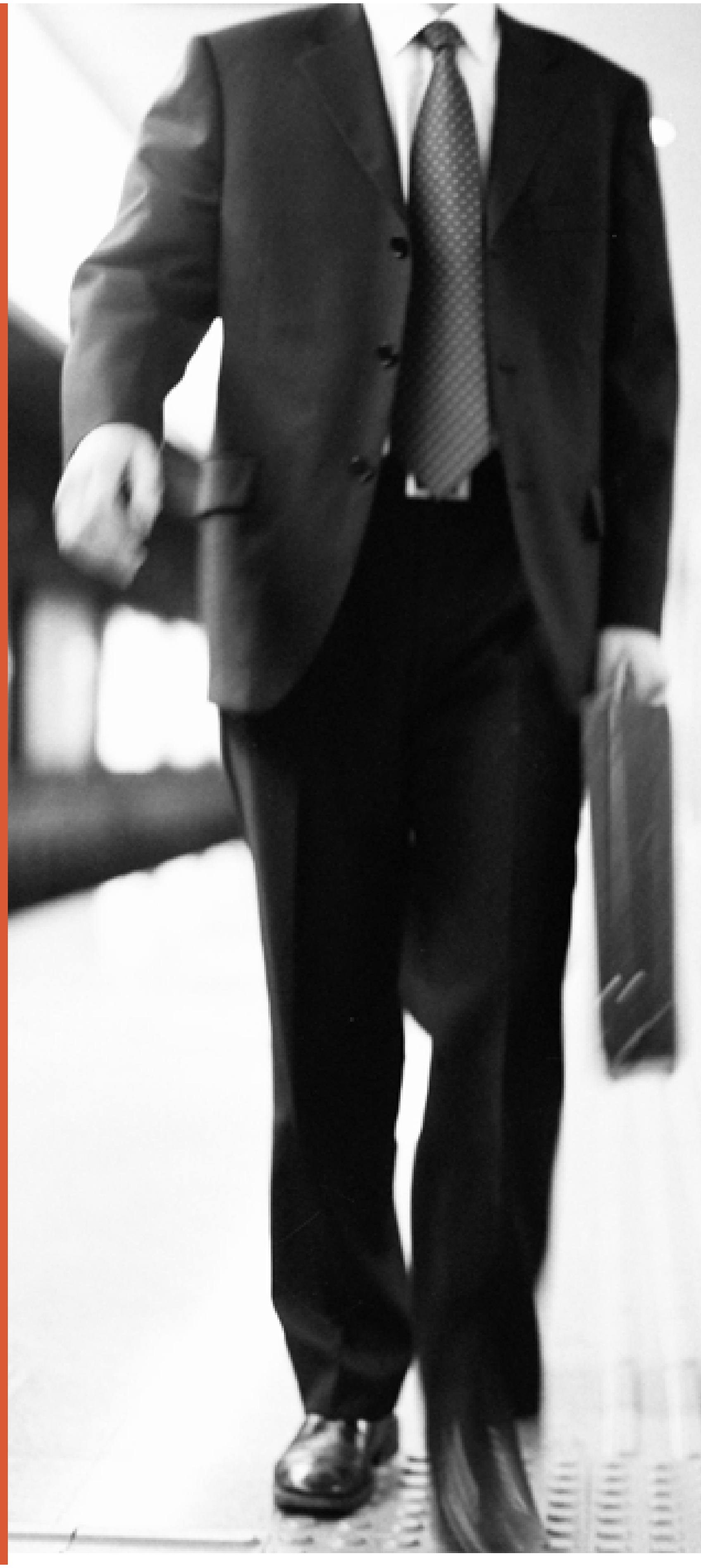

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October 2005

Dear Clients and Friends of Deloitte & Touche LLP,

With recent developments in the regulatory, legislative, and standard-setting environment resulting from corporate failures and loss of investor confidence, attention has significantly shifted to audit committees and their focus, responsibilities, and importance in an organization.

Audit committees fulfill the governing body's fiduciary responsibility by overseeing the entire audit and reporting process, ensuring auditor independence, and ensuring that proper and timely attention is paid to control issues and compliance weaknesses. Audit committees increase the level of confidence in the financial reporting process.

Events in the public sector over the years have provided clear provocation for the use of audit committees by governments. As a result of the fiscal crisis in the mid- to late 1970s,New York City was required to establish an independent audit committee. Failures in the quality of government audits caused the U.S.General Accounting Office (GAO) to recommend that entities "consider the benefit of using audit committees both to help plan and to oversee the entities" audit procurement process. Further, the Government Finance Officers Association (GFOA) in its publications, *Governmental Accounting, Auditing, and Financial Reporting* and *An Elected Official's Guide to Auditing*, encouraged government use of audit committees to ensure the integrity of the audit process.

The Sarbanes-Oxley Act of 2002, related SEC rulemaking, and the proposed modifications of the NYSE, NASDAQ, and Amex listing standards expand, codify, and formalize the composition, duties, and responsibilities of audit committees of public companies.

Additionally, on April 1, 2003, the Securities and Exchange Commission voted to adopt rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements established by the Sarbanes-Oxley Act of 2002.

Government Auditing Standards, 2003 Revision, published by the GAO, requires that auditors communicate certain information related to the audit to the audit committee or to the individuals with whom they have contracted for the audit.

Statement on Auditing Standards No. 61, *Communication with Audit Committees*, further clarifies this requirement by defining an audit committee (for the purpose of the required communication) as a group that has been designated to oversee the financial reporting process "such as a finance committee or a budget committee." Clearly, it is essential that each governmental entity designate an audit committee or an equivalent body to fulfill this role of financial oversight.

This booklet covers the public sector audit committee's principal activities, organization, and conduct of meetings as well as relationships with the governing body, management, internal auditors, and external auditors. Recent significant developments in the use and practices of audit committees are also discussed. Finally, tools are provided for the creation and operation of an audit committee, including a sample charter and bylaws, sample audit committee chairman's letter for inclusion in the comprehensive annual financial report, and sample questions to guide the audit committee in discharging its responsibilities.

Throughout this booklet, the discussion refers to public sector entities.These include general purpose governments; federal agencies, including components, public sector utilities, authorities, hospitals, colleges, and universities, and pension plans. Likewise, references to governing bodies may include city councils, boards of trustees, legislatures, or boards of governors.

With the increased emphasis on accountability in the government environment, the role of the public sector audit committee has become increasingly important. An effective audit committee can significantly increase the integrity and efficiency of the system of internal controls, financial reporting, and the audit process. Audit committees are, indeed, the hallmark of public accountability.

It is for these reasons that Deloitte & Touche is pleased to be able to offer you this useful booklet.We remain dedicated to assisting our clients in successfully implementing reforms and restoring public confidence.

Sincerely,

David Jones
National Managing Partner for Public Sector Assurance Services

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Section One

Emerging Demands on Governing Bodies

The public sector has always been at the forefront of governance and accountability. By their very nature, governments have always had to respond to the demands of their constituencies. In this process, governing bodies more frequently challenge the effectiveness of their governance process. Transparency of reporting is crucial to ensuring public confidence in the public sector.

Governance and Independence

Governance refers to the processes and structure used to guide and direct an organization's operations and activities. It defines the division of power and establishes mechanisms to achieve accountability among constituents, the governing body, and management.The developing role of the audit committee is very much connected to the idea of promoting sound governance. As our society and economy evolve, so does governance. An example is the issue of independence. In the early 1980s, it was common for accounting firms to install accounting systems for their audit clients. The thinking was,"Who better to install an accounting system than the people who do the auditing?"Today, concerns over conflicts of interest are requiring governing bodies to take a second look at the services accounting firms are offering.

The General Accounting Office (GAO) has recently reacted to those concerns by issuing Amendment No. 3,"Independence," that was included in Government Auditing Standards, 2003 Revision.While the new amendment deals with a range of audit independence issues, the most significant change relates to the non-audit or consulting services. The independence standard now includes a principle-based approach to addressing this issue and is based on two overarching principles:

- Auditors should not perform management functions or make management decisions.
- Auditors should not audit their own work or provide non-audit services in situations where the amounts or services involved are significant/ material to the subject matter of the audit.

Independence has been and will always be the concept that drives the structure of governance. Independence builds trust and confidence in the user of financial statements. However, its relationship to the legislature, city council, governing bodies, and others with oversight, especially in the public sector, is also a precarious one. As governing bodies wrestle with independence questions, they must also address ever-increasing accountability requirements.These are influencing governing bodies to embrace audit committees as an effective way to ensure that oversight responsibilities are discharged.

Sarbanes-Oxley Act of 2002

Recent corporate failures have spurred the public to refocus on concepts important to governance.The reforms required by the Sarbanes-Oxley Act of 2002 include many practices that were already present in the business world for protecting organizations and their stakeholders. While the Sarbanes-Oxley Act of 2002 does not apply to the public sector, it has created public awareness and encouraged audit committees to challenge their roles and responsibilities. Additional information about the Sarbanes-Oxley Act of 2002 is presented in the Appendix.

With this refocus on governance and the role of the audit committee, the following are topics that are being considered by many public sector entities:

Evolving Role of the Audit Committee

- Establishing audit committees where the role is performed by an auditor general, internal auditor, or similar role
- Setting a culture and tone for promoting full and adequate disclosure
- Establishing a code of ethics
- Meeting accelerated reporting deadlines
- Accessing resources to fulfill responsibilities (e.g., money to hire appropriate auditors and lawyers)
- Promoting and protecting whistleblowers
- Minimizing and controlling risky investment policies
- Assessing the risks of reliance on information technologies
- Measuring performance that links budgetary to proprietary results
- Ensuring that accounting policies do not become creative, especially in times of budget deficits
- Responding to emergency needs and homeland security initiatives
- Assessing the impact of the 2003 revisions of *Government Auditing Standards* and other accounting and auditing pronouncements such as SAS No. 99, *Consideration of Fraud in a Financial Statement Audit.*
- Determining the adequacy and effectiveness of internal controls for compliance with laws and regulations and financial reporting.

The public perception of governance now gives the legislative branch, executive branch, governing body, management, audit committee, and auditors a public mandate to fulfill their vital role of producing reliable financial information. It is clear that audit committees are an increasingly important element of public sector entities that promote effective accountability and governance.

Section Two

Role of the Audit Committee

Accountability and Governance

Within the public sector, an audit committee is an extension of the governing body. Committees are formed to fulfill the governing body's responsibilities, not expand them. Officials are able to increase their oversight of specific issues by assigning various matters to committees.

In this light, the audit committee is an integral element of public accountability and governance. It plays a key role for the governing body in carrying out its legal and fiduciary responsibilities, especially with respect to the integrity of the government's financial information, system of internal control, and legal and ethical conduct of management and employees.

Varying Roles

The roles and responsibilities of an audit committee can be as broad or deep as the governing body wishes. Both the Government Finance Officers Association (GFOA) and the Office of Management and Budget (OMB) recommend the establishment of audit committees or the equivalent.

With this mandate, audit committees are finding a new power to take on additional oversight roles. Today, typical audit committee responsibilities include:

- Approving the overall audit scope
- Helping to ensure that the audit is conducted in an efficient and costeffective manner.
- Overseeing the organization's financial statements and internal controls
- Recommending to the governing body the approval of the organization's financial statements
- Recommending the appointment of the external auditor and the appropriate fee
- Directing special investigations for the governing body

The roles will vary from entity to entity depending on the complexity and size as well as the requirements of the governing body. However, the one common responsibility for all audit committees, among all their potential roles, is risk management oversight.

Risk Management Oversight

Every organization faces a variety of potential risks, such as:

- Loss of key staff
- Loss of funding or reduction of revenue sources
- Disruption in investment markets that undermines an organization's financial assets
- Erroneous financial reporting
- Regulatory noncompliance
- Conflict of interests
- Fraudulent activities resulting from weaknesses in internal controls

The governing body's responsibility acted upon through the audit committee is to ensure that management has implemented an effective process to identify, monitor, and manage the potential risks the organization faces as it relates to financial reporting, internal control, regulatory noncompliance, conflict of interest, and special investigations.

The audit committee is responsible for ensuring that management has implemented effective systems of internal controls to protect the organization and the necessary management information systems.

Building Blocks

There are three areas that represent the building blocks for the role of the audit committee:

- Independence
- Communication
- Accountability

Independence

An essential feature of an effective audit committee is independence from management and the outside auditor. Independence drives the building of trust and confidence. Corporations satisfy this standard by appointment of outside directors.The Sarbanes-Oxley Act of 2002 requires audit committee members of all public companies to be independent and has set forth a specific criteria for independence.The Treadway Commission also recommends that audit committees be composed entirely of independent directors. However, in the public sector, implementation of this standard may not be simple.

Although the 1992 Committee of Sponsoring Organizations (COSO) of the Treadway Commission stresses the benefits of independent audit committees, it acknowledges that often there are practical limitations for certain entities. Public sector use of independent audit committees is not so straightforward.Often the structure of public sector entities and governments does not separate the governing authority and oversight responsibility from the day-to-day management of the entity. In a "strong mayor" form of government, the mayor is the chief executive officer and is also a member of the governing body. In such cases, the mayor is not independent of management. Likewise, a public college president may be both the chief executive officer and a board member and therefore not independent of management. On the other hand, a "city manager" form of government usually separates management from the governing authority. The city manager is the chief executive officer, and the mayor and city council may not have any significant administrative or managerial responsibilities. In this case, the mayor and council are independent of management.

General rules cannot be developed to determine whether individuals with governing authority are independent of management.The structure of public sector entities in the United States is too diverse. A position that is independent in one jurisdiction may not be independent in another. Public sector audit committees should therefore be independent both in fact and in appearance and have processes in place to ensure such independence.

It is difficult to imagine how a public sector audit committee could operate effectively without the direct and active participation of the governing body. Therefore,we recommend that the audit committee be made up of outside members appointed by the chief executive and confirmed by the governing body and/or independent governing body members themselves.

Communication

Outside audit committees are also useful to the entity's financial management because audit committees can improve technical communications with governing body.

Elected officials represent the constituency or electorate.The skills needed to succeed in electoral and governing processes do not necessarily include financial, accounting, and auditing skills.Governing officials bring diverse abilities to the oversight process.

Public sector financial reporting, accounting, auditing, and internal control processes require specialized knowledge for effective administration. Public sector financial officers are expert professionals in their disciplines. Communication between governing bodies and public sector financial managers can therefore be difficult at times. For example, budgets and expressions of policy conform to a basis of presentation unique to the circumstances of the local organization and jurisdiction. External financial reporting, however, follows generally accepted accounting principles, a basis often very different from the budget basis. Both bases are pertinent and meaningful within their respective contexts. Communication may, nevertheless, be complicated when the governing body votes on and approves a budget but does not approve the financial statements and independent auditors' reports.

Other communication problems may arise because of different concepts of materiality. Control weaknesses may be important to governing officials but may not be material to the financial reporting process. This difference in perspective is magnified in Single Audits of federal financial awards, where the materiality threshold is usually much lower than that of financial reporting.

The GAO has indicated that audit committees can provide the broadest perspective and greatest range of assistance if they possess technical skills in accounting and auditing. Some experts believe that audit committees lose their effectiveness if committee members do not have sufficient specialized training or if any are perceived as not being independent.

Accordingly, the audit committee's outside members should:

- Possess the technical skills necessary to oversee the technical and complex financial reporting and audit processes
- Be able to communicate with public finance officers and auditors on complex issues
- Possess communication skills to advise the governing body and assist the governing body in its oversight responsibilities of the financial reporting and audit process

Accountability

The combination of independent oversight of the financial reporting and audit process and the technical expertise of the independent audit committee members will significantly enhance accountability. Independent audit committees will help establish the proper "tone at the top," contribute to the integrity of the financial reporting process, and positively influence the control environment and culture within which it occurs.

Active oversight by the audit committee can help to reinforce management's commitment to creating a culture with "zero tolerance" for fraud. An entity's audit committee should also ensure that management has implemented appropriate fraud deterrence and prevention measures.The audit committee's evaluation and oversight not only help ensure that management fulfills its responsibility, but also can serve as a deterrent.

The Treadway Commission notes:

The mere existence of an audit committee is not enough. The audit committee must be vigilant, informed, diligent and probing in fulfilling its oversight responsibilities.The audit committee must, of course, avoid unnecessary or inappropriate interaction with the prerogatives of management; but the oversight must be effective.

Section Three

Importance of Relevance of Internal Control

Weaknesses in internal controls have been the root cause of many problems, including fraudulent activities, errors, and noncompliance with laws and regulations. Accordingly, the adequacy of internal control should be the primary concern of the governing bodies and audit committees. Understanding an organization's internal controls will help audit committees understand the organization's risk management and the processes used to mitigate risks.

Definition of Internal Control

The COSO of the Treadway Commission in its *Internal Control Integrated Framework* defines internal control as "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and eficiency of operations
- Realiability of financial reporting
- Compliance with applicable laws and regulations

An organization's internal controls consist of the policies and procedures in place that provide a reasonable level of assurance that these objectives are achieved. Not all of the policies and procedures employed by an entity would be relevant to an independent auditor performing a Single Audit, Chief Financial Officers Act Audit, or audit of the organization's financial statements. Certain controls governing the efficiency of operations, while significant to the ultimate success of the entity,would not necessarily be considered in an audit.

Although *Government Auditing Standards, 2003 Revision* does not prescribe additional internal control standards for financial statement audits, it does emphasize several aspects of internal controls that are important to the judgment auditors make about audit risk and about the evidence needed to support their opinion on the financial statements:

- Controls over the safeguarding of assets
- Controls over compliance with laws and regulations
- Controls over environment and risk assessment (how effective are the controls that are in place?)

It is important to understand that the objective of internal controls is to provide reasonable, but not absolute, assurance that an entity's control objectives have been met. An entity's success in achieving its control objectives is limited by circumvention, breakdown of existing controls, poor management oversight, the ability to override the system, and the high cost of implementing certain controls. Despite the existence of adequate internal controls, the reliability of financial reporting and compliance with laws and regulations are not ensured.

Components of Internal Control

COSO is the most widely used framework in the United States for establishing an internal control structure. The framework that COSO describes encompasses both disclosure and financial reporting controls.

The COSO framework categorizes effective internal control into five interrelated components. By dividing internal control into these elements, the COSO framework simplifies management's task of administering and supervising all the activities that contribute to a successful internal control structure:

Control environment

The control environment encompasses every facet of the internal control framework; it is the universe in which all other elements exist.The control environment includes such concepts as tone, attitude, awareness, competence, and style. It derives much of its strength from the tone established by the organization's governing body and higher management.

Risk assessment

Risk assessment involves management's identification and analysis of relevant risks to achieving business objectives. The goal of a risk assessment is to document each business objective, from the highest level (such as "limit budgetary growth to 5 percent") to the lowest level (such as "collect property tax receivables within 30 days"), and identify every risk that could undermine or block the objective.

Control activities

Control activities are developed to address each control objective in order to mitigate the risks identified.They are the specific policies, procedures, and practices that are designed to ensure that business objectives are achieved and risk mitigation strategies are implemented.The range of controls is broad, and activities for a particular organization will vary according to the nature of the business. Some general examples of control activities include segregation of duties, account reconciliation, use of authorization signatures,matching of invoices to purchase orders, and physical security of assets.

Information and communication

Information and communication support internal control by conveying directives from management to the employees in a form and a time frame that allow them to perform their control activities effectively. The process should also work in reverse, communicating information on results and deficiencies from the ground levels of an organization to executives and the board of directors.

Monitoring

Monitoring is a process to assess the quality of internal control over time through ongoing and special evaluations.Monitoring can include both internal and external oversight of internal control by management, employees, or outside parties (such as outsourced internal audit functions).

Each of these components can be applied to these categories of objectives listed above—effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. In fact, all five of the components should be present and functioning effectively to conclude that internal controls are effective for each category of objectives.

Responsibility for Internal Control

Audit committees can help ensure that each of the five preceding components of internal control are present in their organization and are operating effectively. As part of their responsibilities, audit committees should be actively involved in setting an appropriate control environment, the assessment of risk, the implementation and operation of control activities, the collection and dissemination of pertinent information, and the monitoring of critical controls.

Everyone in an organization has a responsibility in the internal control structure.The COSO designates each party's role and responsibility as follows:

Management

The chief executive officer (such as governor,mayor, county executive, legislative auditor, or entity president) is ultimately responsible and should assume "ownership" of the system. More than any other individual, the chief executive sets the "tone at the top" that affects integrity and ethics and other factors of a positive control environment. The chief executive fulfills this duty by providing leadership and direction to senior managers and reviewing the way that they are controlling the organization. Senior managers, in turn, assign responsibility for establishment of more specific internal control policies and procedures to personnel responsible for each department's functions.

Governing Bodies

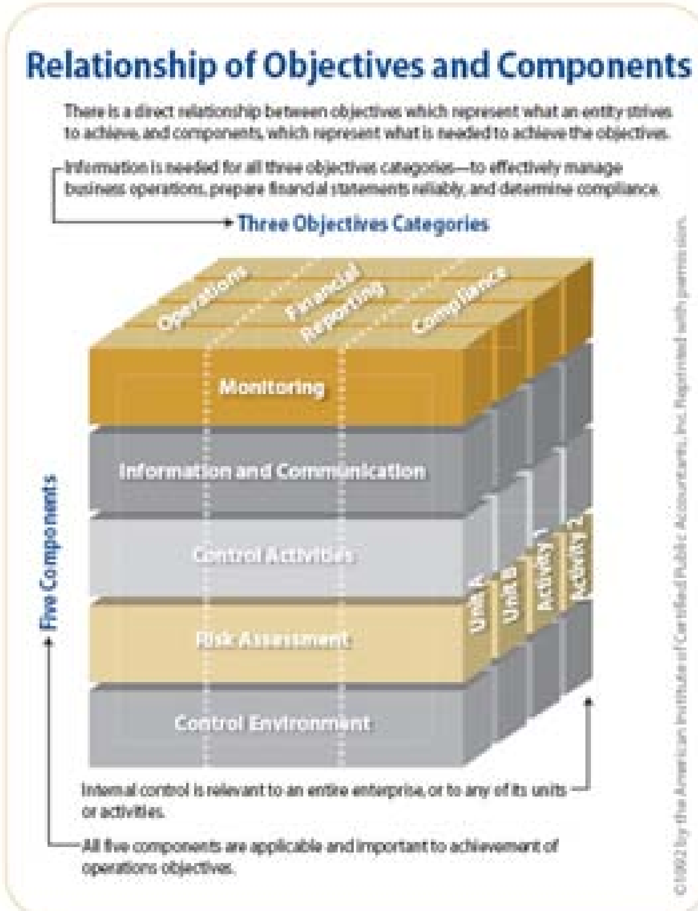
Management is accountable to the governing body, which provides governance, guidance, and oversight. Effective governing body members are objective, capable, and inquisitive.They also have a knowledge of the government's activities and environment and commit the time necessary to fulfill their responsibilities.Management may be in a position to override controls and ignore or stifle communications from subordinates, enabling dishonest management that intentionally misrepresents results to cover its tracks. A strong, active audit committee, particularly when coupled with effective upward communications and capable financial, legal, and internal audit functions, is best able to identify and correct such a problem.

Internal Auditors

Internal auditors play an important role in evaluating the effectiveness of control systems and contribute to ongoing effectiveness. Because of organizational position and authority, an internal audit function plays a significant monitoring role.

Other Personnel

Internal control is, to some degree, the responsibility of everyone in an organization and therefore should be part of each person's job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. All personnel should be responsible for communicating problems in operations, noncompliance with the code of conduct, policy violations, or illegal acts.



Section Four

Principal Audit Committee Activities

As discussed in Chapter 3,"Importance and Relevance of Internal Control," everyone in an organization has a responsibility for the entity's internal controls and compliance with laws and regulations. Management is directly responsible for the entity's financial statements, internal controls, and compliance with laws and regulations.The audit committee should oversee and monitor how management carries out these functions. Through this oversight role, the audit committee must also satisfy itself that the responsibilities of the outside independent auditors are effectively discharged. Outside auditors are responsible for attesting to the fairness of the presentation of the financial statements in accordance with generally accepted accounting principles and, if applicable to the engagement, for satisfying the reporting requirements related to local budget ordinances, the Single Audit Act, Chief Financial Officers Audit Act, and/or *Government Auditing Standards, 2003 Revision..*

Traditionally, audit committees have the following duties:

- To recommend the selection of outside independent auditors
- To assess and monitor the independent status of the outside independent auditors
- To approve the overall audit scope
- To oversee the review of the adequacy of internal controls, including:
  - Internal audit activities
  - Fraud prevention and detection activities
- To review the annual financial statements and audit report
- To direct special investigations for the governing body

Traditionally, audit committees have the following duties:

These traditional duties remain relevant. Indeed, given today's environment, the diligence with which they are pursued has taken on an even greater importance.

With the current focus on internal controls, as evidenced by the COSO report and the 2003 revisions to *Government Auditing Standards*, public sector audit committees must take special care in their role of reviewing the systems and controls that ensure compliance with laws and regulations.

Furthermore, audit committees are now expected to understand:

- Critical accounting policies and practices used by entities
- Alternative accounting treatments within GAAP related to material items that have been discussed with management
- The ramifications of the use of alternative treatments and disclosures and the treatment preferred by the audit firm

The activities related to oversight of management and internal controls are discussed below. Activities relevant to the conduct of the audit are further discussed in Chapters 6 and 7.

Internal Control and Compliance Review

Oversight of an organization's internal controls has traditionally been part of the audit committee's function. The audit committee should ensure that management maintain appropriate internal controls.Therefore, the committee should:

- Understand how the internal control objectives are achieved within the government
- Have knowledge of the risk control areas and the activities needed to be performed by the entity to address those risks
- Consider whether the control environment and specific control procedures could reasonably be expected to accomplish their specific objectives
- Be satisfied that appropriate monitoring devices are in place to detect dysfunctions, including fraudulent activities
- Ensure corrective action is taken, as necessary

To carry out this responsibility, the audit committee must understand how decisionmaking authority is delegated between management and the governing body. It should consider whether management measures the adequacy of controls to identify and correct exceptions or out-of-pattern items. The audit committee should be satisfied that management continually challenges its controls and organization structures to ensure proper alignment with established policies and procedures.

Other Activities

The governing body may assign special projects to the audit committee to ensure that the organization's disclosure obligations are satisfied.These projects may include:

- Investigating questionable payment or lapses of internal control and compliance
- Understanding how compliance with laws and regulations is monitored and achieved
- Monitoring compliance with the government's code of conduct or ethics provisions
- Assessing the adequacy of internal control over data processing operations or computer-accessible data, which is even more important with the proliferation of microcomputers and client/server technology
- Measuring the likely impact of changes in accounting standards proposed by the appropriate standards board (e.g., GASB, FASB, FASAB) or other regulatory bodies

Most audit committees devote some of their meeting time to their own education, selecting certain aspects of the government's internal controls, accounting principles, compliance requirements, and financial reporting requirements.This education may also address legal considerations and the impact of new nonfinancial laws and litigation.The audit committee's educational efforts may reveal areas and issues that should receive greater attention from them and from the governing body.

Establishing the Audit Committee

Charter and Bylaws

A written charter setting forth the duties and esponsibilities of the audit committee is recommended.The charter should be approved by the governing body and periodically reviewed and amended as necessary.

At a minimum, the charter should:

- State the mission or objectives of the audit committee
- Establish its authority
- Define its organization and methodology
- Identify how independent members are appointed
- Prescribe terms of members
- Establish voting and quorum requirements
- Establish liability indemnification
- Be goal-oriented and not be so detailed as to restrict the committee's scope of operations

The formation of audit committees does not relieve governing bodies of responsibility for matters considered by audit committees. In most entities, there are legal restrictions on what can be delegated to committees. The audit committee should use the responsibilities outlined in the charter to develop a responsibility checklist and meetings agenda that are designed to ensure that the provisions of the charter are executed in an appropriate and timely manner.

The bylaws establish the rules and procedures under which the audit committee operates.The bylaws should:

- Be adopted by the committee members themselves
- Guide how the audit committee will discharge its mission and decisionmaking authority
- Identify the specific activities of the committee and organization and who will control meetings
- Specify reporting and documentation requirements
- Set quorum and voting procedures

Exhibit 1 presents a sample audit committee charter and bylaws.

Committee Membership

Skills

Members of the audit committee should collectively have:

- Political, governing, and communication skills
- A knowledge of the needs, interests, and concerns of the constituency
- Accounting, financial reporting, and auditing expertise and experience
- Administrative experience that would allow the audit committee to be able to relate to the pressures and demands of the public finance officer and management

Usually, outside members are sought to have the technical expertise and experience. The audit committee should include a financial expert who is determined by the governing body to possess the following attributes:

- An understanding of financial statements and generally accepted accounting principles
- An ability to assess the general application of such principles in connection with the accounting of estimates, accruals, and reserves
- Experience preparing, auditing, and analyzing or evaluating financial statements
- An understanding of internal controls and procedures for financial reporting
- An understanding of audit committee functions

Qualities

Members should be vigilant and probing. They should be able and willing to ask the hard, penetrating questions sometimes necessary to discharge their oversight responsibility. They should also be able and willing to deal with controversial matters and make difficult comments and recommendations when necessary.

Number of members

Three to six members are usually recommended. The committee should be large enough to accommodate the breadth of skills and experience pertinent to local circumstances and yet not so large that dialogue and communication are restricted.

Terms

The terms of the members should be long enough to maintain continuity and provide an institutional memory but not so long that parochial interests intrude. It is important to maintain a uniform level of interest of the members and yet provide for new perspectives and fresh insight. Terms less than two years are too short and more than eight years are too long. Terms should also be staggered.

Chair and staff support

A chairperson should be designated either by the governing body or by the committee members. The chair is the focal point of communication with the committee and is responsible for the organization and proper flow of meetings.

Staff support should come from management, including an individual designated by the committee to maintain the minutes and records of the committee's activities.

Voting and quorum

Voting and quorum requirements should be established in the charter or bylaws and should seek to maintain the committee's independence. A majority of members should be required for conducting official meetings and casting votes.

It is also important to require the presence and participation of management and the auditors. The committee cannot operate effectively without their participation. Questions and comments of the committee can thereby be exchanged with the responsible individuals.

Section Six

Audit Committee Meetings

This section addresses some basic elements of audit committee meetings, such as the number to be held each year, agendas, suggested meeting types and topics, and minutes.

Number

Factors that determine the number of times an audit committee meets and what specifically needs to be discussed at each meeting include:

- The preparation, knowledge, and experience of the committee members
- The nature of the committee's specific responsibilities
- Characteristics of the jurisdiction, such as the complexity and size of operations
- Quality of the control environment

The average number of audit committee meetings is four per year. At a minimum, separate meetings should be held to discuss:

- Internal and external audit scope and plans
- Financial statements and disclosures
- Internal control and compliance results

Meetings are often open for public observation. This reinforces the appearance of independence of the committee and reinforces public confidence in the audit committee process. Nonpublic executive sessions should also be held with the internal and external auditors at least once per year.

Committee Agenda

One of the most important topics for the audit committee to consider is its own agenda in light of evolving public and governing body expectations and proposals. The committee may make recommendations to the governing body concerning matters that should come within its purview, be transferred to other committees, or be dealt with by the governing body as a whole.

The outside auditors' knowledge and experience give them a unique perspective and an obligation to advise the governing body on its oversight of financial matters.

The auditors may suggest topics for the audit committee's agenda based on current developments that affect the committee's duties or responsibilities.

Exhibit 2 presents a sample audit committee schedule and agenda. It presumes the committee requires five meetings each year and schedules the meetings to coincide with the financial reporting cycle, e.g.,March through February for June 30 fiscal year-end entities.

Audit Scope Meeting

The principal purpose of this meeting, which normally occurs before significant audit work has begun, is to approve the intended audit scope and plan. The meeting usually addresses the outside auditor's planned approach to the annual audit and may include a summary of critical dates and plans for engagement timing. It should also include important aspects of staffing, such as the competence and relevant expertise of individual members of the audit team.

To focus on important phases of the audit, it is helpful to have the auditor's engagement letter (or a written audit plan) in advance of the meeting.The engagement letter or audit plan summarizes the auditor's understanding of the terms and objectives of the engagement, including the estimated fees and the basis on which they are determined.

Topics covered should include:

- Issues affecting the planned scope of the audit, including financial and compliance risks
- Evaluation of management's identification of fraud risks
- The basis for determining audit scope, covering such matters as the audit process, financial reporting requirements,materiality levels, and adequacy of internal controls
- The audit scope for the current year, including the basis for selecting certain units for testing
- Areas subject to audit testing and how sampling is employed to arrive at the satisfactory level of confidence about the overall financial statements
- The coordination of the audit work with internal audit activities
- Other areas to be covered, such as audits of grants, contracts, and compliance with rules and regulations
- Issues from the prior year's engagement that bear on the current year's audit scope

Time will not permit the outside auditor to explain all details of the engagement, especially when the organization's operations are complex. Instead, some audit committees explore one phase of the audit in depth each year, most commonly by having the auditor explain the approach to auditing transactions processed through one of the major accounting cycles or systems. This indepth review allows committee members to understand more fully the major internal control systems and the audit methodology used. Exhibit 3 is a list of questions about audit scope that an audit committee might ask auditors. These questions, as well as those in later exhibits, are illustrative rather than comprehensive.

Another topic often discussed at this meeting is an overview of new developments in accounting and auditing. New standards that have been issued or proposed by the GASB, FASB, FASAB, GAO, or other regulatory agencies that would affect the organization should be discussed with the outside auditors or management and their impact considered.

Financial Statements Meeting

The audit committee's purpose at this meeting, usually held at the conclusion of the audit, is to approve formally the draft financial statements. The committee must ascertain whether the responsibilities of management for the preparation of the financial statements and of the outside auditor for attesting to the fair presentation of the financial statements have been effectively discharged.

Management should present the draft financial statements focusing on the major items disclosed in the statements or footnotes:

- Significant management judgments and estimates, such as estimates for judgments, claims, self-insurance liabilities, allowance for doubtful accounts, or pensions
- Trends or changing patterns
- Management's discussion and analysis (MD&A) section of the financial statementst
- Important changes in the format or account classifications
- Disclosure of commitments and contingencies

Exhibits 4 through 8 illustrate questions an audit committee might ask both management and the auditors about the financial statements and questions an audit committee might ask auditors about audit results.

The audit committee should devote significant attention to the disclosures in the footnotes to the financial statements and significant changes from the prior year. The discussion usually will begin with the organization's accounting policies. The committee should understand the reasons for a change in accounting principles or in methods of their application and assure itself of the concurrence of the outside auditors. The committee may also ask for a comparison of the organization's accounting methods with those of similar organizations.

Disclosures of commitments and contingencies is an area of significant interest. Committee members may challenge the disclosure of a contingency by asking whether it is sufficiently predictable to warrant its recording in the accounts. If not, the committee should ensure that the disclosure conveys the appropriate level of uncertainty.

The auditors will explain the nature of their report and the basis for any modifications or qualifications, which should have been communicated to the committee in advance of this meeting. The auditors also will discuss unexpected conditions that caused them to modify their audit approach and any other matters they believe the audit committee should know about the audit, the financial statements, the footnotes, and supplementary disclosures.

Auditors must follow certain professional standards with respect to communication to audit committees at the conclusion of an audit. In addition to the communication of items related to internal controls (see following section), an auditor should communicate the following matters:

Auditor's responsibility under generally accepted auditing standards and Government Auditing Standards, 2003 Revision

In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed for these matters under generally accepted auditing standards. It is also important for the audit committee to understand that an audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance about the fair presentation of the financial statements.

Significant accounting policies

The auditor should make sure that the audit committee is informed about the selection of and changes in significant accounting policies or their application. The auditor should also inform the audit committee about the methods used to account for unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

Management judgments and accounting estimates

The auditor should explain the process used by management in determining accounting estimates and the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Audit adjustments

The auditor should inform the audit committee about adjustments arising from the audit that could, either individually or in the aggregate, have a significant effect on the government's financial reporting process. An audit adjustment is a proposed correction to the financial statements that, in the auditor's judgment, may not have been detected except through the auditing procedures performed.

Other information in documents containing audited financial statements

The audit committee often considers information prepared by management that accompanies the government's financial statements. An example of this type of information is the transmittal letter or statistical section of a comprehensive annual financial report. The auditor should discuss with the audit committee the auditor's responsibility for other information in documents containing audited financial statements, any procedures performed, and the results. Committee members should focus on whether the supplemental disclosures are consistent with their own knowledge and understanding and are a reasonable portrayal of the government's operations and prospects.

Disagreements with management

Disagreements with management may occasionally arise over the application of accounting principles to a specific transaction or the basis for management's judgment about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the financial statements, and the wording of the auditor's report. The auditor should discuss with the audit committee any disagreements with management, whether or not they are satisfactorily resolved.

Difficulties encountered in performing the audit

The auditor should inform the audit committee of any serious difficulties encountered in the performance of the audit.This may include unreasonable delays in the commencement of the audit or in providing requested information and whether the timetable set by management was unreasonable under the circumstances. Other matters that the auditor may encounter include the availability of client personnel and the failure of client personnel to complete clientprepared schedules on a timely basis. If the auditor considers these matters significant, the audit committee should be informed..

In addition to the above, the auditor is required to communicate whether management consulted with other accountants with regard to accounting pronouncements or their applications and major issues management discussed with the auditor prior to the auditor's retention.

Internal Control and Compliance Meeting

The purpose of this meeting is to present the outside auditor's comments and recommendations concerning the organization's internal accounting, administrative, and compliance controls. Relatively minor deficiencies are usually not discussed with the audit committee, although summaries of such deficiencies may be provided to the committee through a letter from the auditors reporting their summary findings on internal control and compliance. Exhibit 9 lists questions an audit committee might ask auditors about internal controls and compliance.

In addition to the professional standards with respect to communication to audit committees at the conclusion of a financial statement audit, Government Auditing Standards, 2003 Revision imposes additional requirements relating to the scope of internal control and compliance work performed. The auditor is required to communicate the following to the individuals responsible for overseeing financial reporting:

- The auditor's responsibilities for testing internal controls and compliance with laws and regulations in a financial statement audit
- The nature of any additional testing of internal controls and compliance with laws and regulations
- The options for additional testing of internal controls and compliance through agreed-upon procedures or examination
- Possible weaknesses in internal controls of which auditors may be aware prior to undertaking the specific audit engagement
- The effect that possible weaknesses in internal controls could have on the accuracy and sufficiency of financial information used for management decisionmaking, safeguarding of assets, or compliance with laws and regulations

Internal control weaknesses constitute a condition in which the auditor believes the specific control procedures, or the degree of compliance with them, are not sufficient to achieve a relatively low risk that errors or irregularities would be presented or detected within a timely period by employees in the normal course of their assigned functions. Such conditions may be reported to the audit committee as a material weakness, a reportable condition, or another matter involving internal control over financial reporting.

In addition to the requirements of the Generally Accepted Auditing Standards (GAAS) and *Government Auditing Standards, 2003 Revision*, Circular A-133 requires the auditor to:

- Perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major federal programs
- Plan the testing of controls over compliance for major programs to support a low assessed level of control risk
- Perform testing of controls over compliance as planned
- Report on internal controls over compliance

The *GAO/PCIE Financial Audit Manual* has similar requirements.

The committee members should have a basic understanding of the organization's controls over compliance and review the findings and recommendations made by the independent auditor.

Other Meeting Topics

Other meetings may be held to consider.

- Activities and plans of the internal auditort
- Major lawsuits filed against the organization
- Significant changes in new accounting and auditing standards or other regulatory requirements
- Major organizational changes
- The audits of financial statements of related entities, such as major component units

- Events that raise questions about the integrity of a member of senior management
- Form and content requirements for Single Audit or Chief Financial Officers Act Audit reports
- Education of audit committee members on organizational matters or technical developments

Executive Sessions

Audit committees should meet with each of the major participants—outside auditors, internal auditors, and management—without the others present. In such a session, the committee may raise questions with each group to encourage candor.

An audit committee meeting with the outside auditors in closed session by no means indicates that management's or the auditor's credibility is in doubt or that management or the auditor is not meeting its responsibilities. To conduct their audit, the outside auditors must maintain an open and candid relationship with management. Their obligation to discuss sensitive matters with the governing body need not override this. Management and the auditors must use good judgment and tact to avoid misunderstandings.

Committee members should determine whether:

- The auditor received the full cooperation of management
- Management was satisfied with the competence of the auditors and the timing and scheduling of audit work
- Any weaknesses in controls or inefficiencies occurred that could not be brought to the committee's attention in the presence of management
- The auditor believes that management is knowledgeable, conscientious, and competent
- Any instances of errors, irregularities, or illegal acts occurred that the auditor could not discuss in the presence of management

Minutes

Minutes are the formal record of the committee's activities and are a source of input for the committee's annual report. hey should therefore include:

- A copy of the meeting agenda
- The date, attendance, and location of the meeting
- A brief discussion of the salient topics discussed; a transcript of the committee meeting is not necessary
- Transcript of formal resolutions
- Copies of materials discussed or presented at the meeting
- Identification of the end of the minutes and meeting adjournment

These minutes should be circulated to the members who were in attendance for their comments and corrections. Corrected minutes should be formally approved by the committee no later than the following meeting and be signed by the committee secretary. In this manner, the approved minutes will reflect the consensus of the members rather than the recollections of one or more individuals.

Section Seven

Audit Committee Duties

Previous chapters have provided an overview of the principal committee activities and discussed key topics that should be covered at each meeting. This chapter provides further guidance for the committee in the areas of selection of independent auditors, audit scope assessment, and the review of the audit results.

Selection of Independent Auditors

The audit committee may be empowered by the governing body to select the outside auditors or, as is more often the case, to recommend an independent audit firm to the full governing body, which formally approves the selection. In its evaluation, the audit committee should consider a firm's:

- Independence
- Reputation
- Range of services
- Persons who would be responsible for the services provided to the entity and their experience with public sector and Single Audits
- Level of public sector and other relevant technical expertise
- Ability to serve the entity's geographic location
- Quality control standards, including reports on recent peer reviews
- Fee estimates

The GAO in its report *"CPA Audit Quality: A Framework for Procuring Audit Services"* also recommends, regarding audit procurement, that the audit committee:

- Participate in the entity's procurement process, including planning the procurement and identifying and evaluating potential bidders
- Participate in evaluating audit firms using preestablished technical factors
- Provide active oversight of the entity's procurement process

When considering the annual reappointment of the existing auditors, in addition to evaluating the foregoing factors, the audit committee should review:

- Quality of services rendered
- Efficiency and effectiveness achieved in the audit and other services
- Benefits obtained from recommendations for improvements
- Overall strength of the relationship

This evaluation is based partly on the interaction between the outside auditors and the committee, but it is principally dependent on an assessment by management. In making its evaluation, the audit committee must remain cognizant of the AICPA and GAO requirements dealing with auditors' independence on an ongoing basis, not just in conjunction with an initial appointment.

An occasional practice in the public sector arena is mandatory rotation of the independent audit firm. Although there is a perceived benefit to the governmental entity of this practice, in reality there is no credible evidence that mandatory auditor rotation improves audit quality or reduces fees. In fact, the risk of audit failure increases with each change of auditors. Audit quality suffers when a new auditor is unfamiliar with a client's business and specific operations.

The AICPA has indicated that mandatory audit firm rotation is not necessary or appropriate for the following reasons:

- Audits are strengthened by institutional continuity. It is a significant benefit to be well acquainted with a client's business, operations, and controls.
- Audit firm rotation is disruptive and time-consuming and increases overall audit costs.
- Key individuals involved in the audit process—audit firm personnel, client management, and audit committee members—all typically change in the normal course of events.
- Audit committees are in the best position to evaluate the desirability of changing auditors.

Growing public expectations, regulatory changes, and recent professional initiatives have served to improve the auditing and financial reporting processes as well as to create an environment for ongoing improvement without the undesirable consequences of mandatory rotation.

Another reason cited for rotation of audit firms is to ensure independence from management. An active, diligent audit committee does far more to ensure auditor independence than a policy of mandatory rotation. Exhibit 10 lists questions an audit committee might ask in assessing the qualifications of independent accountants.

Audit Scope Assessment

Some determinants of audit scope include key areas of control and compliance risk, adequacy of the entity's internal controls, and controls to ensure compliance with laws and regulations and financial reporting requirements. Committee members may want to discuss:

- Allocation of audit procedures among the entity's units
- Significant transaction cycles
- Significant controls over compliance with laws and regulations
- Individual financial statement balances or disclosures
- Nature of audit tests
- Extent of reliance on internal controls
- Materiality levels
- Levels of assurance obtained

Viewing the audit in terms of a conceptual model may be helpful to the audit committee. In reviewing the audit scope, the audit committee typically considers:

- External financial reporting requirements
- Accounting policies followed by the jurisdiction
- Organizational, operational, and compliance considerations (including their impact on processing and interpreting accounting information)
- Requirements and needs of financial information users (citizen groups, investors and creditors, the GAO, cognizant agencies, and other regulatory bodies)

The audit committee's objective is satisfaction that the scope of the audit contemplated by the outside auditor adequately considers the important reporting needs and questions.

The committee may also request the outside auditors to perform special or supplementary reviews of certain control and compliance areas not required for audit purposes. Such reviews help monitor compliance with specific organizational policies and objectives. Outside auditors might, for example, review an operational unit's purchasing practices for compliance with organizational policy. Ordinarily, additional reviews are considered along with the audit requirements in order to integrate them into the audit logistics efficiently.The committee members should have a basic understanding of the organization's controls over compliance and review the findings and recommendations made by the independent auditor.

Audit Results Review

Understanding the issues

Audit committees acquire the knowledge they need to review the results of the audit by:

- Reading the financial statements, the comprehensive annual financial report, and other reports
- Briefings from management and the independent auditors on the impact of accounting principles important to the entity
- Reading financial press and newsletters prepared by accounting firms and public sector professional organizations that summarize new accounting, auditing, and regulatory compliance developments

Once the issues are understood, audit committee members can define their specific information needs and obtain explanations from management, the independent auditors, and the internal auditors and isolate the sensitive areas requiring in-depth attention. They then can devote time to obtaining a more thorough understanding of the issues in sensitive or important areas and to discussing the way these issues should be handled.

Internal control and compliance

The audit committee should:

- Review the auditors' reports on internal control and compliance with laws and regulations
- Determine whether material weaknesses, reportable conditions, or other findings were reported
- Fully understand the reasons underlying any reportable conditions,material weaknesses, findings of noncompliance, and questioned costs (Even when the scope of the audit did not include reports on internal control and compliance with laws and regulations, the audit committee should satisfy itself that management maintains appropriate internal controls by making inquiries of the auditor.)
- Review the management letter of recommendations in which suggestions for improvement to internal controls are made (The committee should fully understand the issues raised and the related recommendations; the committee should also satisfy itself that management is diligent in following up and correcting previously identified weaknesses in internal control and instances of noncompliance.)

If an agreed-upon procedures engagement was performed in accordance with Statements on Standards for Attestation Engagements (SSAE) No. 3, Compliance Attestation, in which management provides written assertions about the entity's compliance with specified requirements or the effectiveness of the entity's internal control structure, the audit committee should obtain management's assertions, which should be reviewed and fully understood by the audit committee. The assertions and the criteria used to measure the assertions should be reviewed and fully understood by the audit committee. The criteria used must be established by a recognized body or stated in the assertion in a sufficiently clear and comprehensive manner for a knowledgeable reader to understand it.Management's assertions must be capable of measurement using such criteria..

Annual report

A primary responsibility of the audit committee is to review the financial statements and, if appropriate, the comprehensive annual financial report and the underlying audit results with management and the outside auditors. This review considers:

- Reasons for nonstandard audit opinion
- Changes in accounting policies or principles during the year
- Important differences in financial accounting and reporting compared with other organizations
- Significant areas of judgment in the financial statements, such as receivables collectibility and other accounting estimates
- Unusual or significant commitments or contingencies
- Material noncompliance with laws, regulations, and grant provisions
- Significant accounting and auditing problems encountered during the audit, including differences of opinion or disagreements between management and the auditors
- Unexpected adjustments or additional disclosures proposed by the outside auditors
- Changes in report format or the nature of footnote disclosures from the prior year's financial statements

Oversight of Internal Audit

The internal audit function is an important element in providing assurance to an organization that its internal controls are adequate and functioning properly. Internal audit activities should be focused to address the risks of loss of financial resources, instances of noncompliance, or other control risks. Examples of areas on which internal audit might focus are:

- Risk assessment as it relates to risk of misappropriation of assets due to fraud
- Internal control reviews
- Independent audits of various accounts and financial activity
- Federal program compliance reviews
- Accounting policy compliance reviews
- Operational reviews and special projects
- Performance audits

The audit committee should maintain direct oversight of the internal audit function. Responsibilities may include:

- Ensuring that the internal auditor has direct access to the audit committee
- Reviewing the risk assessment prepared by internal audit or an outside party
- Identifying areas of organizational risk or concern
- Reviewing and approving the annual internal audit plan
- Reviewing and taking action on internal audit reports
- Ensuring that management is addressing issues raised in internal audit reports
- Assessing the organizational structure, qualifications, and staffing of the internal audit function
- Assessing the effectiveness of the internal audit function
- Periodically reviewing with the internal audit director any significant difficulties, disagreements with management, or scope restrictions encountered in the course of the function's work

Audit Committee Relationships

The roles and responsibilities of the audit committee, management, internal auditors, and outside auditors are so interrelated that open lines of communication are important. Careful planning and coordination are characteristics of an effective audit committee.

Interaction With Outside Auditors

Independent accountants are required by generally accepted auditing standards and by *Government Auditing Standards* to bring certain matters to the attention of the governing body and audit committee.

Where an audit committee exists, it is the appropriate vehicle for auditor-governing body communications. Audit committees may properly view the outside auditors as a fact-finding arm and as surrogates in making evaluations requiring accounting and auditing expertise.

See Exhibits 3-9 for a sample of questions an audit committee might ask the outside auditor.

The outside auditor has to be sensitive and alert to the needs of the audit committee:

- The importance of issues varies from organization to organization.
- In cases where committee discussion is necessary, issues presented to the committee should be simplified to their essence.

Auditors should also be sensitive to the needs of management:

- Matters should be discussed with management prior to presentation to the committee..
- A written report to the audit committee highlighting the subjects to be raised at any meeting should be prepared by the auditors and distributed to management beforehand.

Interaction With Internal Auditors

Most audit committees regularly review the internal audit function as a part of their consideration of internal accounting control and operating efficiency, anticipating that the internal auditors will cover areas not included in the outside auditors' scope.

Many organizations have taken steps to ensure that the director of internal audit has access to the governing body through its audit committee on both a scheduled and as-needed basis and that management hierarchy does not hamper internal audit effectiveness. Ordinarily, much of this liaison is achieved by having the director of internal audit present at all regular audit committee meetings and by having a report on internal audit activities and scope presented at those meetings.

The Treadway Commission recommends that the chief internal auditor should:

- Have direct and unrestricted access to the audit committee.
- Meet privately with the committee on a regular basis.
- Attend all audit committee meetings.
- Report to the committee at regular intervals on the activities of the internal audit function.

Interaction With Management

By defining the respective roles of management and the audit committee from the beginning, unnecessary strains may be prevented.Management deals with the daily conduct of business; the audit committee serves in an oversight role.

Where a difference of opinion exists, the audit committee should inform management of its position; if management still disagrees, the full governing body could act as a forum for discussion. In short, keeping communication lines open between management and the committee is good practice.

For management to perform efficiently, the committee should not be a part of either the operational or managerial decisionmaking process. It should, of course, review management decisions about internal controls, compliance, and other matters within its scope. But when it becomes part of the decisionmaking process, it intrudes into the areas of management and loses its value. In its role as overseer, the audit committee is an outside function valued for its objectivity and independence.

Auditor, Management, and Committee Relations

To reduce the likelihood of misunderstandings among outside auditors, internal auditors, and management, the parties should be guided primarily by common sense and discretion.Techniques that can be employed include the following:

- The auditors should make certain that they have the relevant facts. For example, indications that an irregularity may exist or that a member of management may have acted improperly do not automatically indict management or impugn its integrity. But such indications do require a thorough examination by the auditors and a discussion with the audit committee.
- An expressed preference by management to adopt an accounting method that appears inappropriate to the auditors does not become a formal disagreement until the auditor and management agree on all the facts. But, when such a disagreement occurs on a material accounting, auditing, or reporting issue, the auditors are obliged to bring this to the attention of the audit committee.
- In view of their potentially sensitive nature, disagreements should be clarified with the facts and with the positions of both management and the outside auditors. These matters should be discussed with management in advance of meeting with the committee to enable management and the auditor to consider the issues fully. While such discussions do not compel the auditors to change their views, they can prevent damage to the mutual trust and candor essential between the auditors and management. Certain matters that the auditors feel should be brought to the attention of the audit committee fall squarely within the province of management, and it may be better for management to raise the topic with the audit committee.
- Representatives of the audit firm and management should discuss in advance all the items on the audit committee's meeting agenda, including the general thrust of the comments that both the auditors and management plan to make, the questions the committee is expected to raise, and the intended responses.

Audit Committee Annual Report and Chairperson's Letter

The culmination of the committee's activities each year should be the preparation and transmittal of an annual report to the governing body.The report should identify how the committee discharged its charter responsibilities and should be addressed to the full governing body. Significant accounting, internal control, or compliance issues considered by the committee should be presented and the committee opinion, advice, or recommendations disclosed.Dissent should also be presented.

The annual report of the audit committee should include:

- Identification of the authority and responsibility of the audit committee
- Discussion of its review of the financial statements and comprehensive annual financial report
- Discussion of its review of the auditor's management letter, internal control, and compliance
- Discussion of its review of component unit financial statements and auditors' reports on internal control and compliance

- Review of accounting issues that arose
- Description of its relationship with management, internal auditor, external auditor, and governing body

Further, the entity's comprehensive annual financial report should include the chairperson's letter reporting on the committee's responsibilities and activities for the period. The Treadway Commission recommends such a letter in order to make the audit committee more visible and improve communications to the public.The letter also reinforces the audit committee members' awareness and acceptance of their charter responsibilities.The Treadway Commission recommends that the letter include discussion of.

- The composition and authority of the audit committee
- The identification and affiliation of the audit committee members
- The audit committee's purpose, objectives, and responsibilities
- The activities of the audit committee during the period, including such matters as the number of meetings held and the significant topics discussed with management, internal auditors, and independent public accountant

An example of the chairperson's letter is included as **Exhibit 11.**

Appendix & Exhibits

Appendix

Sarbanes-Oxley Act of 2002

While the Sarbanes-Oxley Act of 2002 (the Act) does not apply to public sector organizations, the reforms enacted by the Act represent a codification of many practices that were already present, as well as many new forward-thinking means of protecting investor interests. For this reason, audit committees of public sector entities should take the requirements included in the Act into consideration.

The following is a summary of the requirements of the Act as it relates to audit committees:

- The audit committee comprises directors who meet the independence requirements of the Act.
- One member of the audit committee is a financial expert.
- The audit committee has the authority to engage independent counsel and other advisors as it deems appropriate.
  - Appointment
  - Compensation
  - Review of performance
  - Removal, if appropriate
  - Resolutions of disagreements with management
  - Review of any audit problems or difficulties and management's response
- The audit committee should hold timely discussions with the independent auditor regarding:
  - All critical accounting policies and practices
  - All alternative treatments of financial information within GAAP that have been discussed with management, ramifications of the use of such alternative disclosure and treatments, and the treatment preferred by the independent auditor
  - Other material written communications between the independent auditor and management, including the management letter and schedule of unadjusted differences
- The audit committee has the responsibility to review:
  - Certifications by management
  - Management's report on internal controls and the independent auditor's attestation on management's assertionsr
- The audit committee has established and maintains procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting, or auditing matters.
- The audit committee has established and maintains procedures for the confidential, anonymous submission by employees regarding questionable accounting or auditing matters.

Exhibit 1

Sample Audit Committe Charter

The Governing Body hereby constitutes and establishes and audit committee.

Composition

The committee shall be composed of five members appointed by the Governing Body, three of whom are members of the Governing Body and two of whom are outside members. All five members should be independent of management and the independent auditor.The members' terms shall be three years and staggered so that the committee annually includes a new member and members with one and two years of service.The majority of the members of the committee shall have a basic understanding of finance and accounting.The chairman of the committee will have accounting or related financial management expertise and will be appointed by the Governing Body.

Authority and Responsibility

The audit committee is to serve as a focal point for communication between the Governing Body, the independent auditor, the internal auditor, and management.The audit committee is to assist the Governing Body in fulfilling its responsibilities as to accounting policies and reporting practices of the Entity and sufficiency of auditing relative thereto. It is to be the Governing Body's principal agent in ensuring the independence of the Entity's independent auditors, the integrity of management, and the adequacy of disclosures to the public. The opportunity of the independent auditors to meet with the entire Governing Body as needed, however, is not to be restricted.The committee shall oversee and advise the Governing Body and management on the selection of independent auditors.

Sample Audit Committe Bylaws

The audit committee of the Entity was established by charter approved by the Governing Body on [date].The committee's operational guidelines are set down herein and may be amended, after consultation with the Governing Body, by a majority vote of the independent members. The authority and responsibility of the audit committee and the appointment and terms of members are designated in the charter and are incorporated herein by reference.

Meetings

The audit committee is to meet at least

three times per year and as many times as

the committee deems necessary..

Attendance

Members of the audit committee are to be present at all meetings. As necessary or desirable, the chairman may request that members of management, the director of internal audit, and representatives of the independent auditor be present at a meeting of the committee. Three out of five members should be present to have a quorum.

Specific Duties

Financial Reporting

The audit committee is to:

1 Review with management, the independent auditor, and director of internal audit the Entity's policies and procedures to reasonably ensure the adequacy of internal controls over accounting, administration, compliance with laws and regulations, and financial reporting.

2 Have familiarity, through the individual efforts of its members, with the accounting and reporting principles and practices applied by the Entity in preparing its financial statements. Further, the committee is to make, or cause to be made, all necessary inquiries of management and the independent auditor concerning established standards of conduct and performance, and deviations therefrom.

3 Review, prior to the start of the annual audit, the scope and general extent of the independent auditor's planned examination, including its engagement letter. The auditor's fees are to be arranged with management and summarized annually for committee review. The committee's review should entail an understanding from the independent auditor of the factors considered by the auditor in determining the audit scope, including:

- Risk characteristics of the Entity
- External reporting requirements
- Materiality of the various segments of the Entity's combined activites
- Quality of internal accounting, administrative, and compliance controls
- Exttent of the internal auditor's involvement in audit examination
- Other areas to be covered during the audit engagement

4 Review with management, the independent auditor, and director of internal audit the Entity's policies and procedures to reasonably ensure the adequacy of internal controls over accounting, administration, compliance with laws and regulations, and financial reporting.

- Review with management the extent of non-audit services planned to be provided by the independent auditor in relation to the objectivity and independence needed in the audit.

5 Review with management and the independent auditor instances where management has obtained "second opinions" on accounting and financial reporting policies from other accountants.

6 Review with management and the independent auditor, upon completion of its audit, financial results for the year prior to their release to the public.

The audit committee's review is to encompass the Entity's annual financial report, including the financial statements and footnote disclosures and supplemental disclosures required by generally accepted accounting principles, including:

- Significant transactions not a normal part of the Entity's operations
- Selection of and changes, if any, during the year in the Entity's accounting principles or their application
- Significant adjustments proposed by the independent auditor
- The process used by management in formulating accounting estimates and the independent auditor's conclusions regarding the reasonableness of those estimates
- Any disagreements between the independent auditor and management about matters that could be significant to the Entity's financial statements or the auditor's report
- Difficulties encountered in performance of the audit
- Management consultation with other accountants with respect to accounting policies or their applications
- Major issues discussed between auditor and management prior to retention of auditor

The audit committee shall also:

1. Evaluate the cooperation received by the independent auditor during its audit, including its access to all requested records, data, and information. Also, elicit the comments of management regarding the responsiveness of the independent auditor to the Entity's needs. Inquire of the independent auditor whether there have been any disagreements with management that, if not satisfactorily resolved,would have caused the independent auditor to issue a nonstandard report on the Entity's financial statements.
2. Discuss with the independent auditor the quality of the Entity's financial and accounting process and any recommendations that the independent auditor may have.Topics to be considered during this discussion include improving internal financial controls, controls over compliance with laws and regulations, the selection of accounting principles, and management reporting systems.
3. Review written responses of management to "letter of comments and recommendations" from the independent auditor and discuss with management the status of implementation of prior-period recommendations and corrective action plans.
4. Discuss with management the scope and quality of internal accounting, administrative, compliance, and financial reporting controls in effect.
5. Apprise the Governing Body, through minutes and special presentations as necessary, of significant developments in the course of performing the above duties.
6. Recommend to the Governing Body any appropriate extensions or changes in the duties of the committee.
7. Recommend to the Governing Body the retention of the independent auditor..
8. Perform all of the above duties wherever appropriate relative to the Entity's component units. The committee may satisfy this duty by relying on the work of a component unit's audit committee.
9. Report annually to the Governing Body on the discharge of these responsibilities.

System of Internal Controls

The audit committee is to:

1. Review Entity's process for assessing significant risks or exposures and the steps management has taken to minimize such risks.
2. Consider and review with management and the independent auditors:
   - The effectiveness of, or weaknesses in, the Entity's internal controls, including the status and adequacy of management information systems and other information and security, the overall control environment, and accounting and financial controls
   - Any related significant findings and recommendations of the independent accountants, together with management's response thereto, including the timetable for implementation of recommendations to correct weaknesses in internal controls
3. Review internal processes for determining and managing key financial statement risk areas.
4. Review the Entity's process for determining risks and exposures from asserted and unasserted litigation and claims and from noncompliance with laws and regulations.

Ethics

Certain audit committees extend their responsibilities to cover ethics issues for an entity. The following are example responsibilities for an audit committee as they relate to ethics:

1. Ensure the existence of and approve for recommendation to the Governing Body policies and procedures regarding compliance with the law and with significant Entity policies, including, but not limited to, (a) code of conduct expressing principles of business ethics, including conflicts of interest; (b) legal compliance; (c) environmental, health, and safety issues; (d) outside affiliation statements; and (e) other matters relating to business conduct and programs of legal compliance designed to prevent and detect violations of laws, rules, regulations, and guidelines. The chairman of the audit committee shall act as a publicized conduit for receiving ethics concerns.

Exhibit 2

Sample Audit Committe Charter
(for an entity with a June 30 fiscal year-end)

March

- First meeting of the committee year
- Elect chair and secretary, if necessary
- Adopt and/or modify bylaws as needed
- Consider selection or reappointment of independent auditors for the next fiscal year
- Consider potential independence issues
- Develop a workplan, meeting schedule, and tentative agenda for the ensuing year
- Identify potential problem areas or accounting issues that may arise during the year and identify areas for specific and detailed discussion

June

- Review and approve minutes of prior meeting
- Review and comment on the audit plan and scope
- Review the internal auditor's follow-up on the status of prior year's auditor comments and recommendations
- Discuss any significant deficiencies in internal control.
- Discuss any knowledge of instances fraud
- Determine the appropriateness of disclosures in drafts of all publicly disseminated information and reports

September

- Review and approve minutes of the prior meeting
- Review the progress of the audit, interim auditor's letters or suggestions to management, accounting issues that arose, and other relevant topics
- Review draft financial statements and annual report of the Entity and component units
- Review a draft of the auditor's report

November

- Review and approve minutes of the prior meeting
- Review auditor's management letters and management's corrective action plans for the Entity and component units (a review of the minutes or reports of component unit's audit committees might be substituted)
- Review auditor's reports on internal controls and compliance with laws and regulations
- Review the annual report of the internal auditor.
- Hold an executive session with the independent auditor without management and others present

February

- Review and approve minutes of prior meeting
- Review audit committee annual report
- Prepare an open items list for next committee year

Exhibit 3

Questions an Audit Committee Might Ask Auditors About Audit Scope

1 Have all of the Entity's units been considered in formulating your planned audit scope? If not, which ones were excluded, and why?

2 Where you rely on the work of other firms, have you participated in setting the scope of their work? How will you satisfy yourselves as to the scope's adequacy?

3 Has management restricted, or attempted to restrict, your audit scope in any way?

4 Did you plan an audit scope significantly different from last year's? Did you plan significant modifications this year in the nature and extent of procedures to be performed in any major agencies or functions?

5 Have you identified possible changes in the character of the Entity's activities? How have they affected your audit approach or scope?

6 To what extent will you rely on the Entity's systems of internal accounting, administrative, and compliance controls in conducting your examinations?

7 Which techniques and approach do you plan to employ with respect to data processing systems?

8 How do you plan to collaborate with the internal audit department in your audit approach?

9 Are there any areas in which additional Entity assistance could significantly reduce the planned extent of your work?.

10 Are there changes in accounting principles or auditing standards that affected your audit approach or scope?

11 Explain how your audit would uncover any material defalcations or fraudulent financial reporting, questionable payments, or violations of laws or regulations.

12 Which areas of the audit deserve special attention by the audit committee, and why?

13 Address issues of audit staffing such as the number of hours and experience of individuals, etc.

Exhibit 4

Questions an Audit Committee Might Ask About Financial Statements in General

1 How do the Entity's reporting practices and disclosures compare to those of other jurisdictions?

2 Have there been any significant changes in the Entity's accounting practices during the year?

3 Are all of the Entity's accounting practices in accordance with generally accepted accounting principles? Where alternative principles are available, which ones are being used by the Entity? What would be the impact of using the other available choices?

4 Are the Entity's accounting practices appropriate for its specific needs? Are they consistent with other government practices?

5 Were there any unusual items that significantly affected operating results for the year?

6 Are any of the Entity's units operating at a deficit?

7 Were there any important or unusual transactions with component units or other organizations?

8 Are there any new or proposed GASB, FASB, or FASAB statements or Single Audit requirements that will materially affect the Entity's accounting or reporting methods or reported results of operations and financial position in the near future? Has there been full compliance with existing statements and requirements?

9 Were there any disagreements between management and the auditors about accounting, auditing, or reporting matters?

10 Are there any changes in the financial statements from those of the prior year regarding format or the nature of the disclosures in the notes? What are the reasons for any changes?

11 Who has primary responsibility for preparing draft financial statements and note disclosures?

Exhibit 5

Questions an Audit Committee Might Ask About Assets

1 For what periods are the Entity's time deposits committed? What are the Entity's compensating balance requirements? Are deposits and investments adequately collateralized?

2 Has the Entity complied with the investment reporting and disclosures of GASB (FASB or FASAB, when applicable) accounting standards? What is the level of custodial risk category for the Entity's deposits and investments? Has the entity complied with the internal investment policy?

3 What is the average age of receivables compared to a year ago, and how is that change explained? Is the Entity following an appropriate billing and collection policy? Are there large individual amounts where collectibility is in question? Are there receivables from governing body members, management, or other employees?

4 Are there adequate physical controls over inventory? Are inventory levels reasonable?

5 What is the composition of interfund receivables and payables? How has this changed during the year?

6 Are all interfund receivable balances current and collectible?

7 Are capital assets, including infrastructure, adequately accounted for? Has maintenance of capital assets been deferred?

8 Are there non-operating capital assets or idle facilities? Why have they been retained?

9 Has the decision to utilize depreciation accounting or the "modified approach" for each infrastructure asset been adequately explained to the audit committee?

Exhibit 6

Questions an Audit Committee Might Ask About Liabilities and Net Assets/Fund Balances

1. Has the Entity complied with financially related debt indenture covenants, or have waivers been required?
2. Are there any contingencies of a legal or other nature in which the appropriate treatment is in doubt or which might significantly affect the Entity's financial position?
3. Has the Entity made any unusual commitments, such as the purchase of inventories or the acquisition or construction of capital assets? Is the Entity's capital budgeting system adequate?
4. What is the relationship between the Entity's funding of pension plans and the accounting provisions charged against operations? Has the Entity obtained an actuarial valuation of the pension plan? What were the results and what were significant changes since the prior actuarial valuation?
5. Are vendors paid on time?
6. What is the composition and basis for estimating the Entity's judgments and claims liability? How has it changed from prior periods?
7. Does the entity have postemployment benefits not reported in the financial statements?
8. What is the nature of the Entity's restricted, unrestricted, and/or net assets invested in capital, net of related debt?
9. What funds report deficits, and are management plans to eliminate those deficits adequate?

Exhibit 7

Questions an Audit Committee Might Ask About Revenues and Expenses/Expenditures

1. Were there any changes in the current year in the basis or method of accounting for revenue or expenses/expenditures?
2. Were there any significant changes in the trend or pattern of revenue and expenses/expenditures?
3. Were there any significant variations from the budget or from prior period results in revenue or expenses/expenditures?
4. Are receipts deposited timely?
5. Are revenues and expenses/expenditures accounted for in the appropriate fund?
6. Were all interfund transactions properly authorized?

Exhibit 8

Questions an Audit Committee Might Ask About Audit Results

1. Did management attempt to or actually restrict your work in any way?
2. Were Entity personnel cooperative?
3. Why and in what specific ways was your audit approach modified from the plan you discussed with us?
4. Will your report be nonstandard in any respect?
5. Did any irregularities come to your attention during the course of your audit? If so, how were they resolved?
6. What is your opinion about the quality of the accounting and financial staff?
7. Were any important internal control or compliance deficiencies encountered?
8. Did your audit discover material adjustments to be made?
9. Did you propose adjustments that management declined to record?

Exhibit 9

Questions an Audit Committee Might Ask About Internal Controls and Compliance

1. Have you found any material weaknesses or reportable conditions in internal accounting controls or compliance?
2. Have you found other matters in the system of internal accounting, administrative, or compliance controls that call for correction?
3. Has management taken appropriate and timely action in response to comments and recommendations you have made in the past?
4. Have you modified your planned audit approach based on the results of your tests of the internal accounting, administrative, and compliance control system?
5. Is the internal audit function adequately staffed and organized? Is its quality control system adequate and are its operations in accordance with professional standards?
6. What activities would you recommend that the audit committee undertake in its oversight of internal control and compliance?
7. In your judgment, has the Entity succeeded in creating an environment conducive to achieving the objectives of internal control and compliance?
8. Does the system in place provide reasonable assurance that errors and conditions contrary to policy, law, and regulation are reported?
9. Have you found any compliance exceptions with laws and regulations that could have a material effect on the Entity's financial statements?
10. Does management do an adequate job of correcting reported exceptions?
11. During the course of your examination, did any conditions come to your attention that may warrant in-depth investigation by management, the internal auditors, or the audit committee?
12. What are the critical internal control and compliance areas that warrant the attention of the audit committee? Why are they important?

13 What is your impression of the quality of the long-range planning and budgetary controls employed by the Entity?

14 Does the Entity control its electronic data processing operations effectively, especially regarding microcomputer use and access? Are controls adequate to ensure the integrity of computer-accessible data?

15 Is the Entity's policies and procedures manual adequate? Is it maintained on a current basis?

16 Are Entity policies and procedures regarding conflicts of interest adequate?

17 Are you aware of any instance where management has exceeded its authority in any matters prescribed by the law or failed to comply with any resolution of the Governing Body?

Exhibit 10

Questions an Audit Committee Might Ask in Assessing an Auditor's Qualifications

Questions Addressed to Auditors

1 When was the last time your firm received a peer review, and what was the nature of the report rendered? Have you recently been subject to a federal quality control review? If so, what was the result of the review?

2 Is your firm independent of the Entity's component units?

3 What is your policy on rotation of audit partners? Other personnel?

4 What are the qualifications of your firm in the public sector, of the partner who would be in charge of the engagement, and of the staff who will be assigned to the engagement?

5 What type of support services, such as newsletters, public sector programs, and information, can your firm provide?

6 What type of special continuing education programs does your firm have in relation to the public sector?

7 Do the individuals responsible for planning, directing, and conducting substantial parts of the fieldwork or reporting on the government environment and government auditing meet the GAO standards for specialized continuing education in subjects directly related to the government?

8 Do you regularly furnish suggestions for improvements in control, compliance, and operational efficiencies?

9 What is the range of your management and other consulting services? How do you ensure independence with respect to these services?

10 How are your fees determined, and how do you achieve efficiencies and still maintain your quality standards?

11 Does your firm perform quality control reviews of internal audit organizations?

Questions Addressed to Management

1 Have the auditors been responsive on a timely basis to requests for assistance and have they met preestablished deadlines?

2 Are the auditors sensitive to your organizational structure and do they communicate their observations, findings, recommendations, and criticisms to the appropriate management levels?

3 What is your assessment of the level of the auditor's understanding of the Entity and the technical quality of the auditor's services?

4 Do the auditors appear to manage their work effectively to avoid unnecessary time charges?

5 Does the audit partner devote sufficient time to the engagement?

Exhibit 11

Sample Audit Committee Chairperson's Letter

The Audit Committee was created in [year] by Governing Body resolution XXX. The committee performs a role comparable to that of an independent audit committee of a publicly held company and assists the Governing Body in fulfilling its responsibilities as to accounting and financial reporting of the Entity.

Membership is composed of five members appointed by the Governing Body, three of whom are members of the Governing Body; two of whom are outside members; all of whom are independent of Entity management and the Entity's independent auditor.

The committee members are:

- Governing Body members:
  - Honorable John Doe, Chairperson
  - Honorable [Name]
  - Honorable [Name]
- Independent members:
  - [Name]
    Affiliated with
  - [Name]
    Affiliated with

Five meetings were held during fiscal year XXXX.

The firm of XXX was recommended to and approved by the Governing Body as the Entity's independent auditor for the year ended XXX.

The Committee carefully reviewed with the Entity's internal auditor and the independent auditor the overall scope and specific plans for audit and monitored the progress of the audits. Based on a representation from the independent auditors and this review, the Committee is satisfied that the audits were made in accordance with generally accepted auditing standards and that the financial statements are presented in conformity with generally accepted accounting principles without qualification.

The Committee also met with the independent auditor, without management present, to discuss the results of the audit and its evaluation of the Entity's internal accounting, administrative, and compliance controls; management letters were also reviewed. The independent auditor reported that no material weaknesses or instances of noncompliance were found and that recommendations for improvement have been generally implemented or accepted by management in a constructive spirit.

The Committee was available for consultation and advice regarding accounting and auditing issues that may have arisen in the course of the audit.There were no significant accounting or auditing issues discussed for the year ended XXX.

The Committee congratulates Mr./Ms. XXX, director of Finance and Accounting, and his/her staff on being awarded the Government Finance Officers Association's Certificate of Achievement for Excellence in Financial Reporting for the Entity's Comprehensive Annual Financial Report for the year ended XXX.The Committee also reviewed and evaluated the financial statements and auditor's management letter of the Entity's component units. In certain instances, the Committee met with the management and the independent auditors of the various component units and also reviewed the oversight provided by the audit committees of the component units.The Committee is satisfied that the auditors of the component units were independent, the financial statements were presented in accordance with generally accepted accounting principles, and the audits were conducted in accordance with generally accepted auditing standards.

The activities of the Committee for the fiscal year ended XXX are discussed fully in the Committee's annual report dated XXX.

Sincerely,

John Doe, Chairperson

Audit Committee

Notes

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Over the years, we have developed a positive track record and reputation far exceeding our client expectations in this challenging arena, for some of the following reasons:

Responsiveness—We understand the governmental environment and furnish services that respond to each client's specific needs.

Resources—Our large team of experienced local and national professionals is dedicated to serving the unique needs of the public sector industry.

Clients—Our experience with a broad and diverse range of prestigious clients, including some of the largest public sector entities in the world, gives us valuable perspective and insights.

Versatility—Deloitte & Touche is home to specialists from all disciplines, from auditing and accounting and tax to employee benefits and information technology consulting. Our skills and capabilities are extensive, allowing us to do more for our clients.

If you have any questions with regards to this booklet, please contact your lead client service partner, listed on the first page, or an office in your area.

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