2011

AICPA audit committee toolkit : government organizations, 2nd edition

American Institute of Certified Public Accountants. Audit Committee Effectiveness Center

CNA Financial Corporation

Audit Committee Effectiveness Center

In cooperation with CNA

The primary mission of the AICPA's Audit Committee Effectiveness Center is to improve audit committee performance to the benefit of an organization's many stakeholders. The array of current and future resources available through this online Center will support and promote effective audit committees and position the CPA, who has the competencies, ethics, and experience required of financial experts, as the ideal audit committee member. With the goal of improving corporate governance, the Center will provide guidance to management and boards of directors regarding best practices in appointing and managing the audit committee function.

The Center is divided into three main sections: Audit Committee Toolkits, Audit Committee Matching System, and Guidance and Resources Section.

The **Audit Committee Toolkits** are designed to help audit committees uphold their fiduciary responsibilities with various matrices, questionnaires, sample forms, checklists, and other items. There are *Toolkits* for all organizations—public, private, not-for-profit, and government.

The **Audit Committee Matching System** enables CPAs to find opportunities to provide their financial expertise and commitment to corporate governance as audit committee members, and helps companies and organizations searching for audit committee members locate eligible CPAs.

The **Guidance and Resources Section** provides information—such as how to improve the audit committee function—and offers resources that aid in evaluating, selecting, and monitoring external relationships.

These resources are available to you at the Audit Committee Effectiveness Center website: aicpa.org/audcommctr

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The *AICPA Audit Committee Toolkit, Government Organizations* is accompanied by a CD-ROM containing the complete *Toolkit* in Microsoft Word, so you can customize the tools to fit your audit committee's needs.

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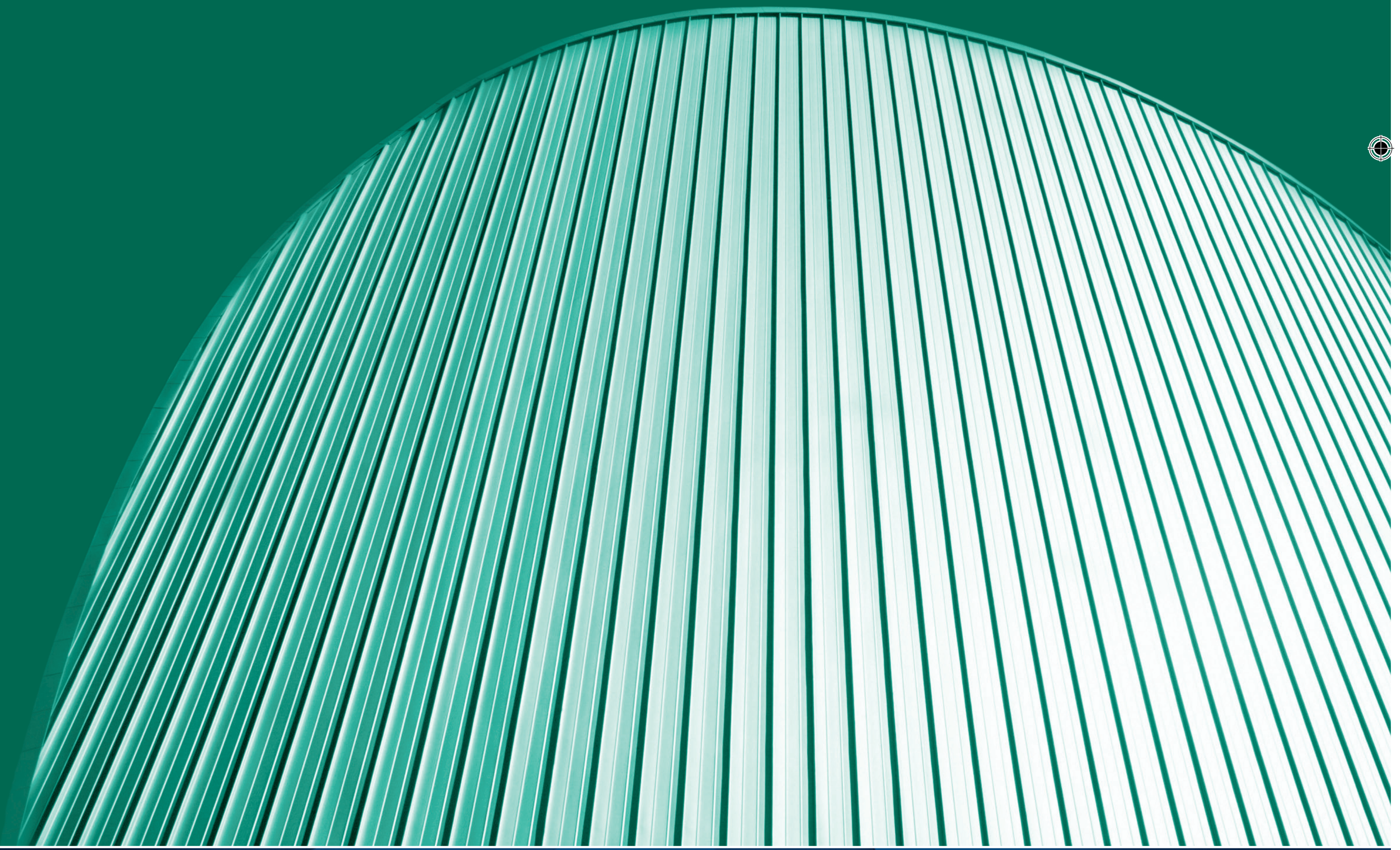
The AICPA Audit Committee TOOLKIT

Government Organizations, 2nd Edition



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Audit Committee TOOLKIT

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NOTICE TO READERS

The AICPA Audit Committee Toolkit: Government Organizations, Second Edition material is designed to provide illustrative information with respect to the subject matter covered. It does not establish standards or preferred practices. The AICPA Audit Committee Toolkit: Government Organizations, Second Edition material has not been considered or acted upon by any senior technical committee or the AICPA Board of Directors and does not represent an official opinion or position of the AICPA or the sponsors of the toolkit. It is provided with the understanding that the author, publisher, and sponsors are not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought. The author, publisher and sponsors make no representations, warranties or guarantees as to, and assume no responsibility for the content or application of the materials contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material.

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In January 2004, the AICPA launched its Audit Committee Effectiveness Center to provide resources in the public interest to those who work with and serve on audit committees and boards of directors. The Audit Committee Effectiveness Center is available at www.aicpa.org/ACEC. The information provided on the center is intended for use by all organizations: publicly owned, privately owned, not-for-profit, and governmental entities.

The two main features of the center—*The AICPA Audit Committee Toolkits* and the *Audit Committee Matching System*—have helped thousands of organizations effectively carry out corporate governance responsibilities.

This second edition of *The AICPA Audit Committee Toolkit: Government Organizations* has been developed by CPAs working in and with government organizations, and is tailored to meet the unique needs of the organizations they serve.

This edition is accompanied by a CD-ROM containing Microsoft Word files of all of the tools for you to modify and customize them to fit your organization and audit committee's needs.

In addition to this toolkit, there are other toolkits available for public companies, private companies, and not-for-profit organizations.

The foundational component of *The AICPA Audit Committee Toolkit: Government Organizations* is the "Audit Committee Charter Matrix." This matrix and the accompanying checklists, interview guides, questionnaires, and other resources are intended to be used as active tools to help the organization and audit committee execute their responsibilities.

We also encourage you to make use of the *Audit Committee Matching System*, which is a means to link CPAs who are willing to serve as members of boards of directors and audit committees with the organizations that need their unique CPA skill set in these roles.

And, finally, another feature of the center is the e-alert option. By registering for e-mail alerts, you will be kept informed of new tools and updates to existing tools as they are released and other developments that relate to audit committee responsibilities.

We are grateful to CNA for their continued sponsorship and support of the center.

If you have questions, comments, ideas for additional tools, or other feedback, please e-mail our staff at acms@aicpa.org.

Sincerely,

Barry C. Melancon, CPA
President and CEO

Carol Scott, CPA, MBA
Vice President—Business, Industry & Government

Acknowledgements

The AICPA Audit Committee Toolkit: Government Organizations was developed by AICPA members working in and with government organizations. We would like to publicly thank the members of the Government Organizations Audit Committee Toolkit Task Force, and the organizations that provided them the opportunity to participate in this project, for their dedication, professional expertise, and hard work.

We specifically would like to recognize the following leaders on the task force:

Eric Berman	Task Force Chair and Charter Matrix Tools Subchair
Marcia B. Buchanan	External and Internal Audit Tools Subchair
Randy C. Roberts	Other Tools Subchair

Finally, we would like to thank Kayla Briggs, AICPA staff liaison, and to recognize CNA for its continued sponsorship, and for making this toolkit and the Audit Committee Effectiveness Center website available in support of our members, the organizations that they serve, and the public interest.

Government Organizations Audit Committee Toolkit Task Force

Ernest A. Almonte, CPA
Partner
Former Rhode Island Auditor General
DiSanto Priest & Co.
Warwick, RI

Eric Berman, CPA
Brown Armstrong Accountancy Corporation
Pasadena, CA

Marcia B. Buchanan, CPA
Assistant Director, Financial Management & Assurance
U.S. Government Accountability Office
Washington, DC

Max Duplant, CPA
Chief Financial Officer
City of Irving, TX
Irving, TX

Lena Ellis, CPA
Director of Finance/Chief Financial Officer
Fort Worth, TX

H. Tina Kim, CPA
Deputy Comptroller for Audit
Office of the Comptroller
City of New York
New York, NY

Michael E. Martin, CPA
Assistant Comptroller
Lee County, MS
Tupelo, MS

Taylor Powell
Associate
Clifton Gunderson, L.L.P.
Arlington, VA

Randy C. Roberts, CPA
Director of Professional Practice
Arizona Office of the Auditor General
Phoenix, AZ

Bob Scott, CPA
Assistant City Manager/Chief Financial Officer
City of Carrollton, Texas
Carrollton, TX

Preface

This toolkit was designed for use by individuals and governmental organizations at all levels that represent varying degrees of technical experience with governmental audit committees. The following executive summary is intended to provide a general overview for all readers to gain a broad understanding of how to use the toolkit to maximize understanding of roles and requirements that may be tailored to specific and unique circumstances. It is important to note when using this toolkit that we use the term *governing body* to describe those in government organizations that have the ultimate authority and responsibility and accountability of that government's public resources. At different levels of government, the governing body will vary and may be a federal agency department head, legislative body, elected official(s), governing board, supervisory board, council, or any designee established by law or charter.

This toolkit is designed for use by the following groups:

- Governmental organizations, regardless of size
- Executive leadership and board and audit committee members of governmental organizations
- Chief executives, finance officers, accounting executives, and other key staff positions of a governmental organization
- External and internal auditors

The toolkit has been organized into subgroups:

- General considerations
- Management and the organization
- Internal control and internal audit
- External auditors and resources

Governmental audit committees are still evolving as a tool for governments. Frequently, their roles are relegated to hiring external auditors; receiving financial, single audit, and similar reports; and communicating their approval to a full board, committee, or executive leadership. Yet, they can be among the most effective tools in combating fraud, waste, and abuse. An audit committee should be the focal point of internal auditing of a government and should be the champions of accountability and transparency for any government—two qualities that are so important in today's financial uncertainty.

Audit committees should lead the charge in enhancing internal controls. They should push management for a fraud control program and set the tone for the government in combating fraud, waste, and abuse.

To accomplish this seemingly monumental task, audit committee members should have at least business or industry skills and possess an air of skepticism and independence. They should have the theme of "trust, but verify" with regard to their relationship with management. They should have at least a summary understanding of the government's operations to be able to gauge fraud risk. Finally, they should possess, or be able to acquire some knowledge of, laws and regulations that may affect the government.

This toolkit may use various acronyms and titles that may have different meanings for governments, in general, or different levels of government. Because of the diverse titles in government organizations, we ask that you focus more on the function of a particular position rather than the title of that position. For example:

Type of Government	CEO	CFO	Controller	Director of Financial Reporting	Chief Audit Executive
County	County manager	Assistant county manager for business, budget, or finance *(could also be the comptroller)*	Comptroller; finance director	Chief accountant	(Chief) Internal auditor
City	Mayor or city manager	Assistant city manager for business, budget, or finance *(could also be the comptroller)*	Comptroller; finance director	Chief accountant	(Chief) Internal auditor
School District	Superintendent	Assistant superintendent for business	Finance director	Chief accountant	(Chief) Internal auditor
University or Community College	President	Vice president for financial services	Comptroller	Chief accountant	(Chief) Internal auditor
State	Governor; delegated to others	Comptroller	Comptroller; finance directors *(usually one for each large agency)*	Chief accountant	(Chief) Internal auditor *(usually one for each large agency)*

Type of Government	CEO	CFO	Controller	Director of Financial Reporting	Chief Audit Executive
Federal	President; delegated to others, such as cabinet secretaries	Controller, Office of Management and Budget	Chief financial officer *(usually one for each large department or agency)*	Chief financial officer	Comptroller General of the United States Inspector General *(usually one for each large department or agency)*

Internal and external audit roles are similar in governmental organizations to for-profit and not-for-profit entities. Often, internal auditors are appointed or otherwise employed by the government, whereas the external auditor is a public accounting firm. In some governments, the internal auditor or external auditor may be elected from the government's citizenry, or the external auditor may be a government audit organization specified by law or regulation to be the government's external auditor.

Audit committee members in any type of organization are the center of financial accountability and financial skepticism. They should be the hub of activity as a liaison to a full board; other standing committees; and external and internal audit, management, and operations.

As you read through this toolkit and implement its recommendations, it is important to keep in mind some of the differences between governments and other organizations. These are, generally, as follows:

- *Different responsibilities.* Governments are in place for the public good and not personal gain. Effectively, the stockholders of governments are taxpayers, ratepayers, and the citizenry at large; the ultimate accountability is to them.
- *Budgets are key.* Budgets are a strong control mechanism for all governments. In some governments, overspending a budget can have dire consequences on a program or personnel. To the average citizen and the law, budgets may be *more* important than financial reports as they have a force of law and a force of control.
- *Expenditures may occur either independent of or before revenues.* Frequently, governmental services operate in a 24 hours a day, 7 days a week, 365 days a year environment and operate totally separately from the revenue generation cycle. In terms of federal reimbursement, many federal grants require outflows before inflows occur.
- *The concept of interperiod equity.* A key element in all governmental financial operations. Interperiod equity stipulates that current revenue generation pays for current expenses or expenditures. Many governments get into fiscal difficulties because of not implementing this one important concept.
- *Tax collections.* Do not depend on an exchange of inventory or services. With the exception of sales and similar taxation, tax collections are levied despite the lack of an exchange. They are

levied with a force of law and for property and similar taxes; they can include a seizure of property provision if taxes are not paid.

- *Capital assets and debt, though important, are not prime drivers of economic activity for a government.* Capital assets are more of a burden for a government than a benefit because for most governments they are expensive to build and maintain, requiring debt issuances that are complex and lengthy. It is infrequent that capital assets are funded by operations of a government.
- *External forces may restrict assets of a government.* Laws of a different level of a government (federal to state, state to municipal or other government) may have the effect dictating how, when, and how much money is spent. Laws may require revenues or resources to be directed to certain programs or to settle certain claims and judgments.
- *Many different types of governments exist.* There may be many different "sub" governments within a larger general purpose government such as a city. All may be related to the city, but legally separate. The city may have dozens of separate governments contained within it from transit, water, electricity, sewer, school, public college, and cemetery to conservation, library, and other districts. Governance is also different from place to place. Cities and other similarly structured municipalities generally have a mayor and city council structure. However, towns and townships may have a selectman or even town meeting format with no singular leadership (as in New England). Counties tend to have their most important responsibilities for unincorporated areas and focus on public safety and similar issues. All totaled, beyond the 50 states and the federal government, there are over 87,000 other types of governmental entities in the United States.
- *Governments have a short term focus.* Many officials in government only have a horizon to the next election. Therefore, long-term planning and goal setting is either extraordinarily difficult or nonexistent.
- *Governments may have "for profit" business entities within them.* Usually commissions, utilities, boards, investment and pension systems, and colleges and universities operate very similar to for-profit entities and operate under similar accounting and reporting standards.
- *Government entities may not have choice of external auditor.* Laws, regulations, contracts, grant agreements, or policies may require government entities and their audit committees to use government audit organizations to perform their external audit. In other cases, the government audit organization may elect to perform the audit, and the government is required to allow this organization to do so. Some government audit organizations may compete with CPA firms for selection as another government entity's auditor. In other cases, the government audit organization or other government organization may control the hiring, firing, and evaluation process over the external auditor. Audit committee members need to be aware of their authority in this area and should use the relevant tools.
- *Governments may or may not use generally accepted accounting principles (GAAP).* While all state governments use GAAP for state-level financial reporting, GAAP use by local governmental entities varies. Some states require, either by state law or regulation, that the local governmental entities within those states use GAAP. Other states, however, do not require GAAP use by their local governments, or may prescribe a regularity basis of accounting. In states where GAAP use is not required for local governments, local governments preparing GAAP-based financial statements tend to be larger or more frequent debt issuers.
- *Governments have varying document retention and destruction requirements.* Although all governmental entities should have a written, mandatory document retention and periodic destruction policy, many state and local governments have laws governing these practices.

> The document retention and destruction policy identifies the record retention responsibilities of management and staff of the governmental entity for maintaining and documenting the storage and destruction of the entity's documents and records. Establishing policies that cover the requirements for the relevant requirements for each governmental entity will eliminate accidental or innocent destruction. In addition, it is important for administrative personnel to know the length of time records should be retained to be in compliance.

We hope you use this toolkit to strengthen your understanding of how governments operate and are accountable to their citizenry. Contained within this toolkit are the following:

I. Audit Committee—General Considerations

Audit Committee Charter Matrix

This matrix is designed as a checklist for audit committees to consider using annually to assist when documenting compliance with outlined roles and responsibilities.

Audit Committee Member Roles and Responsibilities

This section outlines the basic responsibilities of an audit committee that organizations should consider when selecting members to participate in an audit committee. This section also provides a sample matrix of the defined roles of both the audit and finance committees of a governmental organization.

Audit Committee Financial and Other Experience Considerations

Much has been said about the need for the audit committee to have financial expertise. This chapter outlines the major components that define financial expertise, and whether the committee has the necessary expertise to fulfill its duties for a government organization.

Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee

This tool provides an introduction and summary to the key aspects that audit committees should consider related to a governmental organization's enterprise risk management.

Conducting an Audit Committee Executive Session: Guidelines and Questions

This section defines an executive session and provides a sample matrix of questions to consider when conducting an executive session.

Conducting an Audit Committee Self-Evaluation: Guidelines and Questions

This checklist may be utilized on an annual basis to help determine the fulfillment of the responsibilities of the audit committee.

II. Audit Committee—Management and the Organization

Independence and Conflict of Interest

The topics discussed in this tool are critical for governmental organizations and provide a foundation for participation in and involvement with transactions related to government organizations. This section provides guidance for audit committees in handling these key issues and contains a sample conflict of interest policy.

Management's Summary of Unique Transactions, Risks, and Financial Reporting, and Financial Relationships

This tool discusses the audit committee's responsibilities and considerations related to a governmental organization's financial transactions and relationships, including a sample set of questions for use by audit committees.

Significant Issues, Estimates, and Judgments: Management's Report to the Audit Committee

This tool provides an overview and examples pertaining to the discussion of significant issues, estimates, and judgments between management and the audit committee.

III. Audit Committee—Internal Control and Internal Audit

Internal Control: A Tool for the Audit Committee

Understanding the internal control environment and structure is vital for governmental audit committees. This tool provides assistance to audit committees both in their understanding of responsibilities related to government organization internal control structures and practical advice on how the audit committee provides oversight to these organizations.

Fraud and the Responsibilities of the Government Audit Committee

This tool gives audit committees a summary on their responsibilities related to potential fraud in a governmental organization.

Anonymous Submission of Suspected Wrongdoing (Whistle-Blowers): Issues for Government Audit Committees to Consider and Sample Whistle-Blower Tracking Report

This section provides a sample tracking report for use by audit committees with respect to a formal whistle-blower policy of government organizations.

Guidelines for Hiring the Chief Audit Executive

Depending upon a number of factors, government organizations may need a separate internal audit function. This tool provides guidelines to the audit committee in the hiring of a chief audit executive for government organizations.

Evaluating the Internal Audit Team: Guidelines and Questions

Audit committees should evaluate the internal audit teams of governmental organizations. This tool provides sample questions to use during while reviewing the internal audit department.

Monitoring the Internal Auditor: An Overview of the Peer Review Process for Internal Audit

This tool provides information related to the internal audit department and its peer review process.

IV. Audit Committee—External Auditors and Resources

Guidance for Developing a Request for Proposal Letter for CPA Services (Governmental Organizations)

This section provides guidance on developing a letter that requests services from a CPA (for example, audit, consulting, and similar).

Evaluating the Auditor's Engagement Letter: Questions to Consider

This checklist is designed to assist audit committees with the review of the auditor's engagement letter for the scope of services to be performed by an external auditor.

Discussions to Expect From the External Auditors

This tool provides an overview of the typical discussions between the audit committee and the external auditors.

Evaluating the External Auditor: Questions to Consider

This section provides a sample checklist to follow when evaluating external auditors upon the completion of the annual audit.

Single Audits—Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*

This section provides information related to the risks associated with and the compliance by governmental organizations that accept federal awards.

Monitoring the External Auditor: An Overview of the Peer Review Process for External Audit Organizations

This tool provides information related to CPA firms and their peer review process.

Points to Consider When Engaging External Experts and Advisers

This tool is designed to assist audit committee members when engaging external experts and advisers, if needed.

Appendix A: Resources for Audit Committees

This appendix provides additional resources related to government committees

Appendix B: Glossary of Acronyms

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PART I: Audit Committee—General Considerations

Audit Committee Charter Matrix

PURPOSE OF THIS TOOL: Adopting and maintaining an audit committee charter is a best practice for government organizations; for some states, it is required for government organizations. However, the charter is often adopted and filed away except for its annual review. This tool is designed to help audit committees make the charter a living document and use it to manage the agenda.

This tool is meant as a sample of a best practice. Users of the tool should put their own charter in the first column and use this example as a guide for defining the steps to accomplish each objective, the associated performance measure, and the scheduling.

This tool is intended to serve government organizations of all sizes and organizational structures. For instance, some small governments cannot justify the expense of an internal auditor, whereas others have very large internal audit departments headed by a senior executive. Similarly, relatively few government organizations employ in-house legal counsel. Instead, most government organizations rely on the professional services of outside attorneys engaged on a retainer basis or rely on volunteer services. The guidance provided in this tool is applicable whether in-house resources are employed, an outsource arrangement exists, or volunteers provide services.

Government Audit Committee Charter Matrix
For the Year Ending: ____________

I. Audit Committee Charter—General Considerations

Audit Committee Charter—General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
I-A. Audit Committee Member Roles and Responsibilities				
Establish an audit committee charter with approval from the governing body that sets forth the audit committee member roles and responsibilities. Review the committee's charter annually, reassess the adequacy of this charter, and recommend any proposed changes to the governing body. Consider changes that are necessary as a result of new laws, regulations, and best practices. (See the tool "Audit Committee Member Roles and Responsibilities" in this toolkit.)	Review the charter each year. Assess the appropriateness and completeness of the charter in light of the previous year's experience, new best practices, and new legal or regulatory requirements.	Report to the governing body on the appropriateness of the charter and recommend any revisions for approval by the governing body.	Review annually, unless changes are needed during the course of the year.	
I-B. Audit Committee Financial and Other Experience Considerations				
The audit committee should have access to financial expertise, whether in the form of a single individual serving on the committee, or collectively among committee members. If the financial expertise is provided by one individual, it is desirable that he or she be a member of the governing body or be appointed by the governing body. When no single member of the governing body has the requisite skills, other arrangements should be made to ensure that the audit committee has the financial expertise to carry out its duties.	Ascertain that the committee has the requisite financial expertise as defined by the organization.	Indicate in audit committee meeting minutes how financial expertise is available to the committee.	Affirm annually and when there is a change in status.	

I. Audit Committee Charter—General Considerations *(continued)*

Audit Committee Charter—General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
The audit committee should undertake education initiatives to improve the financial expertise of the committee as a whole, including attendance at seminars and conferences, special speakers at committee educational sessions, and study of analytical tools for audit committees. (See the tool "Audit Committee Financial and Other Experience Considerations" in this toolkit.)				
I-C. Audit Committee Membership				
The audit committee shall consist of at least three members, and preferably three, five, or seven members. The chair of the audit committee shall be selected from among those members of the audit committee who are also members of the governing body. No officer or employee of the organization under audit may serve on the committee. Audit committee members need to be free from conflicts of interest Although not all audit committee members need be members of the governing body, a majority of the committee members should be members of the governing body. (See the tool "Independence and Conflict of Interest" in this toolkit.)	Test for independence, based on the policies established by the organization. Minimal independence standards would prohibit employees of the organization or those with direct financial interests in entities serving the organization from serving on the committee. No employee of the organization's external auditors should serve on the committee or on the governing body.	Indicate in the committee minutes whenever a new member is appointed. Indicate in the committee minutes whenever a new committee chair is elected.	Affirm annually or whenever a change in status by any committee member occurs.	

(continued)

I. Audit Committee Charter—General Considerations *(continued)*

Audit Committee Charter—General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
I-D. Enterprise Risk Management				
Provide oversight of enterprise risk management, including determining overall strategy, and influencing the entity's risk philosophy and appetite. Inquire of management, the chief audit executive (CAE), and the external auditors about significant risks or exposures facing the organization; assess the steps management has taken or proposes to take to minimize such risks to the organization; and periodically review compliance with such steps. (See the tool "Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee" in this toolkit.)	Discuss with the CAE, external auditors, and others if the organization has a risk management strategic plan that documents the risk philosophy and appetite or establish such a plan where nonexistent. Document the material risks that the organization faces related to the organization's financial condition and controls and financial reporting. Update as events occur. Review with management and the CAE on a periodic basis.	Submit a risk report to the governing body and the external auditors, including mitigation strategies and quantifiable risks and insurance to cover such risks (for example, loss of revenue).	Review at least once each year, and more frequently if necessary.	
Review with the general counsel, external auditors, external counsel, and the CAE legal and regulatory matters that, in the opinion of management, may have a material impact on the financial statements, related organization compliance policies, and programs and reports received from regulators. (See the tool "Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee" in this toolkit.)	Discuss whether the organization is in compliance with laws and regulations that govern the environment(s) in which it operates, as well as other applicable laws and regulations.	Report to the governing body that the review has taken place and any matters that need to be brought to its attention.	Review at least annually.	
I-E. Audit Committee Meetings				
The committee will meet as needed to address matters on its agenda, but not less frequently than twice each year. The committee may ask members of management or others to attend the meeting and provide pertinent information as necessary.	In-person meetings should be held at least once each year. All members are expected to attend each meeting in person, via telephone conference, or videoconference.	Prepare minutes that document decisions made and action steps following meetings and review for approval. Meeting minutes should be filed with the governing body.	Minutes should be distributed as soon as possible but no later than before the next meeting.	

I. Audit Committee Charter—General Considerations *(continued)*

Audit Committee Charter—General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
The meetings should be scheduled so that the external auditor's engagement letter is approved at one meeting and the final audited financial statements and report of the external auditors are approved at another meeting. Provision for unanimous consent approval of actions should be included in the charter to deal with decisions required between meetings. (No additional tool included in this toolkit.)	Telephone conference meetings may be held more frequently. The agendas for meetings should be prepared and provided to members in advance, along with appropriate briefing materials.			
I-F. Audit Committee Annual Agenda and Report				
Create an agenda for the ensuing year, or review and approve the agenda submitted by the CAE.	Use this "Audit Committee Charter Matrix" as a sample, and tailor it to your organization.		Review before the upcoming year.	
Oversee the preparation of, or prepare, an audit committee annual report to the governing body. (No additional tool included in this toolkit.)	Review and discuss the annual report with the CAE and auditors.	Annual report finalized and approved. Present to the governing body.	Review annually upon completion of audited financial statements.	
I-G. Conducting an Audit Committee Executive Session				
Conduct executive sessions with each of the external auditors, the CEO, and the CFO. If the organization has a CAE, general counsel, or outside counsel, executive sessions should be conducted with each of these individuals as well. Circumstances may dictate that additional executive sessions may be needed with the director of financial reporting, controller, or others as deemed appropriate by the committee. See the tool "Conducting Audit Committee Executive Session: Guidelines and Questions" in this toolkit.)	Establish these sessions in conjunction with regularly scheduled meetings or as necessary.	Develop action steps to be taken, if appropriate. Minutes should generally only reflect that executive sessions took place. Minutes should not be kept of the sessions themselves.	Review as necessary, but not less frequently than regularly scheduled meetings.	
I-H. Conducting an Audit Committee Self-Evaluation				
The committee will review its effectiveness annually. (See the tool "Conducting an Audit Committee Self-Evaluation: Guidelines and Questions" in this toolkit.)	The committee will review its accomplishments and make recommendations for improving its effectiveness.	Discuss recommendations with governing body.	Review annually.	

(continued)

I. Audit Committee Charter—General Considerations *(continued)*

Audit Committee Charter—General Considerations	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
I-I. Other Responsibilities				
The committee will perform such other functions as assigned by the organization's charter, bylaws, or governing body. (See the tool "Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee" in this toolkit.)	The committee will review what needs to be added based upon charter, bylaws, or as assigned by governing body.		Review new business at all meetings.	

II. Audit Committee Charter—Management and the Organization

Audit Committee Charter—Management and the Organization	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
II-A. Code of Conduct				
Periodically review the organization's code of conduct/ethics to ensure that it is adequate and up-to-date. Review with the chief audit executive (CAE) and the organization's general counsel the results of their review of the monitoring of compliance with the organization's code of conduct/ethics. (No additional tool included in this toolkit.)	Review results with the CAE and general counsel. Consider any adjustments that may be necessary to the organization's code of conduct/ethics. Consider steps that may need to be taken to ensure that compliance is at the highest possible level.	Report to the governing body that the review of the code of conduct/ethics was completed. Recommend changes to the code of conduct/ethics to the governing body as needed.	Review at least annually. Review any significant findings as they arise.	
II-B. Document Retention and Destruction Policy				
Establish a document retention and destruction policy. Review it with the CAE, management, the external auditors, and with the governing body. Review the policy annually to ensure compliance with legal, tax, and regulatory requirements. (No additional tool included in this toolkit.)	Prepare and approve a policy and review it with the governing body.	A document retention and destruction policy. An annual review of the policy, recommending amendments as required to comply with legal, tax, and regulatory requirements.	Review the policy annually.	

II. Audit Committee Charter—Management and the Organization *(continued)*

Audit Committee Charter—Management and the Organization	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
II-C. Unique Transactions and Financial Relationships				
Review with management and the external auditor the effect of any regulatory and accounting initiatives and unique transactions (including off-balance-sheet transactions). This also includes derivatives, securities lending transactions, relationships with legally separate entities (component units), and joint ventures. Review accounting for such transactions to ensure best practices are applied. Review significant related party transactions. (See the tool "Management's Summary of Unique Transactions, Risks, Financial Reporting, and Financial Relationships" in this toolkit.)	Independently, through professional reading and continuing education, keep up-to-date on new developments related to the public sector, and consider the environment in which the organization operates, including any regulatory requirements it may be subject to. Discuss with management and the external auditors in meetings.	Record discussion and any action steps in committee meeting minutes.	Review as necessary.	
II-D. Review of Interim Financial Reports				
Review with management, and the CAE, any interim financial reports issued since the last meeting. (No additional tool included in this toolkit.)	Discuss the financial statements with emphasis on changes in reporting, new and unusual transactions, and financial trends.	Record discussion and any action steps in audit committee meeting minutes.	Review as necessary.	
II-E. Significant Issues, Estimates, and Judgments: Management's Report to the Audit Committee				
Review the following with each external auditor who performs an audit: • All critical accounting policies and practices used by the organization. All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management of the organization, the ramifications of each alternative, and the treatment preferred by the organization. • Any consultation with audit firms other than the external auditors, including reasons for and results of the consultation.	Discuss each matter, and related matters that may come to the attention of the audit committee or the external auditor, or both through this process. Create an action plan and follow-up plan as necessary.	Submit reports and documentation of discussions and resolution of disagreements. Report to the governing body on significant issues, findings, and actions taken as a result of these reviews.	Review, at least annually, in conjunction with the year-end audit, or both.	

(continued)

II. Audit Committee Charter—Management and the Organization *(continued)*

Audit Committee Charter—Management and the Organization	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
II-E. Significant Issues, Estimates, and Judgments: Management's Report to the Audit Committee (continued)				
• Any other information relating to significant estimates and judgments (for example, pensions and other postemployment benefits, self-insurance, derivatives, and so on). (See the tool "Significant Issues, Estimates, and Judgments: Management's Report to the Audit Committee" in this toolkit.)				

III. Audit Committee Charter—Internal Control and Internal Audit

Audit Committee Charter—Internal Control and Internal Audit	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-A. Internal Control: A Tool for the Audit Committee				
Review the following with the external auditors and the chief audit executive (CAE): • The adequacy of the organization's internal controls, including computerized information system controls and security. • Any related significant findings and recommendations of the external auditors and internal audit services, together with management's responses thereto. (See the tools "Internal Control: A Tool for the Audit Committee" and "Fraud and the Responsibilities of the Audit Committee" in this toolkit.)	Review the reports of the internal audit team for all audits completed since the prior audit committee meeting. Review key internal controls with the CAE, and understand how these controls will be tested during the year. Review these plans with the external auditor to understand their scope with respect to key controls. Review with the CAE the plans for audits of other elements of the control environment. Determine that all internal control weaknesses are quantified, reviewed, and addressed.	Report to the governing body on issues relating to internal controls with emphasis on management's ability to override controls and the monitoring and testing relating to this capacity.	Submit a comprehensive report to the governing body at a specified meeting each year. Update on anything new, or any changes to the internal control system, at every meeting.	

III. Audit Committee—Internal Control and Internal Audit *(continued)*

Audit Committee Charter— Internal Control and Internal Audit	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-B. Internal Control: Accounting Policies and Procedures				
Ensure that accounting policies, procedures, and related controls are documented and reviewed with the committee. Review accounting controls on an annual basis. Review with management the policies and procedures with respect to officers, key employees (CEO, CFO, chief operating officer), disqualified persons as defined by the IRS (under Internal Revenue Code Section 4958), expense accounts, and perks, including excess benefit transactions; consider the results of any review of these areas by the internal auditor or the external auditors. (No additional tool included in this toolkit.)	Ensure written policies and procedures exist. Discuss with the CAE, or equivalent, the need for testing by either the internal auditors, external auditors, or other parties.	Report issues, if any, to the governing body.	Review policies and procedures annually. Review any significant findings as they arise.	
III-C. Internal Control: Monitoring				
Inquire of the CEO and CFO regarding the fiscal health of the government. (See the tools "Internal Control: A Tool for the Audit Committee" and "Conducting an Audit Committee Executive Session: Guidelines and Questions" in this toolkit.)	Discuss the fiscal condition of the government organization and its financial status in relation to the adopted and revised budget. Identify any issues, potential corrective measures, and subsequent resolutions. Establish a standing agenda for executive sessions.		Review, as necessary, but at least annually.	
III-D. Fraud and the Responsibility of the Audit Committee				
The committee should review the organization's antifraud programs and controls and aid in its discovery and remedy if it does occur. (See the tool "Fraud and the Responsibilities of the Government Audit Committee" in this toolkit.)	On a periodic basis, the committee should review the major risk exposures of the organization to fraud and the programs and controls to aid in its prevention and discovery. The committee should review all instances of fraud to determine enhancements to antifraud programs and controls.	Report to the governing body on a periodic basis on the condition of the organization's risk exposure to fraud and the organization's antifraud programs and controls.		

(continued)

III. Audit Committee—Internal Control and Internal Audit *(continued)*

Audit Committee Charter—Internal Control and Internal Audit	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-E. Whistle-Blower Tracking				
Review the procedures for the receipt, retention, and treatment of complaints received by the organization regarding accounting, internal accounting controls, auditing matters, or suspected fraud that may be submitted by any party internal or external to the organization. Review any complaints that might have been received, current status, and resolution if one has been reached. (See the tool "Anonymous Submission of Suspected Wrongdoing (Whistle-Blowers): Issues for Government Audit Committees to Consider" in this toolkit.)	Review procedures with CAE, external auditors, and the general counsel. Review all complaints that have been received and the status of resolution. Ensure that proper steps are taken to investigate complaints and resolve them in a timely fashion.	Review an original of each complaint received no matter the media used to submit. Discuss the status of resolution of each complaint. Review a cumulative list of complaints submitted to date to review for patterns or other observations.	Review at least annually.	
IIII-F. Guidelines for Hiring the Chief Audit Executive				
The committee is responsible for guiding, reviewing, and approving the appointment, replacement, reassignment, or dismissal of the CAE. The CAE should report functionally to the audit committee and administratively to a senior executive of the organization, typically the CEO or CFO. The committee chair should meet with the CAE between meetings, either in person or by telephone. The committee should evaluate the performance of the CAE annually. (See the tool "Guidelines for Hiring the Chief Audit Executive" in this toolkit.)	Meet in executive session at each meeting with the CAE. Hold special meetings as may be necessary to address appointment, reassignment, or dismissal of CAE. The committee chair should be available if any unforeseen issues arise between meetings relating to the CAE. Meet at least once annually with other members of executive management and the external auditors to discuss the performance of CAE. Discuss job satisfaction and other employment issues with the CAE.	Report to the full governing body on the performance of the CAE, including the effectiveness of the internal audit function.	Conduct ongoing reviews, as changes can be made at any time during the year.	

III. Audit Committee—Internal Control and Internal Audit *(continued)*

Audit Committee Charter—Internal Control and Internal Audit	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-G. Internal Audit Scope and Plan				
Review with the external auditor, CFO, controller, and CAE the audit scope and plan of the internal auditors. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources. The committee should discuss with the CAE and the external auditors opportunities for reliance by the external auditors on the audit activities of internal audit. (No additional tool included in this toolkit.)	Meet with external audit partner, CFO, controller, and CAE to discuss scope of the previous year's audit and lessons learned. Later, discuss planned scope for audit of current year and the standard of work to be followed. In addition, discuss the timing of progress reports, to be provided by the external auditors, and the communications process to be followed in the event of deviations from the plan.	Document the meeting in the audit committee meeting minutes.	On an annual basis, review the scope of the previous year's audit, and the interrelationship between the internal and external auditors with respect to the scope of the external auditors' work. At another of the meetings each year, review the plans of internal audit for audits in the current year, if applicable.	
III-H. Review of Internal Audits				
Consider reviewing the following with management and the CAE: • Significant findings on internal audits during the year and management's responses thereto • Whether the internal audit department encountered any difficulties in the course of its audits, such as any restrictions on the scope of its work or access to required information • Any changes required in the scope of its internal audit • The internal audit department's budget and staffing • The internal audit department's charter • The internal audit department's compliance with the Institute of Internal Auditors' (IIA's) *International Standards for the Professional Practice of Internal Auditing*, if applicable	Review reports of all internal audits issued since the previous meeting and planned for the upcoming year, along with the status of each planned audit. Review and discuss the findings for each audit completed since the prior meeting, and management's response to the report. Discuss internal audit department budget and staffing with the CAE.	Report on the status of all internal audits planned for the next quarter or year. Internal audit should provide a summary of findings for completed audits, including management's plan to address findings and weaknesses identified.	Review at each meeting.	

(continued)

III. Audit Committee—Internal Control and Internal Audit *(continued)*

Audit Committee Charter—Internal Control and Internal Audit	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
III-H. Review of Internal Audits (continued)				
Internal audit should meet separately with the external auditors to coordinate audit plans to optimize the ability of the external auditor to rely upon the results the internal audit team. (No additional tool included in this toolkit.)	Discuss internal audit's compliance with IIA standards, if applicable, including the requirement for a peer review at least once every five years. If the organization receives federal funds, internal audit is required to have a peer review once every three years if the external auditors plan to rely on their work to reduce the external audit scope. Review the internal audit charter periodically and update, if necessary.			
III-I. Evaluating the Internal Audit Team: Guidelines and Questions				
Evaluate the performance of internal audit annually, if applicable, including the adequacy of the audit plan, the management of the execution of the audit plan, the adequacy of the human and other resources available to execute the plan, the ability of the external auditors to rely upon the internal audit work product in its annual audit, and the nature of the findings or results of the internal audits. (See the tool "Evaluating the Internal Audit Team: Guidelines and Questions" and "Monitoring the Internal Auditor: An Overview of the Peer Review Process for Internal Audit" in this toolkit.)	Use information from executive sessions conducted throughout the year. Use a formal assessment tool for each group.	Submit recommendations for change in process and procedures.	Review after completion of the annual audit.	

IV. Audit Committee Charter—External Auditors and Resources

Audit Committee Charter—External Auditors and Resources	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
IV-A. External Auditors				
Subject to approval by the governing body, the committee selects and appoints the external auditors to be engaged by the organization. The committee will approve the audit plan, establish the audit fees of the external auditors, and preapprove any nonaudit services provided by the external auditors, including tax services, before the services are rendered. Review with management the significance of bidding out audit services. Evaluate the performance of the external auditors on an annual basis. Ensure that single audit obligations are incorporated into the annual audit plan. (See the tools "Guidance for Developing a Request for Proposal for CPA Services (Governmental Organizations);" "Evaluating the External Auditor's Engagement Letter: Questions to Consider;" "Evaluating the External Auditor: Questions to Consider;" "Single Audits—Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*;" and "Monitoring the External Auditor: An Overview of the Peer Review Process for External Audit Organizations" in this toolkit.)	At least once each year, discuss each of these items with management, the chief audit executive (CAE), and the governing body. Review total audit fee in relation to any nonaudit services being provided by the external auditor. Review and evaluate the professional relationship with the auditors, including continuity of partner, manager, and staff; and level of service provided by auditors. Review the scope of *all* services provided by the audit firm throughout the organization.	Document these discussions in the audit committee meeting minutes. Report on findings and provide recommendations to the governing body as considered necessary.	Review soon after the audit has been approved by the governing body, so the recommendation for the appointment of the outside auditor in the next fiscal year can be documented in the governing body minutes.	
IV-B. Discussions With the External Auditors				
Review all material written communications between the external auditors and management, such as any management letter or schedule of unadjusted differences. (See the tool "Discussions to Expect From the External Auditors" in this toolkit.)	Discuss each item with the external auditors and management (including the CAE) and conclude on the appropriateness of the proposed resolution.	Submit reports and documentation of discussions, resolution of issues, and the action plan for any items requiring follow-up and monitoring.	Review, at the completion of the external audit.	

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IV. Audit Committee—External Auditors and Resources *(continued)*

Audit Committee Charter—External Auditors and Resources	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
IV-C. Evaluating the External Auditors: Questions to Consider				
The committee will evaluate annually the external auditors. Communications with the external auditors in the evaluation should respect the need to maintain the open flow of communication between the external auditors and the committee. (See the tool "Evaluating the External Auditor: Questions to Consider" in this toolkit.)	Use information from executive sessions conducted throughout the year. Use a formal assessment tool.	Submit recommendations for changes in processes and procedures. Request proposals if changes are being considered.	Review after completion of the annual audit.	
IV-D. Annual Audit—Review				
Review the following with management and the external auditors: • The organization's annual financial statements and related footnotes • The external auditors' audit of the financial statements and their report thereon • The external auditors' judgments about the quality, not just the acceptability, of the organization's accounting principles as applied in its financial reporting • Any significant changes required in the external auditors' audit plan • Any serious difficulties or disputes with management encountered during the audit • Matters required to be discussed by Statement on Auditing Standards No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, AU sec. 380), related to the conduct of the audit.	Discuss each matter, and others that may come to the attention of the audit committee through this process with management (including the CAE) and the external auditors. Review with management the course of action to be taken for any action requiring follow-up. Monitor any follow-up action that requires continued audit committee intervention.	Submit reports and documentation of discussions, resolution of disagreements, or action plan for any item requiring follow-up.	Review at the completion of the annual external audit.	

IV. Audit Committee—External Auditors and Resources *(continued)*

Audit Committee Charter—External Auditors and Resources	Steps to Accomplish Objective (Checklist)	Deliverable	When to Achieve (Frequency/Due Date)	Date Completed
The audit committee shall be authorized to hire external auditors, counsel, or other consultants as necessary. (This may take place any time during the year.) In particular, this may be required to fully explore any issues arising through the whistle-blower procedure. Many organizations receive funding support from governmental and other regulated agencies that may require statutory or contractual procedures when engaging external resources. (See the tool “Discussions to Expect From the External Auditors” in this toolkit.) (See the tools “Points to Consider when Engaging External Experts and Advisers,” “Guidance for Developing a Request for Proposal for CPA Services (Governmental Organizations),” and “Appendix A: Resources for Audit Committees” in this toolkit.)	Establish a policy for the audit committee to preapprove engaging external auditors and other experts. Discuss whether a standing budget should be established for this purpose. Requests for proposals should be used if time permits.	Prepare an engagement letter for each engagement. Report submitted by external auditor, counsel, or consultant.	Continually review the policy and compliance with it as needed.	

Audit Committee Member Roles and Responsibilities

PURPOSE OF THIS TOOL: The following information illustrates how the audit committee might be structured and assigns roles and responsibilities between the audit committee and finance committee.

Governments should carefully consider the roles and responsibilities in both the formation of the committee and in the members considered for the committee. Many governments are too small to have an audit committee, or don't have the authority to establish a committee in statute. However, even an ad hoc committee could benefit a governmental organization.

Governments should tailor the committee's roles and responsibilities to best fit the government considering the following:

- Size of the government
- Diversity of governmental revenues
- Complexity of financial position and statements
- Geographic footprint of the government's staff and mission

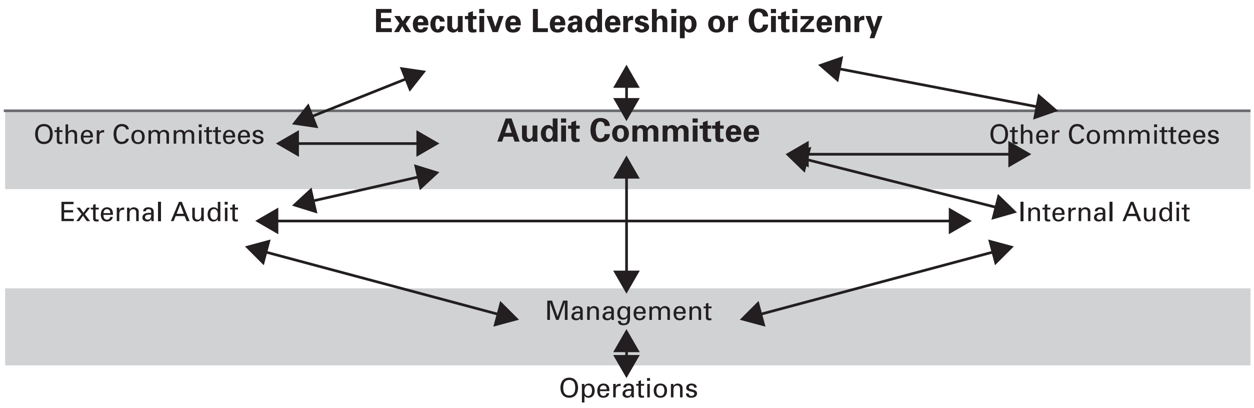
The government should consider having a minimum of three members on its audit committee with at least one of the members being a board member and one member having financial expertise. Frequently, committee members are based on charter, statute, or other authority and may be comprised of members of different levels or branches of government. The same charter, statute, or authority may also govern the number of members of the committee.

Audit Committee and Finance Committee

Some governments may have statutory authority to have an audit committee independent of the government. The audit committee generally assists the executive leadership of a government in its oversight of

- setting and conveying the tone of governance and accountability.
- integrity of the government's financial statements.
- internal control over the financial reporting process.
- the assessment of the independent auditor's qualifications, independence, and performance.
- performance of the internal audit function.
- compliance with legal and regulatory requirements.
- review of the audit in accordance with White House Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, as well as programmatic audit results.
- follow up on management letter comments provided by independent auditors (if any).

A way to view the centralization of an audit committee is as follows:



Specific responsibilities for an audit committee are typically set forth in the government's financial policy manuals, laws and regulations, other policies and procedures, or an audit committee charter, which should be approved by a full governing entity in the form of a law or regulation. Audit committee charters will vary by government due to factors such as size, type of government, and the complexity of the government's operations.

The following is an illustrative list of responsibilities for audit committee members:

Audit Committee Processes and Procedures

- Develop audit committee charter
- Conduct annual review of the audit committee charter
- Develop annual calendar based upon audit committee charter that ties to the government's legislative calendar
- Set agenda for the audit committee meetings based upon the audit committee charter
- Determine audit committee information and communication framework (that is, information requirements from management, reports, format, and timeliness)
- Ensure meeting minutes are prepared, documented, and approved by the audit committee
- Provide reports to statutorily required entities
- Educate the other leaders on the understanding of the financial statements and financial statements risks
- Prepare annual audit committee report
- Conduct annual self-assessment of effectiveness and efficiency of the audit committee and evaluation
- Review the government's procedures for reporting on problems, including whistle-blower hotline and other communication methods

- Determine the audit committee's process for special investigations (that is, whistle-blower allegation, antifraud plan compliance, discovery of error, illegal acts, and so on)
- Review reports from internal audit function
- Awareness of legal and regulatory requirements for financial reporting and auditing of financial statements
- Approval of reports prepared in accordance with OMB Circular A-133 as well as programmatic audit results

Oversight of the Financial Reporting Process

- Meet privately and separately with executive, legislative, and financial officials or bodies; independent external auditor; the chief audit executive (CAE); general counsel; senior management; audit committee members; and others as appropriate to the government (executive sessions)
- Review critical accounting policies, practices, judgments, estimates, significant issues, significant transactions, adjustments, unusual items, complex issues and operating arrangements
- Approval of annual audited financial statements including any federal OMB Circular A-133 reports
- Review information provided to watchdog agencies
- Obtain explanations from management on all significant variances
- Question management and independent auditor on significant financial reporting issues
- Facilitate the resolution of disagreements between management and the independent auditor regarding financial reporting
- Determine when a subject matter expert is required and hire advisers when needed
- Determine and designate the audit committee's financial expert (or designee)
- Oversee system for compliance with legal and regulatory requirements (for example, OMB circulars, grants, and similar items)
- Oversee adequacy of the government's system of internal control
- Review management letters containing the recommendations of the independent auditor and management's responses

Oversight of the External and Internal Audit Functions

- Provide preapproval of all audit and permitted nonaudit services performed by the external auditor
- Appoint or replace independent auditor
- Concur in the appointment of the CAE—internal audit (unless elected)
- Review the audit plan and scope of audit to be conducted by internal audit and external auditor
- Conduct evaluations of internal auditor and external auditor
- Oversee system of risk assessment and risk management as determined by the government (audit committee primarily focused on financial risk)

Limitation of Audit Committee's Role

Although the audit committee has the responsibilities set forth in a charter, it is not the responsibility of the audit committee to plan or conduct routine audits or to be the primary determinant that the government's financial statements and disclosures are complete and accurate and in accordance with generally accepted accounting principles and applicable rules and regulations. These tasks are the responsibility of management and the independent auditor; the audit committee has an oversight responsibility to see that the objective is achieved.

Audit Committee Versus Finance Committee

In general, the finance committee monitors financial transactions; the audit committee makes sure things are done according to policy and with adequate controls. Finance committees are less frequently found in governments—primarily in pension and investment entities or public education. Also, the finance committee provides guidance about what can be done; the audit committee ensures that independent oversight occurs. Therefore, duties are generally assigned as follows:

Audit Committee	Finance Committee
The audit committee	The finance committee
(a) reviews the financial statements of the government and other official financial information provided to the public.	*(a)* oversees the preparation of the operating and capital budgets as well as the financial statements. The finance committee ensures that budgets and interim financial statements are prepared.
(b) has oversight for ensuring that reports are received, monitored, and disseminated appropriately.	*(b)* oversees the administration, collection, and disbursement of the financial resources of the government as well as the policies and procedures related to the financial resources.
(c) provides oversight of the government's systems of internal controls, including overseeing compliance by management with applicable policies and procedures and risk management.	*(c)* advises the governing board with respect to making significant financial decisions.
(d) oversees the annual independent audit process, including the recommended engagement of the external auditor, and receives all reports, and management letters from the independent CPAs.	

Audit Committee	Finance Committee
(e) reviews the audit in accordance with OMB Circular A-133 and recommends for approval, signature, and submission of filing the audit with the single audit clearinghouse and similar entities by the appropriate officer. The audit committee also transmits the audited information to the executive leadership for its review prior to signing and submission. The audit committee engages (on leadership's behalf) and interacts with the independent auditor or auditing firm.	*(e)* oversees the preparation and implementation of the governance policies, including conflict of interest, document retention, whistle-blower, review of executive compensation, investments, endowments (for institutions of higher education, public museums of public arts, or other cultural venues), and so on.
(f) reviews the government's procedures for reporting problems. The audit committee may exercise primary responsibility to review the whistle-blower policy and process, antifraud policies, policies and procedures related to the discovery of errors or illegal acts, whistle-blower hotline and other communication methods, and determine the process for special investigations (whistle-blower allegations, antifraud compliance, discovery of errors, or illegal acts).	*(f)* should ensure that joint membership between the audit committee and the finance committee is appropriate and meets local laws and regulations.
The audit committee shall have such other authority and perform such other duties as may be delegated to it by the governing board.	

There may be some joint membership between the audit committee and the finance committee. Governments should refer to state or other local laws and regulations to ensure compliance.

Certain states may have legal requirements or other regulations that require certain members of the audit committee that are *not* also members of the finance committee. The purpose is to promote independence within the government.

Each government will need to consider these roles and responsibilities, as well as the structure of its government, and may need to reassign responsibilities, as needed.

Originally published as What's The Difference? Audit Committee vs. Finance Committee.
This paper has been adapted and edited with the consent of the Nonprofit Risk Management Center at www.nonprofitrisk.org.

Audit Committee Financial and Other Experience Considerations

PURPOSE OF THIS TOOL: Although there is no explicit requirement for a government audit committee to include a member having some level of financial or other expertise, it is considered good practice. In addition, it should be the goal of the government audit committee that all its members have some level of experience in financial matters. The following information illustrates how the audit committee might approach assuring it has access to requisite financial expertise.

Audit Committee Financial and Other Expertise

The following attributes are all deemed to be typical components of financial expertise:

- An understanding of generally accepted accounting principles, including those relevant standards for state and local government accounting and financial reporting issued by the Governmental Accounting Standards Board; an understanding of financial statements, generally accepted auditing standards, and generally accepted government auditing standards (also known as *Yellow Book*). Depending on the circumstances at the government organization in question, knowledge of the Single Audit Act of 1984, as amended, and the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, might also be appropriate. Also, at least a working knowledge of the enabling laws and regulations that the government operates within might be appropriate.
- The ability to assess the general application of the foregoing principles and standards in connection with the accounting for estimates, accruals, external restrictions, and reserves.
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that can reasonably be expected to be raised by the organization’s financial operations, or experience actively supervising (that is, direct involvement with) one or more persons engaged in such activities.
- An understanding of internal controls and procedures for financial reporting.
- An understanding of audit committee functions and responsibilities
- A general understanding of the government environment and specific knowledge of the government sector operations (for example, local government, municipal services and finance, labor relations, public health, education, transit, and so on) in which the organization participates.

The following questions should be used to assess whether an individual audit committee member, or the committee as a whole, possesses the preceding attributes:

- Have one or more individuals completed a training program in accounting or auditing?
- Do one or more individuals have experience as a chief or principal financial officer (for example, finance director or business manager), principal accounting officer, controller, public accountant, or auditor in either the private or public sector?
- Do one or more individuals have experience in position(s) that involve the performance of similar functions?

- Have one or more individuals gained experience by actively supervising a person(s) performing one or more of these functions?
- Do one or more individuals have experience overseeing or assessing the performance of other government organizations, companies, not-for-profit organizations, public accountants, or government auditors with respect to the preparation, auditing, or evaluation of financial statements?
- Do one or more individuals have other relevant financial experience in the government sector (for example, service on other government boards or experience as a banker or investment adviser)?
- Do one or more individuals have experience serving on audit committees of other government organizations?
- Is the person either independent of the government or can be viewed as free from bias?

Alternative Approaches to Acquiring Financial Expertise on the Committee

If no individual member of the audit committee possesses the attributes required for financial expertise, and the committee members collectively do not possess such attributes, several options might be considered:

- Establish a relationship with a peer or otherwise comparable government organization to have the CFO for one organization provide financial expertise to the other. Such arrangements can be reciprocal or involve multiple organizations. (Although this could be a solution, the appearance of interlocking boards might be seen as an impairment of independence or objectivity.)
- Engage a financial professional to provide financial expertise as a paid consultant to the audit committee. Such an individual must be otherwise independent with respect to the government organization (that is, must have no other financial arrangements with the organization).
- Establish a training program for audit committee members to develop the necessary financial expertise. Such training can include professional development programs offered by the AICPA; associations serving the government industry or the specific sector in which the government organization participates; or in-house training programs led by members of the organization's financial management team.

Resources

Various organizations provide information to support audit committees in carrying out their responsibilities. In addition to this toolkit, the AICPA maintains the Audit Committee Effectiveness Center (www.aicpa.org/ACEC). The independent sector has devoted significant attention to issues related to financial expertise, as have sector organizations such as the National Association of College and University Business Officers. Many public accounting firms provide information on these subjects as well. Finally, although its provisions are not directly applicable to government organizations, the Securities and Exchange Commission's Final Rule *Audit Committee Financial Experts* contains information that may be of interest. See appendix A, "Resources for Audit Committees," of this toolkit for additional sources of information.

Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee

PURPOSE OF THIS TOOL: Historically, risk management efforts in most organizations have been focused on preventing losses of physical or financial assets at the operational level. However, entities now recognize the linkage between governance, enterprise risk management (ERM), and entity performance.

ERM is an attempt to manage risk in a comprehensive manner that is aligned with the strategic direction of the organization and integrated with the everyday management of the organization. Many organizations, their boards, and audit committees are beginning to view risk management from this strategic perspective and consider risk management oversight to be a critical element of governance.

This tool is intended to give boards an overview of ERM, its opportunities and limitations, the relationship between ERM and internal control, and the roles and responsibilities for risk management in the organization. Importantly, ERM is a management responsibility, subject to oversight of the governing body.

ERM Primer—Basics of ERM and its Relationship to Internal Control

In September 2004 the Committee of Sponsoring Organizations (COSO)[1] of the National Commission on Fraudulent Financial Reporting (also known as the Treadway Commission) published the document *Enterprise Risk Management—Integrated Framework*,[2] which defined ERM as follows:

> Enterprise risk management is a process, effected by an entity's board of directors, management and other personnel, applied in a strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

The ERM framework is geared to achieving an entity's objectives, set forth in four categories:

1. *Strategic.* High-level goals, aligned with and supporting its mission.
2. *Operations.* Effective and efficient use of its resources.
3. *Reporting.* Reliability of reporting.
4. *Compliance.* Compliance with applicable laws and regulations.

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[1] The Committee of Sponsoring Organizations (COSO) consists of the AICPA, the Institute of Management Accountants, the Institute of Internal Auditors, Financial Executives International, and the American Accounting Association.

[2] The COSO publication *Enterprise Risk Management—Integrated Framework* (product no. 990015) may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

The COSO ERM framework consists of eight interrelated components as follows:

1. *Internal environment.* The internal environment sets the foundation for how risk is viewed and addressed by an entity's people, including risk philosophy and risk appetite, integrity and ethical values, and the environment in which they operate.
2. *Objective setting.* Objectives must exist before management can identify potential risks affecting their achievement. ERM ensures that management has in place a process to set objectives and that the chosen objectives support and align with the entity's mission and are consistent with its risk appetite.
3. *Event identification.* Internal and external events affecting the achievement of an entity's objectives must be identified, distinguishing between risks and opportunities.
4. *Risk assessment.* Risks are analyzed, considering likelihood and impact, as a basis for how they should be managed. Risks are assessed on an inherent and residual basis.
5. *Risk response.* Management selects risk responses—avoiding, accepting, reducing, or sharing risk—developing a set of actions to align risks with the entity's risk tolerances and risk appetite.
6. *Control activities.* Policies and procedures are established and implemented to help ensure the risk responses are effectively carried out.
7. *Information and communication.* Relevant information is identified, captured, and communicated in a form and timeframe that enables people to carry out their responsibilities. Effective communication also occurs in a broader sense, flowing down, across, and up the entity.
8. *Monitoring.* The entire ERM process is monitored and modifications are made as necessary. Monitoring is accomplished through ongoing management activities, separate evaluations, or both.

ERM is not a serial process, but a multidirectional iterative process with the eight components affecting one another. Likewise the eight components will not function identically in every entity. Application in small- and medium-sized organizations is likely to be less formal and less structured.

The components are the criteria for the effectiveness of ERM. When each of the eight components is determined to be present and functioning effectively, and risk has been brought within the entity's risk appetite, management and the board of directors have reasonable assurance that they understand the extent to which each of the four categories' objectives is being achieved by the entity.

Relationship Between COSO *Enterprise Risk Management—Integrated Framework* and *Internal Control—Integrated Framework*

In 1992, COSO published the document *Internal Control—Integrated Framework*,[3] which established a comprehensive framework for internal control. In 2006, COSO issued its publication *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*,[4] which provides guidance on how to apply the original framework, particularly as it relates to the objectives of financial reporting.

[3] The COSO publication *Internal Control—Integrated Framework* (product no. 990012) may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.
[4] The COSO publication *Internal Control over Financial Reporting—Guidance for Smaller Public Companies* (product no. 990017) may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

Internal Control—Integrated Framework remains in place as a tool for evaluating internal control by itself and is also encompassed within ERM. The relationship between internal control and ERM is possibly best captured by the phrase “You can have effective internal control without effective ERM, but you cannot have effective ERM without effective internal control.”

Internal control is an integral part of ERM, which is a broader conceptual tool, expanding and elaborating on internal control, focusing more fully on risk, especially as it relates to strategic considerations.

Certain of the key areas where the ERM framework expands on the internal control framework include the following:

Objectives. The internal control framework specifies three categories of objectives—operations, financial reporting, and compliance. The ERM framework adds strategic objectives and expands the reporting objective to cover all reports developed and disseminated internally or externally, and expands the scope to cover nonfinancial information.

Environment. The ERM framework discusses an entity’s risk management philosophy, which is the set of shared beliefs and attitudes characterizing how an entity considers risks, and reflects its culture and operating style.

Key components of a risk management philosophy are *risk appetite* and *risk tolerance*. *Risk appetite*, set by management with oversight by the board of directors, is a broad-based conceptualization of the amount of risk that an entity is willing to take to achieve its goals. An entity’s risk appetite serves as a guidepost for making strategic choices and resource allocation decisions that are consistent with its established risk appetite.

The risk appetite is supported by more specific *risk tolerances* that reflect the degree of acceptable variation in executing the organization’s activities. Risk tolerances are usually best measured in the same units as the objectives that they relate to, and are aligned with the overall risk appetite.

The ERM framework also introduced the notion of taking a *portfolio view of risk*—looking at the composite of entity risks from a portfolio perspective. A portfolio view of risk can be depicted in a variety of ways. A portfolio view may be gained from looking at major risks or event categories across units, or by focusing on risk for the organization as a whole using net assets, changes in net assets, or other metrics. Taking a portfolio view enables management to determine whether it remains within its risk appetite, or whether additional risks should be accepted in some areas in order to enhance returns.

Risk assessment and response. In addition to considering risk from a portfolio perspective, the ERM framework calls attention to interrelated risks—where a single event or decision may create multiple risks.

The framework also identifies four categories of risk response that are taken into consideration by management in looking at inherent risks and achieving a residual risk level that is in line with the entity’s risk tolerances and overall risk appetite.

The following are the four risk response categories:

1. *Avoidance.* Not engaging in activities giving rise to the risk or exiting those activities.
2. *Reduction.* Any action taken to reduce risk likelihood, impact, or both.

3. *Sharing.* Reducing risk likelihood or impact by transferring or otherwise sharing a portion of the risk. Insurance products, hedging transactions, and outsourcing are common examples.
4. *Acceptance.* No action is taken to affect risk likelihood or impact.

Other Key Terms in ERM

You will hear a few additional terms when discussing ERM, described as follows:

Event identification techniques. An entity's event identification methodology may comprise a combination of techniques and supporting tools ranging from interactive group workshops and process flow analysis to technology-based inventories of potential events. These tools and techniques look to both past trends as well as to the future. Some are industry specific; most are derived from a common approach. They vary widely in level of sophistication and most organizations use a combination of techniques.

Risk assessment techniques. Risk assessment methodologies comprise a combination of qualitative and quantitative techniques. An example of the use of qualitative risk assessment is the use of interviews or group assessment of the likelihood or impact of future events. Quantitative techniques include probabilistic and nonprobabilistic models. Probabilistic models are based on certain assumptions about the likelihood of future events. Nonprobabilistic models such as scenario-planning, sensitivity measures, and stress tests, attempt to estimate the impact of events without quantifying an associated likelihood.

Roles and Responsibilities

Everyone in the organization has some role to play in ERM.

Board of directors. Authority for key decisions involving strategic direction, broad-based resource allocation, and setting high-level objectives is reserved for the board. Ensuring that objectives are met, determining that resources are utilized effectively, and ascertaining that risks are managed appropriately in the execution of strategy are key functions of the board and its committees.

The board's role in providing oversight of ERM in an organization includes the following:

1. Influencing and concurring with the entity's risk philosophy and risk appetite
2. Determining that overall strategy and strategic decisions are in alignment with the entity's risk appetite and philosophy
3. Ascertaining the extent to which management has established effective ERM in the organization
4. Reviewing the entity's portfolio view of risk and considering it in relation to the entity's risk appetite
5. Being apprised of the most significant risks and ascertaining whether management is responding appropriately

Internal audit. If the organization has an internal audit function, its role in ERM is twofold. In addition to identifying and evaluating risk exposures, *International Standards for the Professional Practice of Internal Auditing* charge the internal audit function with the responsibility for monitoring and evaluating the effectiveness of the organization's risk management system. In this role, internal auditors may support management by providing assurance on the:

- ERM processes—both design and function.
- effectiveness and efficiency of risk responses and related control activities.
- completeness and accuracy of ERM reporting.

This responsibility for evaluating the effectiveness of the organization's risk management efforts requires the internal audit function to maintain its independence and objectivity. Accordingly, best practice from a governance perspective would suggest that reporting responsibility for the risk function be a management responsibility that is separate from internal audit.

Limitations of ERM

Effective ERM will provide reasonable assurance to management and the board of directors regarding the achievement of an entity's objectives. However, achievement of objectives is affected by limitations inherent in any management process and the inherent uncertainty of all human endeavors.

The role and reality of human judgment in all aspects of management, including the selection of appropriate objectives, the inevitability of some degree of failure or error, and the possibility of collusion or management override of the process are all limiting factors. Another important limitation that must be considered is the cost of various risk response alternatives in relation to their projected benefits.

Conclusion

This primer should have given you a sense of what is meant by ERM and the responsibilities of a board of directors and audit committee with respect to risk management within an organization.

Although some risk management practices and techniques are complex and sophisticated, the overall concept of ERM is not. Essentially, COSO ERM is a robust, comprehensive framework that organizations, management, and boards can use to effectively manage risks and opportunities in line with strategic choices.

Much of what is encompassed in ERM are board and management responsibilities that have previously been carried out intuitively or in a manner less comprehensive and systematic than is contemplated by an enterprise approach.

All organizations from small single unit entities to large multinationals face a myriad of risks and opportunities in a rapidly changing world. Whether large or small, local or global, a more explicit, enterprise approach to risk management can help an organization maximize its opportunities while avoiding unnecessary pitfalls or surprises.

Enterprise Risk Management—The COSO Framework: A Tool for Strategic Oversight

The following tool, "Enterprise Risk Management—The COSO Framework: A Tool for Strategic Oversight," contains questions modeled on the framework in COSO's *Enterprise Risk Management—Integrated Framework*.

Enterprise Risk Management—The COSO Framework: A Tool for Strategic Oversight

PURPOSE OF THIS TOOL: This tool is created around the eight interrelated components of the COSO ERM framework. Refer to "Enterprise Risk Management—The COSO Framework: A Primer and Tool for the Audit Committee" for a discussion of the components.

When each of the eight components is determined to be effective in each of the four categories of objectives, the board of directors and management have reasonable assurance that they understand the extent to which the entity's strategic and operations objectives are being achieved, that the entity's reporting is reliable, and that applicable laws and regulations are being complied with.

INSTRUCTIONS FOR USING THIS TOOL: Within each section is a series of questions that the audit committee should focus on to assure itself that each of the components of the ERM is present and functioning properly.

These questions should be discussed in an open forum with the individuals that have a basis for responding to the questions. The audit committee should ask for detailed answers and examples from the management team, including key line and staff managers as well as members of the financial management, risk management, and internal audit teams to assure itself that the ERM function is operating as management represents.

Evaluation of the risk management process is not a one-time event, but rather a continuous activity for the audit committee, which should always be alert for potential deficiencies, and should continually probe the responsible parties regarding risks and opportunities. These questions are written in a manner such that a "No" response indicates a weakness that must be addressed.

COSO Framework	Yes	No	Not Sure	Comments
Internal Environment				
1. Are the audit committee's responsibilities for strategic oversight of risk assessment and risk management defined in its charter?	☐	☐	☐	
2. Is the organization's philosophy for managing risk articulated in a comprehensive code of conduct or other policies addressing acceptable practices and expected behavior?	☐	☐	☐	
3. Is the risk appetite for the organization formally articulated in qualitative terms, quantitative terms, or both?	☐	☐	☐	
4. Is the risk appetite consistent with the stated risk management philosophy and aligned with the organization's strategy?	☐	☐	☐	
5. Is the risk management approach of the organization consistent with the strategy, structure, and delegation of authority and responsibility in the organization (that is, is the approach to risk assessment and response and the resulting portfolio view appropriate in the context of these dimensions)?	☐	☐	☐	
Objective Setting				
1. Has the board established high level objectives that are consistent with the strategic direction, key strategic options, and risk appetite for the organization?	☐	☐	☐	
2. Has the board identified critical success factors, relevant performance measures, milestones, and risk tolerances for the achievement of the organization's strategic objectives?	☐	☐	☐	
3. Has the board identified breakpoints, risk tolerances, or both that will trigger board discussion of potential need for intervention or modification of strategy?	☐	☐	☐	

(continued)

COSO Framework	Yes	No	Not Sure	Comments
Objective Setting (cont.)				
4. Has management established operations, reporting, and compliance objectives that are aligned with the overall strategic objectives?	☐	☐	☐	
5. Does the board have a relevant and timely progress reporting mechanism in place to monitor implementation of the strategy consistent with the risk philosophy and within the established risk appetite for the organization?	☐	☐	☐	
Event Identification				
1. Has management employed a systematic approach in the identification of potential events that could affect the entity?	☐	☐	☐	
2. Is the categorization of events across the organization, vertically through operating units, by type, and by objective, among others, appropriate to the organization and consistent with the risk philosophy and appetite of the organization?	☐	☐	☐	
Risk Assessment				
1. Has management conducted a systematic assessment of the likelihood and impact of all events with the potential for significant impact on the entity?	☐	☐	☐	
2. Has management sufficiently considered the interdependency of potentially related events in its event identification and risk assessment process?	☐	☐	☐	
Risk Response				
1. Has management adopted an appropriate and cost effective array of risk responses at the activity level of the organization to reduce inherent risks to levels in line with established risk tolerances?	☐	☐	☐	

COSO Framework	Yes	No	Not Sure	Comments
Risk Response (cont.)				
2. Has management taken a portfolio view to assure that the selected risk responses have reduced the entity's overall residual risk to a level within the identified risk appetite for the organization?	☐	☐	☐	
3. If the residual risk level at the entity level is below the entity's risk appetite, has management provided incentives in appropriate target areas to enhance the organization's overall performance?	☐	☐	☐	
Control Activities				
1. Has management implemented adequate control activities throughout the organization to assure that its risk responses are carried out properly and in a timely manner?	☐	☐	☐	
Information and Communication				
1. Does the organization's management information systems capture and provide reliable, timely, and relevant information sufficient to support effective ERM?	☐	☐	☐	
2. Have adequate communication vehicles been implemented to assure that relevant risk related information is communicated by front line employees upward in the organization and across its units or processes?	☐	☐	☐	
Monitoring				
1. Are sufficient ongoing monitoring activities built into the organization's operating activities and performed on a real time basis to allow for appropriate reaction to dynamically changing risk conditions?	☐	☐	☐	
2. Has evaluation of the ERM process, either in its entirety or specific aspects, been given adequate consideration in the scope of the monitoring activities, including internal audit work, if applicable?	☐	☐	☐	

(continued)

COSO Framework	Yes	No	Not Sure	Comments
Monitoring (cont.)				
3. Have all deficiencies in risk management processes identified as a result of ongoing monitoring activities, or by the internal audit work, been communicated to the appropriate levels of management or the board?	☐	☐	☐	
4. Have all deficiencies and recommendations for improvement in risk management processes been addressed and appropriate corrective actions taken?	☐	☐	☐	

Conducting an Audit Committee Executive Session: Guidelines and Questions

PURPOSE OF THIS TOOL: Although it is generally accepted that audit committees should hold executive sessions with various members of executive management, leaders of the financial management team, the leader of the internal audit team, and the external auditor, the audit committee member may not understand the type of questions and the extent of the questions they should ask. This tool is intended to help the audit committee ask the right *first* questions, bearing in mind that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up questions. See the "Other Questions for Management" section of this tool for possible follow-up questions audit committee members can ask key members of the financial management team in order to improve their understanding of the day-to-day operating environment and management teams' decision-making processes and interactions.

What is an Executive Session?

An executive session provides the opportunity to meet with key members of the financial management team on a one-on-one basis. Executive sessions should occur at every meeting of the audit committee, though not every individual needs be in an executive session at every meeting. For example, it is appropriate for the chief audit executive (CAE) and the external auditor to have an executive session at every meeting, but the director of financial reporting might be in executive session with the audit committee only at the meeting before year-end results are released.

Depending on the government's laws or regulations, an audit committee meeting, and even an executive session, may be subject to open meetings laws, which typically require advance notice of the meetings. During an executive session meeting, minutes may or may not be recorded. When they are recorded, the government's open records laws or regulations may specifically exclude executive session minutes from public view, or may allow it. When meeting with members of the financial management team or the leader of the internal audit team, anyone who is not a member of the audit committee is excluded from the meeting. The purpose is to ask questions of various members of the financial management or internal audit teams in a safe environment. It is important that, when meeting with the controller, for example, the CFO not be in the room. Executive sessions should be a matter of routine at every audit committee meeting, and not on an exception basis.

The audit committee should avoid asking in an open session whether an individual has anything to discuss in an executive session. Such a question could put the individual in an awkward position with others in the government.

Asking open-ended questions in an executive session should generate useful information for the audit committee. This tool includes examples of the kinds of questions the audit committee should ask. These are meant to be sample questions to help start a conversation and create dialogue between the individual and the audit committee. *These sample questions are not intended to be a checklist.* Audit committee members need to be financially sophisticated enough to understand the answers to the questions and to use these answers to develop appropriate follow-up questions. Because it will not be unusual to ask similar questions of key government officials or employees, the external auditor, and the internal auditor, a comparison of their responses could be a good source of insight. Depending on the answers, follow-up action may also be necessary and the audit committee must be prepared to take that action. The most important thing to do when conducting an executive session is to *listen to the answers that are given and follow up on anything that is not understood*.

Note that an executive session provides safety and comfort that allows discussants to give honest answers to questions that they might not feel free to answer in an open environment.

There may be other information that the audit committee wants to know beyond that which would be covered in an executive session. “Other Questions” is an associated section of questions that follow the suggested executive session questions. The formality of an executive session may not be required for these questions, which nevertheless may elicit information the audit committee wants.

Audit committee members should also consider the history of the governmental entity, the current economic climate, the political environment, and so on, when asking questions in an executive session. Finally, each executive session should be concluded with a reminder to the member of management and the leader of the audit team that audit committee members are accessible outside the meeting. The individual should be advised to reach out to the audit committee member at other times if the need arises.

It is important to note that not every government will have different individuals in each position, as assumed in the following questions. Nevertheless, the audit committee should be aware of the functions that are part of dual roles, and adjust the questions accordingly. For example, the CFO and controller might share the duties of the director of financial reporting. The audit committee should explore how a function or role is accomplished, and compose questions accordingly. Also, the audit committee should consider and take into account other roles in the government. It may be that other people within a government should also be asked to meet with the audit committee in executive session.

INSTRUCTIONS FOR USING THIS TOOL: This tool is intended to help the audit committee ask the right *first* questions, bearing in mind that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up questions. Audit committee members may want to use the questions in the “Other Questions for Management” section in conjunction with this one in order to formulate and ask the appropriate follow-up questions. The first list of suggested questions are applicable to all positions, followed by position-specific questions.

Conducting an Executive Session—Sample Questions	Comments
All Positions	
1. Are you aware of any current or past occurrences of any kind of fraud within the government? Do you know of any situations in which fraud could occur?	
2. Are you aware of any situations of management override (as it relates to financial reporting) within the government?	
3. Is there any activity at any level within the government that you consider to be a significant violation of laws, regulations, contracts or grants, or significant departures from generally accepted accounting principles (GAAP)? Are you aware of any abuse within the government that you would consider to be material?	
4. Are you aware of any disagreements between the management of the government and the internal or external auditors?	
5. Have you encountered any situations in which the government complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	
6. Is there any activity within the government that you are uncomfortable with or consider unusual that warrants further investigation?	
7. Are there any questions we have not asked that should have been asked? If so, what are those questions? Are there any individuals within or external to the government to whom we should address questions?	
CFO	
1. Do you believe the financial statements fairly present the government’s financial position and changes in financial position in accordance with GAAP or some other comprehensive basis of accounting (OCBOA)?	

(continued)

Conducting an Executive Session—Sample Questions	Comments
CFO (cont.)	
2. Do you believe the disclosures are adequate and are understandable to the average user?	
3. Are you satisfied that an appropriate audit was performed by the external auditors?	
4. Discuss areas in which an accounting treatment could be complex or unusual.	
5. Do you feel comfortable raising issues without fear of retribution?	
CEO	
1. Do you believe the financial statements fairly present the government's financial position and changes in financial position in accordance with GAAP or OCBOA?	
2. Do you believe the disclosures are adequate and are understandable to the average user?	
3. Are you satisfied that an appropriate audit was performed by the external auditors?	
4. Are you aware of any disagreements between management of the government and the internal or external auditors?	
CAE (Leader of Internal Audit Team)	
1. Overall, is management cooperating with the internal audit team? Does management have a positive attitude in responding to findings and recommendations, or is it insecure and defensive of findings?	
2. Has management set an appropriate "tone at the top" with respect to the importance of and compliance with the internal control system around financial reporting?	
3. Discuss areas in which there is an accounting treatment that could be construed as complex or unusual.	
4. Do you have the freedom to conduct audits as necessary throughout the government?	
5. Were you restricted or denied access to requested information?	

Conducting an Executive Session—Sample Questions	Comments
CAE (Leader of Internal Audit Team) (cont.)	
6. Have you been pressured to change findings, or minimize the language in those findings so as to not reflect badly on another member of management? Are findings and recommendations given the level of discussion needed to properly satisfy any issues raised to your satisfaction?	
7. Do you feel comfortable raising issues without fear of retribution?	
Controller/Director of Financial Reporting	
1. Do you believe the financial statements fairly present the government's financial position and changes in financial position in accordance with GAAP or OCBOA?	
2. Do you believe the disclosures are adequate and are understandable to the average user?	
3. If you were the CFO, would you change the financial statements and accompanying footnotes, and, if so, for what reason(s) would you change them?	
4. Discuss areas in which there is an accounting treatment that could be construed as complex.	
5. Are you satisfied that an appropriate audit was performed by the external auditors?	
6. Are you aware of any situations of management override (as it relates to financial reporting) within the government?	
7. Are you aware of any disagreements between the management of the government and the internal or external auditors?	
8. Has management set an appropriate "tone at the top" with respect to the importance of and adherence with the internal control system around financial reporting?	
9. Do you feel comfortable raising issues without fear of retribution?	
10. Is there any activity within the government that you are uncomfortable with or consider unusual that would warrant further investigation?	

(continued)

Conducting an Executive Session—Sample Questions	Comments
General Counsel	
1. Are you aware of any issues that could cause embarrassment or significant public outcry regarding the government's operations?	
2. Have you ever been told anything in confidence or otherwise that would embarrass or cause significant negative publicity for the government if it was known publicly?	
3. Are you aware of any situations of management override of internal controls (as it relates to financial reporting) within the government?	
4. Are there any items that you have discussed with the CEO, CFO, other government officials, or outside counsel about which the audit committee is not already aware?	
5. Are you aware of any disagreements between the management of the government and the internal or external auditors?	
6. Do you feel comfortable raising issues without fear of retribution?	
7. Is there any activity within the government that you are uncomfortable with or consider unusual that would warrant further investigation?	
Chief Information Officer	
1. Is there any activity within the government that you are uncomfortable with or consider unusual that would warrant further investigation?	
2. Do you feel comfortable raising issues without fear of retribution?	
External Auditor	
Note that certain communications are required between the external auditor and the audit committee. A separate tool, "Discussions to Expect From the External Auditors," has been prepared for the audit committee to ensure the completeness of the external auditor's required communication with the audit committee. These suggested questions are meant to be in addition to the required communications.	
1. Explain the process your firm or audit organization goes through to assure that all of your engagement personnel are independent and objective with respect to our audit. Particularly, with respect to nonaudit services, how do those services affect the work that you do or the manner in which the engagement team or others are compensated? Are you aware of any anticipated event that could possibly impair the independence, in fact or in appearance, of the firm and any member of the engagement team?	

Conducting an Executive Session—Sample Questions
External Auditor (cont.)
Comments:
2. Has management, legal counsel, or others made you aware of anything that could remotely be considered a significant violation of laws, regulations, contracts or grants, or significant departures from GAAP or OCBOA? Are you aware of any abuse within the government that you would consider to be material?
Comments:
3. Are there any areas of the financial statements, including, and most important, the notes, in which you believe we could be more explicit or transparent, or provide more clarity to help a user better understand our financial statements?
Comments:
4. Have you expressed any concerns or comments to management with respect to how our presentation, including the notes or Management's Discussion & Analysis (MD&A) could be improved?
Comments:
5. Which accounting policies or significant accounting transactions do you think a user would have trouble understanding based on our disclosure? What additional information could (should) we provide?
Comments:

(continued)

Conducting an Executive Session—Sample Questions
External Auditor (cont.)
6. Based on your auditing procedures, do you have any concerns about whether management may be attempting to commit management override? Have you noticed any biases as a result of your audit tests with respect to accounting estimates made by management?
Comments:
7. In which areas have you and management disagreed?
Comments:
8. Discuss your impressions of the performance of the CAE in terms of enhancing internal control processes.
Comments:
9. Has the firm been engaged to provide any services besides the independent audit of which the audit committee is not already aware?
Comments:
External Auditor (cont.)
10. How can management improve in terms of setting an appropriate "tone at the top"?
Comments:

Conducting an Executive Session—Sample Questions
11. Describe the ideas you have discussed with management for improving the internal control system over financial reporting.
Comments:
12. Describe for us any situation in which you believe management has attempted to circumvent the intention of GAAP, but has yet complied with GAAP.
Comments:
13. Is there anything going on within the government that you are uncomfortable with or consider unusual that would warrant further investigation?
Comments:
14. Are there any questions we have not asked that you wish to share with the audit committee?
Comments:

(continued)

Conducting an Executive Session—Sample Questions
Comments:

Other Questions for Management

PURPOSE OF THIS SECTION: It is important for the audit committee to be solidly familiar with the management team and the internal audit team because the committee relies heavily on them. This section lists other questions that the audit committee may wish to address to key members of the financial management team and the leader of the internal audit team. These questions need not be asked in an executive session, but can be addressed more informally as opportunities arise.

Other Questions for Management	Comments
All Positions	
1. What are the biggest risks, financial pressures, and uncertainties facing the government in the next year? How do these affect the government's ability to fairly present its financial position and results of operations, and to explain it to stakeholders in the financial statement's MD&A section?	
2. Has the external auditor been engaged for services other than the annual audit about which the audit committee is not already aware?	
3. What have you done to promote a work environment that values and respects both internal controls and ethical behavior among employees?	
CFO	
1. Describe your working relationship with the CEO.	
2. If you were the partner-in-charge of the audit, what would you do differently?	
3. How frequently do you meet with the lead audit partner? Describe your relationship with him or her.	
4. Are you aware of any disagreements between management and the internal auditors?	
5. Describe your relationship with the CAE. Discuss your impressions of his or her performance.	
6. How do you interface with the internal audit function?	
7. What significant issues arose from the understanding of the internal control systems?	

(continued)

Other Questions for Management	Comments
CFO (cont.)	
8. What aspects of the government appear to put the most strain on management? Could any of these aspects significantly strain the government's financial position and changes in financial position?	
9. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	
10. Which systems are the most difficult to work with?	
11. Are there any new systems or functionality that you would like to purchase but have delayed due to cost considerations?	
12. What procedures or oversight do you apply to manual journal entries that are proposed during the book-closing process?	
13. Do each of the accounting and finance departments of the government have adequate personnel, both in numbers and quality, and authority to meet all their obligations?	
14. What are the most difficult challenges facing the finance department today?	
15. Which departments might benefit the most from additional people resources?	
16. What are the personnel turnover rates in the accounting and finance teams for the last year?	
17. Which of the government's business-type activities caused the largest decrease in net assets in the past year? The biggest increase?	
18. What, if any, changes do you believe need to be made in these areas?	
19. Describe your working relationship with the heads of the respective departments.	

Other Questions for Management	Comments
CEO	
1. Discuss your impressions of the performance of the CAE.	
2. What issues arose from the understanding of the internal control systems?	
3. Which of the government's business-type activities had the largest decrease in net assets this past year? The largest increase?	
4. What, if any, changes do you believe need to be made in these areas?	
5. Describe your working relationship with the heads of the respective departments.	
CAE (Leader of Internal Audit Team)	
1. What procedures do you apply to the review of manual journal entries made during the book-closing process, and to other entries that could be termed as a management override of the internal control system around financial reporting?	
2. If you were the CEO, how would you do things differently in the internal audit department?	
3. Do you believe you have adequate resources available to you to fulfill the charge of the department? If not, what additional resources are needed?	
4. Did you encounter any disagreements or difficulties between the internal audit team and the external auditors in connection with the recently completed audit of the government's financial statements? How will you approach the financial statement audit differently next year?	

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Other Questions for Management	Comments
CAE (Leader of Internal Audit Team) (cont.)	
5. What critical risks are being monitored by the internal audit team on a periodic or regular basis? How do you address the continuous auditing of these critical risks? Is automation and integrated system reporting assisting you in this effort?	
6. Are you aware of any other disagreements between management of the government and the external auditors?	
7. Are there any disagreements between the internal audit team and management?	
8. What issues arose from the understanding of the internal control system?	
9. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	
10. Do you monitor payments to the independent audit firm to ensure that the audit is only providing services that are related to the audit, or other services that have been preapproved by the audit committee?	
11. Which of the government's business-type activities had the largest decrease in net assets this past year? The largest increase?	
12. What, if any, changes do you believe need to be made in these areas?	
13. Describe your working relationship with the heads of the respective departments.	
Controller/Director of Financial Reporting	
1. If you were the partner-in-charge of the audit, what would you do differently?	
2. Discuss your impressions of the performance of the CAE.	
3. How could the financial statements and related disclosures be improved?	
4. Are the computer systems upon which you rely integrated, or does it require manual intervention to integrate your systems?	

Other Questions for Management	Comments
Controller/Director of Financial Reporting (cont.)	
5. What procedures do you apply to review manual journal entries proposed during the book-closing process, or to other entries that could be termed as a management override of the internal control system around financial reporting?	
6. Which of the government's business-type activities had the largest decrease in net assets this past year? The largest increase?	
General Counsel	
1. Discuss your impressions of the performance of the CAE.	
2. Describe your working relationship with the heads of the respective departments.	
Chief Information Officer	
1. Are you satisfied with the integrity of the information running through the systems in the government? How could technology improve the integrity of the information?	
2. What exposure is associated with the government's firewalls, as well as any Internet-based financial operations, such as online payments for certain government services?	
3. If you had an unlimited budget, how would you spend money to improve the government's information architecture?	
4. What do you consider your critical risk areas?	
5. Describe your relationship with the CFO and other key people in the accounting and finance team.	
6. Are manual journal entries identified and approved? Are they somehow brought to the attention of the CAE, or other officer(s) that did not have a hand in creating the journal entries?	
7. Is documentation updated every time there is a change to the internal controls process?	

(continued)

Other Questions for Management	Comments
Chief Information Officer (cont.)	
8. Describe your working relationship with the heads of the respective departments.	
External Auditor	
1. What audit procedures do you apply to manual journal entries that are proposed during the book- closing process, or to other journal entries that could be termed as a management override of the internal control system around financial reporting?	
2. Was any audit work not performed due to any limitations placed on you by management (for example, any areas scoped out by management, or any restriction on fees that limited the scope of your work)?	
3. Was the audit fee that you charged the government sufficient for the work that you performed?	
4. If you had an unlimited audit fee, what additional work would you have performed?	
5. What are the biggest risks facing the government in the next year? What steps do you think the government should take to address those risks?	
6. What are the biggest risks facing the government over the long term? What steps do you believe the government should take to address those obstacles?	
Notes	

Conducting an Audit Committee Self-Evaluation: Guidelines and Questions

PURPOSE OF THIS TOOL: Audit committees should conduct a self-evaluation on an annual basis. This can be accomplished in a number of evaluation formats and scenarios (for example, through the use of outside evaluators, a 360-degree evaluation format, or other methods). The sample questions included in this tool are suggestions and intended to provide a starting point to evaluating the performance and effectiveness of the audit committee. Follow-up questions are encouraged and the committee should plan for further action as appropriate.

The self-evaluation can take different forms, involve a number of participants, and use diverse techniques. Most importantly, however, the self-evaluation should adopt a straightforward approach that will aid the audit committee in assessing its strengths and weaknesses and lay a foundation for future improvement. Some guidelines in designing the format for self-evaluation would include the following areas of consideration.

1. *Introspection.* Be introspective. Evaluate the audit committee's performance by asking specific questions about the impact it has had on the organization, such as its financial reporting process, the annual audit, the relationship with the internal and external auditors, members of management, and elected officials. Consider including a representative of the governing body or an equivalent official in this evaluation process.
2. *Comprehensive.* Conduct 360-degree evaluations of all audit committee members and the committee chair. A 360-degree evaluation is one that obtains anonymous feedback from a large group of individuals representing various perspectives. In this setting, each committee member would conduct a self-evaluation and be evaluated by the other committee members, the governing body's chair, chief audit executive, CFO, and executive director, and if appropriate, other senior finance or accounting personnel. There should be thought into how the data will be collected (that is, by someone independent), and the governing body chair and the audit committee chair should consider the results of the evaluations. Making sure to stay consistent with any audit committee bylaws, the governing body chair and the audit committee chair should consider whether any members should be rotated off the committee. The members' attendance record and level of participation should be considered during this process.
3. *Qualifications.* Considering the roles and responsibilities of the audit committee members, evaluate each member's performance during the year. At least one member should have financial experience (see the "Audit Committee Financial and Other Experience Considerations" tool). Using that and other tools that are available, including the AICPA Competency Self-Assessment Tool (CAT), evaluate the performance of applicable members. The CAT and other tools are available on the AICPA website.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions provided in this tool are only a starting point to evaluating the performance and effectiveness of the audit committee. Before completion, the committee should determine how it can best ensure that responses reflect a forthright exchange of ideas and opinions among audit committee members. The committee should determine how the process should be completed. The following sample questions can be completed anonymously before attending an evaluation discussion meeting or during a session of the committee. These questions are intended to provide guidance on assessing the general effectiveness of the audit committee in its roles and relationships, which includes understanding the government's activities, its risk factors, and acquiring the technical and communication proficiency necessary for proper oversight of the accounting, financial reporting, and internal control environment.

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
A. Roles and Relationships				
1. Does the audit committee have a positive working relationship with management, the internal auditors, and the external auditors?	☐	☐	☐	
2. Does the committee provide its own view on issues to the chair?	☐	☐	☐	
3. Are differences of opinion on issues resolved to the satisfaction of the committee?	☐	☐	☐	
4. Do all members provide input to the committee chair as appropriate?	☐	☐	☐	
5. Is an audit committee charter used as a document to guide the committee in its efforts, and to help guide the committee's agenda?	☐	☐	☐	
6. Does the committee engage outside experts as appropriate?	☐	☐	☐	
7. Does the committee conduct executive sessions in a manner that offers a safe haven to the individual, while asking tough and necessary questions, evaluating the answers, and pursuing issues that might arise to a satisfactory resolution?	☐	☐	☐	
8. Did the audit committee evaluate the internal auditor's overall effectiveness?	☐	☐	☐	

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
A. Roles and Relationships (cont.)				
9. Did the audit committee evaluate the external auditors, including the auditors' responsiveness to the committee's expectations?	☐	☐	☐	
10. Is the size of the committee appropriate for the complexity and operations of the government organization?	☐	☐	☐	
11. Are committee members independent of management?	☐	☐	☐	
12. Do committee members encourage a "tone at the top" that conveys basic values of ethical integrity as well as legal compliance and strong financial reporting and control?	☐	☐	☐	
B. Government Activities				
1. Does the committee understand the organizational structure and programs of the government's activities and programs?	☐	☐	☐	
2. Does the committee evaluate whether management exhibits the proper tone at the top and foster a culture and environment that promotes high-quality financial reporting and appropriate attention to internal controls and compliance with laws and regulations?	☐	☐	☐	
3. Does the committee evaluate management's procedures for monitoring compliance with the government organization's code of ethics?	☐	☐	☐	
4. Does the committee receive the internal and the external auditors' assessments of the risks for fraud and other risk factors that lead to potential fraudulent financial reporting?	☐	☐	☐	
5. Is the audit committee aware of reports or other communications received from regulators, and updates from the general counsel on legal and regulatory matters, that may have a material effect on the financial activities and related financial statements, or that may affect related organizational compliance policies?	☐	☐	☐	

(continued)

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
C. Risk Factors				
1. Does the committee have discussions with the chief information officer to understand the organization's technology strategy, information systems, and measures taken to protect technology resources, including disaster recovery and emergency preparedness?	☐	☐	☐	
2. Has the audit committee reviewed all significant control deficiencies identified by the internal or external auditors, as well as management's corrective action plan and timetable to address those recommendations?	☐	☐	☐	
D. Technical Proficiency				
1. Is the committee cognizant of the line between oversight and management, and does it endeavor to respect that line?	☐	☐	☐	
2. Are committee members financially literate?	☐	☐	☐	
3. Has a representative number of committee members attended recent training on governmental accounting, auditing, and financial reporting developments, and current business and industry practices?	☐	☐	☐	
4. Does the committee review reports, financial statements, and related audit results with management, staff, and external auditors? Does the committee include reviewing interim audit and Circular A-133 Single Audit results?	☐	☐	☐	
5. Has the committee discussed with management any significant year-end issues that may affect the financial integrity of accounting and reporting practices?	☐	☐	☐	
6. Does the committee have a system to assess whether assets are being managed effectively?	☐	☐	☐	
7. Are the government's financial reporting processes stronger as a result of management's interactions with the committee?	☐	☐	☐	

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
D. Technical Proficiency (cont.)				
8. Does the committee discuss the audit plans with the internal and external auditors, along with the extent of control testing to be performed and related concerns and challenges?	☐	☐	☐	
9. Did the committee assess whether independence has been maintained by the external auditors (and internal auditors, if relevant)? Has the committee discussed the processes used by such auditors to monitor for independence?	☐	☐	☐	
10. Where appropriate, did the committee approve and sign the engagement letter(s) for the annual and Circular A-133 audits and nonaudit services?	☐	☐	☐	
E. Communication Process				
1. Are meeting agendas prepared and distributed in advance to ensure effective and efficient meetings, to allow that necessary topics are addressed, and to comply with open meeting laws?	☐	☐	☐	
2. Are minutes of meetings taken and circulated after the meeting?	☐	☐	☐	
3. Does the committee review management's response to audit recommendations and whether follow-up audits indicate corrective action is in place, timely, and effective?	☐	☐	☐	
F. Relationship With Governing Board				
1. Is the remainder of the governing board supportive of strong internal controls and open reporting of financial issues?	☐	☐	☐	
2. Does the committee use its knowledge and position to educate its fellow board members on issues of financial and financial reporting importance?	☐	☐	☐	
3. Has the governing board as a whole encouraged management to make strong internal controls? Has the governing board made including an adequately staffed and well trained financial department a priority?	☐	☐	☐	

PART II: Audit Committee—Management and Organization

Independence and Conflict of Interest

PURPOSE OF THIS TOOL: The purpose of this tool is to provide the audit committee and board members with an overview of issues of independence and conflict of interest. These topics must be considered in connection with audit committee membership, board membership, and relationships with external auditors and other parties.

Independence

Independence implies one's ability to act with integrity and exercise objectivity and professional skepticism. Therefore, independence in federal, state, and local governments is critical to promote ethical behavior and reliable financial reporting. With direct contacts to the management team and the auditing firm, the audit committee is quite possibly in the best position to monitor an organization's compliance with independence standards.

There are many groups that define and require independence from the auditor, the board, and management (see the summary table at the end of this tool). The AICPA's independence standards apply to CPAs when performing the attestation function. In addition, Government Accountability Office (GAO) standards, which are generally very similar, apply to many engagements involving federal entities and state and local government organizations. The GAO standards have been voluntarily adopted by many state and local governments and other entities both domestically and internationally.

In addition, there are practices self-imposed by those charged with governance of the governmental entity. Many governmental entities include definitions of *independence, ethics,* and *integrity* in their policies and procedures. Others require that the board, staff, or both, sign annual statements of independence or conflict of interest. It is recommended that senior management define, communicate, and exhibit these qualities to set a high standard throughout the organization. A sample conflict of interest policy for a governmental entity is provided as a part of this tool.

AICPA: Auditor Independence

Independence shall be considered impaired by a variety of factors. Generally, CPAs are not independent if they are in a position to influence, make management decisions, provide accounting services or certain nonaudit services, or have financial interests in an entity. A CPA is required to document any possible situations that might impair his or her independence on an engagement, inform his or her audit organization, and inform the potential client if any such situations may exist.

Auditor independence requirements will be determined by state boards of accountancy; state CPA societies; and any organization that issues or enforces standards of independence that would apply to the auditor's engagement. Individual auditors who are members of professional organizations or are licensed or certified professionals may also be subject to ethical requirements of those professional organizations or licensing bodies. Such organizations may have independence requirements or rulings that differ from (for example, may be more restrictive than) those of the AICPA. In addition, many government auditors are subject to government ethics laws and regulations, which also could differ from those of the AICPA.

GAO Yellow Book: Auditor Independence

The GAO requires auditor independence requirements under *Government Auditing Standards*, commonly referred to as the Yellow Book, to be revised by the GAO in September, 2011. Laws, regulations, contracts, grant agreements, or policies frequently require audits in accordance with *Government Auditing Standards*. Many auditors and audit organizations also voluntarily choose to perform their work in accordance with these standards.

Although the standards deal with a range of auditor independence issues, the foundation of the Yellow Book independence standards is a conceptual framework that requires auditors to identify, evaluate, and apply safeguards to appropriately address threats to independence. The professional requirements most significant for many governmental entities are those associated with nonaudit services. Auditors have the capability of performing a range of services for their clients. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, his or her client, or both will have to make a choice about which of these services the auditor will provide.

One of the most common nonaudit services is bookkeeping and preparing accounting records. Although auditors can assist management is preparing financial statements, the auditor should determine that the government entity's management taking responsibility for the preparation and fair presentation of the financial statements possesses suitable skill, knowledge, or experience to evaluate the adequacy of any services in this area provided by the auditor. Although this requirement parallels the rules in the AICPA Code of Professional Conduct (*Professional Standards*), *Government Auditing Standards* requires additional documentation of the auditor's assessment of management's skill, knowledge, or experience.

The focus of the auditor independence standards is so their opinions, findings, conclusions, judgments, and recommendations will be impartial and viewed as impartial by objective third parties with knowledge of the relevant information. Auditors are to avoid situations that could lead objective third parties with knowledge of the relevant information to conclude that auditors are not independent and thus not capable of exercising objective and impartial judgments on all issues associated with conducting the audit and reporting on the work.

Government Auditing Standards' practical consideration of independence consists of four interrelated sections, providing

1. a conceptual framework for making independence determinations based on facts and circumstances that are often unique to specific audit environments;
2. guidance for auditors considering independence issues as they relate to audit organizations that are structurally located within the governments they audit;
3. independence requirements when performing nonaudit services, including indication of specific nonaudit services that would normally impair independence; and
4. guidance on documentation necessary to support adequate consideration of auditor independence.

Auditors should apply the conceptual framework at the audit organization, engagement, and individual auditor level to (1) identify threats to independence; (2) evaluate the significance of the threats identified; and (3) apply safeguards as necessary. Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether it would be reasonable to expect that the threat would compromise an auditor's professional judgment and, if so, if the specific safeguards applied to eliminate the threat or reduce it to an acceptable level. Safeguards are controls designed to eliminate or reduce to an acceptable level threats to independence.

Certain conditions may lead to threats that are so significant that they cannot be eliminated or reduced to an acceptable level through the application of safeguards, resulting in impaired independence. Under these conditions, certain nonaudit services are prohibited, but should result in consistent results when compared with AICPA requirements.

According to *Government Auditing Standards*, internal auditors are defined as those auditors who are employed to work for management of the audited entity and may be subject to administrative direction from persons involved in the entity management process. These auditors and audit organizations are encouraged to use the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing* in conjunction with the Yellow Book. Under *Government Auditing Standards*, internal auditors and audit organizations that work under the direction of the audited entity's management are considered independent if the head of the audit organization

1. is accountable to the head or deputy head of the government entity and to those charged with governance;
2. reports the audit results both to the head or deputy head of the government entity and to those changed with governance;
3. is located organizationally outside the staff or line-management function of the entity under audit;
4. has access to those charged with governance; and
5. is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisals.

Summary of Significant Independence and Conflict of Interest Standards and Requirements

AICPA	• Standards document: Code of Professional Conduct ET section 100, *Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*). • Sets independence standards that CPAs must adhere to with regards to the type of work performed. • Applies to CPAs in all situations involving an attest client. • Attest: Services requiring independence and assurances from the CPA, such as audits, reviews, and agreed-upon procedures.

(continued)

Summary of Significant Independence and Conflict of Interest Standards and Requirements

GAO (formerly General Accounting Office)	• Standards document: *Government Auditing Standards* (also known as generally accepted government auditing standards or Yellow Book). • Establishes independence standards for most federal entities and many state and local entities. Various laws require compliance with the comptroller general's auditing standards in connection with audits of federal entities and funds. Furthermore, many states, local governments, and other entities, both domestically and internationally, have voluntarily adopted these standards. • GAO rules are generally consistent with AICPA rules, but may require additional documentation. • Establishes criteria for the independence of internal auditors and audit organizations, and encourages internal audit organizations to use the IIA *International Standards for the Professional Practice of Internal Auditing* in conjunction with the Yellow Book.

Conflict of Interest

Another common area of concern about objectivity and impartiality in carrying out certain functions is the notion of conflict of interest. In government, conflict of interest has importance, among other things, because of the fiduciary responsibility that governments and government officials and employees have for their citizenry. A common example of the consideration of conflict of interest is in the area of procurement. If a member of the governing body also owns a company that the government buys services or products from, there is an actual or perceived risk that when the government's employees enter into contracts with the company, the amounts paid to the company may be other than an arm's-length transaction because of favoritism to the company, which is owned by the governing body member.

An audit committee should expect the government to have a conflict of interest policy and require, at a minimum, governing body members, management, and those who perform key financial and legal functions for the government to complete a conflict of interest statement, updated annually. The sample conflict of interest policy is a tool for helping an audit committee establish such a policy or evaluate an existing conflict of interest policy.

Sample Conflict of Interest Policy*

[*Organization Name*]

Policy on Conflicts of Interest
and Disclosure of Certain Interests

This conflict of interest policy is designed to help directors, officers, and employees of the [*Organization Name*] identify situations that present potential conflicts of interest and to provide [*Organization Name*] with a procedure that, if observed, will allow a transaction to be treated as valid and binding even though a director, officer, or employee has or may have a conflict of interest with respect to the transaction. In the event there is an inconsistency between the requirements and procedures prescribed herein and those in federal or state law, the law shall control. All capitalized terms are defined in Part 2 of this policy.

1. **Conflict of Interest Defined.** For purposes of this policy, the following circumstances shall be deemed to create Conflicts of Interest:

   A. Outside Interests.

      (i) An Agreement or Transaction between [*Organization Name*] and a Responsible Person or Family Member.

      (ii) An Agreement or Transaction between [*Organization Name*] and an entity in which a Responsible Person or Family Member has a Material Financial Interest or of which such person is a director, officer, agent, partner, associate, trustee, personal representative, receiver, guardian, custodian, conservator, or other legal representative.

   B. Outside Activities.

      (i) A Responsible Person competing with [*Organization Name*] in the rendering of services or in any other Agreement or Transaction with a third party.

      (ii) A Responsible Person's having a Material Financial Interest in; or serving as a director, officer, employee, agent, partner, associate, trustee, personal representative, receiver, guardian, custodian, conservator, or other legal representative of, or consultant to; an entity or individual that competes with [*Organization Name*] in the provision of services or in any other Agreement or Transaction with a third party.

   C. Gifts, Gratuities and Entertainment. A Responsible Person accepting gifts, entertainment, or other favors from any individual or entity that:

      (i) does or is seeking to do business with, or is a competitor of [*Organization Name*]; or

      (ii) has received, is receiving, or is seeking to receive a loan or grant, or to secure other financial commitments from [*Organization Name*];

      (iii) is a charitable organization;

      (iv) under circumstances where it might be inferred that such action was intended to influence or possibly would influence the Responsible Person in the performance of his or her duties. This does not preclude the acceptance of items of nominal or insignificant value or entertainment

* This example of a conflict of interest policy, with key definitions included, was adapted with permission from the Minnesota Charities Review Council.

of nominal or insignificant value that are not related to any particular transaction or activity of [*Organization Name*].

2. **Definitions.**

   A. A *Conflict of Interest* is any circumstance described in Part 1 of this Policy.

   B. A *Responsible Person* is any person serving as an officer, employee, or member of the board of directors of [*Organization Name*].

   C. A *Family Member* is a spouse, domestic partner, parent, child, or spouse of a child, brother, sister, or spouse of a brother or sister, of a Responsible Person.

   D. A *Material Financial Interest* in an entity is a financial interest of any kind that, in view of all the circumstances, is substantial enough that it would, or reasonably could, affect a Responsible Person's or Family Member's judgment with respect to transactions to which the entity is a party. This includes all forms of compensation. (The board may wish to establish an amount that it would consider to be a "material financial interest.")

   E. An Agreement *or Transaction* is any agreement or relationship involving the sale or purchase of goods, services, or rights of any kind, the providing or receipt of a loan or grant, or the establishment of any other type of pecuniary relationship by [*Organization Name*]. The making of a gift to [*Organization Name*] is not an Agreement or Transaction within the meaning of this document.

3. **Procedures.**

   A. Before board or committee action on and Agreement or Transaction involving a Conflict of Interest, a director or committee member having a Conflict of Interest and who is in attendance at the meeting shall disclose all facts material to the Conflict of Interest. Such disclosure shall be reflected in the minutes of the meeting.

   B. A director or committee member who plans not to attend a meeting at which he or she has reason to believe that the board or committee will act on a matter in which the person has a Conflict of Interest shall disclose to the chair of the meeting all facts material to the Conflict of Interest. The chair shall report the disclosure at the meeting and the disclosure shall be reflected in the minutes of the meeting.

   C. A person who has a Conflict of Interest shall not participate in or be permitted to hear the board's or committee's discussion of the matter except to disclose material facts and to respond to questions. Such person shall not attempt to exert his or her personal influence with respect to the matter, either at or outside the meeting.

   D. A person who has a Conflict of Interest with respect to an Agreement or Transaction that will be voted on at a meeting shall not be counted in determining the presence of a quorum for purposes of the vote. The person having a conflict of interest may not vote on the Agreement or Transaction and shall not be present in the meeting room when the vote is taken, unless the vote is by secret ballot. Such person's ineligibility to vote shall be reflected in the minutes of the meeting. For purposes of this paragraph, a member of the board of directors of [*Organization Name*] has a Conflict of Interest when he or she stands for election as an officer or for re-election as a member of the board of directors.

   E. Responsible Persons who are not members of the board of directors of [*Organization Name*], or who have a Conflict of Interest with respect to an Agreement or Transaction that is not the subject of board or committee action, shall disclose to the Chair or the Chair's designee any Conflict of

Interest that such Responsible Person has with respect to an Agreement or Transaction. Such disclosure shall be made as soon as the Conflict of Interest is known to the Responsible Person. The Responsible Person shall refrain from any action that may affect [*Organization Name*]'s participation in such Agreement or Transaction.

In the event it is not entirely clear that a Conflict of Interest exists, the individual with the potential conflict shall disclose the circumstances to the Chair or the Chair's designee, who shall determine whether there exists a Conflict of Interest that is subject to this policy.

4. **Confidentiality.** Each Responsible Person shall exercise care not to disclose confidential information acquired in connection with such status or information the disclosure of which might be adverse to the interests of [*Organization Name*]. Furthermore, a Responsible Person shall not disclose or use information relating to the business of [*Organization Name*] for the personal profit or advantage of the Responsible Person or a Family Member or the Responsible Person's company.

5. **Review of Policy.**

    A. Each new Responsible Person shall be required to review a copy of this Policy and to acknowledge in writing that he or she has done so.

    B. Each Responsible Person shall annually complete a disclosure form identifying any relationships, positions, or circumstances in which the Responsible Person is involved that he or she believes could contribute to a Conflict of Interest arising. Such relationships, positions, or circumstances might include service as a director of or consultant to a not-for-profit organization, or ownership of a business that might provide goods or services to [*Organization Name*]. Each Responsible Person should also disclose to those charged with governance any potential Conflict of Interest that may arise during the course of the year between the submission of annual disclosure forms. Any such information regarding business interests of a Responsible Person or a Family Member shall be treated as confidential and shall generally be made available only to the Chair, the Executive Director, and any committee appointed to address Conflicts of Interest, except to the extent additional disclosure is necessary in connection with the implementation of this Policy.

    C. This policy shall be reviewed annually by each member of the board of directors. Any changes to the policy shall be communicated immediately to all Responsible Persons.

[*Organization Name*]

Conflict of Interest Information Form

Name:____ Date: ___________________________________

Please describe below any relationships, positions, or circumstances in which you are involved that you believe could contribute to a Conflict of Interest (as defined in [*Organization Name*]'s Policy on Conflicts of Interest) arising.

*I hereby certify that the information set forth above is true and complete to the best of my knowledge. I have reviewed, and agree to abide by, the Policy of Conflict of Interest of [*Organization Name*] that is currently in effect.*

Signature: ____________________________________ Date: ___________________________________

Management's Summary of Unique Transactions, Risks, and Financial Reporting, and Financial Relationships

PURPOSE OF THIS TOOL: Some transactions and financial relationships put a government organization at greater financial risk. Generally accepted accounting principles for governments provide guidance about how a government organization should account for and report these transactions and relationships as a means to fully inform the government organization's constituents. It is important that the audit committee understand the nature and the reason for these transactions and relationships, and ensure that management adequately discloses them in its financial statements. This tool is intended to assist audit committee members in gaining an understanding of management's use of certain unique transactions and relationships so they may weigh in on the appropriateness of the treatment and whether it will meet the government organization's objectives for public accountability.

Some transactions and financial arrangements put a government organization at greater financial risk. The audit committee should be aware of these transactions, relationships, and circumstances that may require recognition in the government organization's financial statements and should ensure that those transactions and events have been accounted for properly. Some of the more common of these transactions and relationships that the audit committee should be aware of are as follows:

1. Investments in derivative financial instruments
2. Securities lending and debt-issuing transactions
3. Relationships with legally separate entities
4. Joint ventures with other governments or organizations

The following information provides background about these types of transactions and relationships.

Derivatives

A government organization's investment polices, when allowed by laws or regulations, may allow investments in financial instruments that are not routine or actively traded in the market. Audit committees should be aware of the government organization's investment policy, which should be approved by the finance committee. In addition, the audit committee should be aware of the monitoring procedures used by the finance committee in monitoring the government organization's compliance with the investment policy.

Routine or actively traded financial instruments, such as repurchase agreements, government agency debt securities, and money market funds, have some degree of risk. Derivatives, however, which are financial instruments or contracts that have unique characteristics underlying their ultimate investment yield, typically have much greater risk. The fair values and cash flows of derivative instruments are derived from or determined by other data, such as bond or commodity prices or indexes based on those prices. By entering into these arrangements, governments receive and make payments based on prices without actually entering into the related financial or commodity transactions.

If a government organization holds derivatives, these financial instruments are reported at fair value in the government's financial statements. Fair value is either the price an item is expected to garner if sold on the open market between two unrelated willing parties or the value or future cash flows in today's dollars. Derivative financial instruments take many forms, such as the following:

- *Interest rate lock.* An agreement between a government and a lender that ensures the government will get a specific interest rate when it ultimately issues bonds or another form of debt.
- *Interest rate swap.* Also related to debt issued by the government. A government issues variable-rate debt, for example, and also enters into a swap in which it agrees to pay a fixed interest rate to a financial firm, usually larger than the interest it currently pays on the variable-rate debt. In return, the firm agrees to pay the government an amount that is expected to offset the government's interest payments to the owners of the bonds—an amount that changes as market interest rates change.
- *Futures contract.* Agreements to buy or sell a product for a specific price on a specific future date. Use of the futures contract allows a government to convert the variable, uncertain price of a commodity into a fixed known price, and is used more often by governments that purchase significant quantities of a commodity.

Governments also will disclose information about their derivatives in the notes to the financial statements. In these cases, the notes to the financial statements will include summary information about a government's derivatives, and will be divided among those related to the government's governmental activities, its business-type activities, and its fiduciary funds.

Governmental Accounting Standards Board (GASB) Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, as amended by GASB Statement No. 59, *Financial Instruments Omnibus*, provides more information about reporting derivatives on the financial statements and the related disclosures.

Securities Lending Transactions

Sometimes, government organizations have large amounts of long-term investments in their portfolios. If a government organization wants to earn additional income, it might lend some securities to brokers or financial institutions that need to borrow those securities to cover a short position (that is, they sold a security without owning it) or to avoid a failure to receive a security they purchased for delivery to a buyer. In these transactions, the government organization transfers its securities for collateral, which may be cash or other securities, and agrees to return the collateral for its original securities at some time in the future.

When a government organization lends its securities, it still reports these securities as investments in its financial statements. If the government organization receives cash as collateral on the securities lending transactions, makes investments with that cash, or can sell the securities it received as collateral, these amounts are also reported as assets in the financial statements. Of course, because the collateral must be returned in the future, the government organization also reports a liability for these transactions in the financial statements. In addition, the notes to the financial statements should explain the following:

- The legal or contractual authorization for the use of securities lending transactions, and any significant violations of those provisions
- Whether the maturities of the investments made with cash collateral generally match the maturities of the securities loaned

- Summary information about the credit risk associated with the transactions
- General information about the types of securities lent, the types of collateral received, and whether the government has the ability to sell collateral securities

GASB Statement No. 28, *Accounting and Financial Reporting for Securities Lending Transactions*, provides specific guidance on accounting and reporting for securities lending transactions.

Relationship With Legally Separate Entities

The structure of many government organizations has become increasingly complex. For a variety of reasons, many government organizations create separate organizations. Some of the more common reasons include greater efficiency in financing and administering debt backed by revenue-generating activities, providing additional services that may not have been envisioned when the charter or statute was written, and overcoming constitutional or statutory limitations on the issuance of debt or other financial resources. Whatever the reason, financial reporting for public accountability requires determining which of these organizations should be included as part of a government organization's financial reporting entity.

Although detailed and complex analyses ultimately determine which legally separate organizations should be included in a government organization's financial reporting entity, these organizations are generally included if it is fiscally dependent on the primary government and a financial benefit or burden relationship is also present. For illustration, if the government organization appoints a voting majority of an organization's governing board, or is able to impose its will on that organization, it would be considered a component unit of the primary government. An organization has a financial benefit or burden relationship with the primary government if, for example, any one of these conditions exists:

- The primary government is legally entitled to or can otherwise access the organization's resources.
- The primary government is legally obligated or has otherwise assumed the obligation to finance the deficits of, or provide financial support to, the organization.
- The primary government is obligated in some manner for the debt of the organization.

If a legally separate organization should be included in a government organization's financial reporting entity, the financial statements of the legally separate organization will be included in the government organization's financial statements, usually in a column separate from the government. Notes to the financial statements also explain why the organization is included, and any significant transactions between the government and the separate organization.

GASB Statement No. 14, *The Financial Reporting Entity*, as amended by GASB Statement No. 39, *Determining Whether Certain Organizations Are Component Units—an amendment of GASB Statement No. 14*, and GASB Statement No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34*, provide specific guidance on financial reporting under such circumstances.

Joint Ventures

Sometimes, a government organization decides to pool resources and share the costs, risks, and rewards of providing goods or services with other governments or organizations for the benefit of the general public or specific service recipients. This arrangement, known as a joint venture, is a legal entity that results from a contractual arrangement between a government entity and another government or organization. In a joint venture such as this, each of the participants retains an ongoing financial interest or an ongoing financial responsibility.

For financial reporting purposes, there are two types of joint ventures:

- Joint ventures whose participants have equity interests
- Joint ventures whose participants do not have equity interests

If the government has an equity interest in the joint venture, that equity interest should be reported

- as an asset in the government organization's government-wide financial statements;
- as a receivable from or payable to the joint venture in the fund financial statements of the governmental fund that has the equity interest; and
- as an asset in the fund financial statements of the proprietary fund that has the equity interest.

GASB Statement No. 61 provides guidance on joint ventures and other, similar arrangements, such as undivided interests and cost-sharing arrangements.

It is important that the audit committee have a healthy and continuing dialogue with management about these kinds of transactions and relationships. In doing so, following tool provides some questions that should be regularly asked of management.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are a starting point for understanding unique transactions and special relationships that may be present in a government organization. Audit committee members should answer the following questions in discussion with management and consultation with the external auditor or other experts as needed.

Audit Committee Questions of Management	Notes
Derivatives	
1. Describe the government organization's policies for investing in derivative financial instruments. Are there any restrictions as to the type, maturity length, or percentage of total portfolio?	
2. Describe how management has valued its derivatives for financial statement presentation. Discuss the types of credit risk, interest rate risk, or other risk these investments have and how management has decided to manage those risks.	
3. Describe the procedures management will implement to ensure compliance with state and federal laws and IRS and Securities and Exchange Commission (SEC) regulations governing tax-exempt bond transactions. Specifically, how will management protect the organization from the risk of noncompliance default?	
Securities Lending	
1. Describe the government organization's policies for entering into securities lending agreements, including the legal authority to do so.	
2. Describe how any securities lending transactions have been accounted for and whether they have been included in the government's financial statements. Include whether collateral can be used to purchase securities, whether maturities of original and collateral securities match, and the credit risk associated with the securities.	
Legally Separate Entities	
1. Has the government organization created, authorized, or become aware of any legally separate organizations that have financial relationships with the government organization (for example, flood control, public works, library, jail, assessment, lighting, or other special purpose districts; capital or property financing authorities; or fundraising organizations)? If so, please provide details.	

(continued)

Audit Committee Questions of Management	Notes
Legally Separate Entities (cont.)	
2. For any such organizations, describe who appoints its government body, whether the government organization can impose its will on the organization or receive a financial benefit or burden from the organization, and whether the organization is fiscally dependent upon the government organization. Also explain if and how such organizations are displayed and disclosed in the government's financial statements.	
Joint Ventures	
1. Has the government organization entered into any agreement with another government or organization to share resources, cost, and risks for providing goods and services to the general public or specific recipients? If so, please describe the details of the arrangement.	
2. For any such agreements, please describe how the government organization accounts for its participation and how the effects of such participation are displayed or disclosed in the government's financial statements.	

Significant Issues, Estimates, and Judgments: Management's Report to the Audit Committee

PURPOSE OF THIS TOOL: The audit committee needs to be proactive and consistent in its inquiries to management about significant issues, estimates, and judgments. Management should be encouraged to use this tool as a means to document and communicate these matters with the audit committee.

At each meeting, the audit committee should inquire about current or unresolved issues or problems that have arisen in the financial, compliance, or operational control environment. Management should prepare a separate report for each matter. Statements should be clear and concise. Some matters may carry over to subsequent meetings, in which case, any updated information should be included and highlighted.

Identifying Significant Issues, Estimates, and Judgments

As a first step to any discussion of this nature among the audit committee members, it is important for the audit committee to establish the threshold for a significant issue, estimate, or judgment. The following are some points that the audit committee should consider in its quest to identify a significant issue, estimate, and judgment.

A significant issue, estimate, or judgment is one that

1. creates controversy among members of the management team, or between management and the internal or external auditors.
2. has or will be material to the financial statements.
3. involves significant uncertainty or volatility that could materially affect the estimate.
4. is or will be a matter of public interest or exposure.
5. must be reported to an external body and management is unclear or undecided on its presentation; for example, single audit findings, grants, public requests for disclosure, or bond issuances.
6. applies a new accounting standard. (Note that the application of a new accounting standard may or may not be considered a significant issue, estimate, or judgment for the organization. However, for the record, the audit committee may ask management to use this format as a means to brief the audit committee on the application of the new standard and the impact it has on the government organization.)
7. relates to the application of a standard in a way that is not consistent with general practice or the way that it has been applied in past years.
8. relates to key controls over financial information that are being designed or redesigned, have failed, or otherwise are being addressed by the organization.

The audit committee needs to be proactive and consistent in its inquiries regarding significant issues, estimates, and judgments. At each meeting, the audit committee should inquire about current or unresolved issues or problems that have arisen in the financial, compliance, or operational control environment. Management's response should be documented in the meeting minutes.

Management's report to the audit committee concerning significant issues, estimates, and judgments should contain the following elements to provide a proper basis for discussion by the audit committee:

1. *Identify the significant issue, estimate, or judgment.* In this section of the issues report, management should describe or summarize the matter as concisely and clearly as possible.
2. *Management's position.* This section should address management's position on the matter. If there is disagreement among members of management, those disagreements should be described here as explicitly as possible with brief explanations of each respective position.
3. *Relevant literature.* Any professional literature or regulatory requirements addressing this matter should be cited here. If there is no professional literature available, it would be appropriate to reference common or best practices in governments in this space. If this is a developing area, and there is no accepted best practice or other source to support or refute these positions, this fact should be reported. If there is a choice regarding the accounting treatment, that should be disclosed here along with an explanation of how the choices of treatment were compared and the rationale for the final choice made.
4. *Risks.* Management should identify and describe various risks and opportunities (both short- and long-term) associated with this matter.
5. *Regulatory disclosure.* Management must inform the audit committee of how it intends to address any required disclosures to appropriate regulatory bodies as required by law.
6. *Auditor's position.* If management has consulted with the internal or external auditors on this matter, the discussions should be summarized in this section. The discussion should include an indication about whether the internal or external auditors agree with management's position. When appropriate, the discussion should also include whether or how the auditors have addressed any audit issues that might be associated with the position. This section should also include, when necessary, the internal or external auditors positions. If management has not discussed this matter with the auditors, management should explicitly state that the auditors have not been consulted.
7. *Other information relating to this issue, estimate, or judgment.* Management should use this section to highlight other related and relevant information that is not already included in the previous sections.

Sample Report From Management

1. *Define the significant issue, estimate, or judgment.* Management is concerned with the inability to accurately estimate its health care costs at year end. At any given time, including year end, the most difficult estimate related to those costs is what is known as claims that are incurred but not reported (IBNR). Plan participants have received treatment from health care providers and incurred liabilities that have not yet been billed to the government's self-funded plan for payment. The government uses a third-party administrator (TPA) to pay the claims and to actuarially estimate what the IBNR is at year end. Generally, about 80 percent of these expenses will be paid during the first 3–4 months after the end of the plan year. Because of recent changes in the TPA's billing system, changes in the demographic makeup of the government's participant base, and an unusual increase in the number of large dollar claims, the IBNR estimate or accrual was significantly underestimated. This has caused the fund, which is funded by employer and employee contributions, to experience unexpected deficits in recent years.

2. *Management's position.* The government has covered these deficits through general fund transfers. Management plans to request that the TPA carefully review the actuarial assumptions used to compute the IBNR, determine the cause of the shortage, and identify how to improve the accuracy of the IBNR estimate. Management is also considering creating a reserve to handle such fund fluctuations caused by the IBNR and considering adding stop-loss insurance coverage to the self-funded plan to mitigate the effects of unusually large claims. Stop-loss coverage insures the self-funded plan for claims exceeding a certain dollar amount ($100,000 is typical). The premiums for this coverage are paid from the fund but protect it against the negative effects of catastrophic claims and help in the IBNR estimate.

3. *Relevant literature.* The government's TPA agreement for its self-funded health plan contains the required computation of the IBNR. Creating a reserve is *not* a legal requirement, therefore, there is no regulatory literature regarding this issue. There is a variety of actuarial and industry literature concerning the computation of the IBNR and reserve issues.

4. *Risks.* Underestimating the IBNR can cause administrators of the plan to misread the true profitability and solvency of the plan. This may delay the recognition of emerging claim and demographic trends as well as cause administrators to make faulty decisions in setting unrealistic rates and employee or employer contribution amounts needed to cover the plan's expenses. If the true IBNR paid out over the ensuing months is much greater than estimated amounts accrued, other sources of revenue must be called upon to bail the fund out, causing budget difficulties and ill will elsewhere in the organization.

5. *Regulatory disclosure.* None.

6. *Auditor's position.* Management has held informal discussions with the external auditors on this issue. The external auditors are in full support of management's position to have the TPA review its actuarial assumptions for calculating the IBNR, create a reserve in the fund to handle fluctuations due to the inexact nature of IBNR estimates, and negotiate a stop-loss policy for the self-funded plan that will hedge against the effects of unanticipated large catastrophic claims.

7. *Other information relating to this issue, estimate, or judgment.* While exploring the possibility of creating a reserve, it is important to remember the difference between a reserve and a contingency. A contingency is set up for an event that has not, and, in fact, may never occur. For a contingency to be accruable it must be both probable and reasonably estimable. The IBNR reserve, on the other hand, is for events that have already occurred and, therefore, is not a contingency and must always be accrued. Because we do not know the exact amount of the liability we must use our best estimate.

PART III: Audit Committee—Internal Control and Internal Audit

Internal Control: A Tool for the Audit Committee

PURPOSE OF THIS TOOL: Internal control over financial reporting has always been a major area in the governance of any organization, and this importance has been magnified in recent years. This tool is intended to give audit committees basic information about internal control to understand what it is, what it is not, how it can be used most effectively in a governmental organization, and the requirements of management with respect to the system of internal control over financial reporting. Note that the primary responsibility area of the audit committee with respect to internal control is the system of internal control over financial reporting.

Internal Control Primer—Basics of Internal Control

In 1992, the Committee of Sponsoring Organizations (COSO)[1] of the National Commission on Fraudulent Financial Reporting (also known as the Treadway Commission) published a document called *Internal Control—Integrated Framework*,[2] which defined *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 three categories:

1. Effectiveness and efficiency of operations
2. Reliability of financial reporting
3. Compliance with applicable laws and regulations

Internal control can be judged as effective in each of these categories if the board of directors and management have reasonable assurance that

1. they understand the extent to which the entity's operations objectives are being achieved.
2. published financial statements are being prepared reliably.
3. applicable laws and regulations are being complied with.

The COSO framework went on to say that internal control consists of five interrelated components as follows:

1. *Control environment.* Sometimes referred to as the "tone at the top" of the organization, meaning the integrity, ethical values, and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility and organizes and develops its people; and the attention and direction provided by the board of directors. It is the foundation for all other components of internal control, providing discipline and structure.

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[1] The Committee of Sponsoring Organizations (COSO) consists of the AICPA, the Institute of Management Accountants, the Institute of Internal Auditors, Financial Executives International, and the American Accounting Association.

[2] The COSO publication *Internal Control—Integrated Framework* (product no. 990012), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

- Stable management with an established ethics policy and history of following its own rules for everything from travel, routine purchases and approvals, to high profile issues. If management has changed recently, has the new management made establishment or endorsement of ethics an early priority?
- Separate governance policy adopted by all elected officials making it clear how the governing board will interact with staff, introduce items for governing board action, and make purchases and guidelines for expense reimbursement.
- Ethics policies should clearly establish how government is different. As fiduciaries of taxpayer's funds, government employees have a higher responsibility to demonstrate that they have been efficient, effective, unbiased, and transparent in discharging their official responsibilities.
- Establishment and endorsement of an anonymous fraud hotline by top management.
- Support for professional development. Accounting and finance staffs in governments and, particularly, smaller governments often fill multiple roles making it difficult to stay abreast of rapidly changing professional standards.
- Programs and policies to disseminate the importance of adhering to internal controls throughout the organizations not just in finance or central administration. Governments are often segmented into semiautonomous departments and without a comprehensive training program to teach both the reason for and importance of internal control rules, widespread noncompliance is likely. For example, clerical staff that do not understand segregation of duties might feel that it is more efficient to swap tasks so that each employee can see a task through from start to finish.

2. *Risk assessment.* The identification and analysis of relevant risks to achieve the objectives that form the basis to determine how risks should be managed. This component should address the risks, both internal and external, that must be assessed. Before conducting a risk assessment, objectives must be set and linked at different levels.
3. *Control activities.* Policies and procedures that help ensure that management directives are carried out. Control activities occur throughout the organization at all levels in all functions. These include activities such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.
4. *Information and communication.* Components that address the need in the organization to identify, capture, and communicate information to the right people to enable them to carry out their responsibilities. Information systems within the organization are key to this element of internal control. Internal information, as well as external events, activities, and conditions must be communicated to enable management to make informed business decisions and for external reporting purposes.
5. *Monitoring.* The activity undertaken by management and others in the organization with regard to the internal control system. This is the framework element that is associated with the internal audit function in the company, as well as other means of monitoring, such as general management activities and supervisory activities. It is important that internal control deficiencies be reported upstream, and that serious deficiencies be reported to top management and the board of directors and corrective action taken.

These five components are linked together, thus forming an integrated system that can react dynamically to changing conditions. The internal control system is intertwined with the organization's operating activities and is most effective when controls are built into the organization's infrastructure, becoming part of the very essence of the organization.

Note that although the Sarbanes-Oxley Act of 2002, which applies to publicly traded companies, does specifically mention the COSO framework, the act acknowledges that this is not the only framework that can be used to fulfill management's requirements about the internal control system. The act specifically states that other frameworks may be created either within or outside the United States that may satisfy the intent of the statutes. The act further states certain conditions that must be met for a framework to be considered suitable. Although this act is not applicable to government organizations, its internal control system intent is equally important to government organizations and should be considered.

An effective internal control structure can actually be part of the competitive advantage of the government organization.

Key Terms in Internal Control

A few terms arise frequently during discussions of internal control, identified and described as follows:

Deficiency in internal control. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. There can be a deficiency in *design* or *operation*. A deficiency in *design* exists when a necessary control is missing or not properly designed. A deficiency in *operation* exists when a properly designed control does not operate as designed or the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Material weakness. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

Significant deficiency. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Compensating controls. Instituted by management to cover for the lack of a basic control, or if a basic control is not able to function for some period of time. They are important for some organizations that, by virtue of their size, are not able to implement basic controls such as segregation of duties.

What Internal Control Cannot Do

As important as an internal control structure is to an organization, an effective system is not a guarantee that the organization will be successful. An effective internal control structure will keep the right people informed about the organization's progress (or lack of progress) in achieving its objectives, but it can neither turn a poor manager into a good one nor ensure success.

Internal control is not an absolute assurance to management and the board about the organization's achievement of its objectives. It can only provide reasonable assurance, due to limitations inherent in all internal control systems. For example, breakdowns in the internal control structure can occur due to simple error or mistake, as well as to faulty judgments that could be made at any level of management. In addition, controls can be circumvented by collusion or by management override. Finally, the design of the internal control system is a function of the resources available, meaning that there must be a cost-benefit analysis in the design of the system.

Compensating Controls

It is important to realize that both the design and compliance with the internal control system is important. The audit committee should be "tuned-in" to the tone-at-the-top of the organization as a first indicator of the functioning of the internal control system.

In addition, audit committees should realize that the system of internal control should be scaled to the organization. Some organizations will be so small, for example, that they will not be able to have appropriate segregation of duties. The message here is that the lack of segregation of duties is not automatically a material weakness, or even a reportable condition, depending on the compensating controls that are in place.

For example, suppose an organization's accounting department is so small that it is not possible to segregate duties between the person that does the accounts payable, and the person that reconciles the bank statements. In this case, it is the same person, so the implication is that there are no checks and balances on the accounts payable person, who could be writing checks to a personal account, then passing on them during the bank reconciliation process (that is, there is no one to raise the red flag that personal checks are being written on the organization's account).

Compensating controls could make up for this apparent breech in the internal control system. Here are some examples of compensating controls in this situation:

1. All checks are hand signed by an officer, rather than using a signature plate that is in the control of the person that prepared the checks.
2. The bank reconciliation may be reviewed by the person's manager.
3. A periodic report of all checks that are cleared at the bank could be prepared by the bank and forwarded to an officer for review.

Audit committees should be aware of situations like this and be prepared to ask questions and evaluate the answers when an obvious breach in internal control becomes apparent.

Management Override of Controls

Another area that an audit committee needs to focus on is the ability of management to override internal controls over financial reporting to perpetrate fraud. Examples of techniques used by management in overriding internal controls over the financial reporting function include the following:

- Approving inappropriate or irregular transactions without proper support
- Making adjusting entries during the financial reporting closing process
- Reclassifying items improperly between the statement of financial position and the statement of changes in financial position

Some of these override techniques were used in some of the recent scandals and have gained substantial notoriety.

An audit committee has the responsibility to help prevent or deter a management override of controls. It is important for the audit committee to understand that there is a system to uncover an override, as well as follow-up to determine its appropriateness. Questions about management override, and the controls over management override, as well as audit steps to detect if a management override has occurred, should be addressed to the CEO, CFO, chief audit executive (CAE), and independent auditor during the respective executive sessions with the audit committee as noted elsewhere in this toolkit.

Conclusion

This primer should have given you a sense of what is meant by *internal control*. The concepts are not complex, but sometimes the application of internal control can be a challenge in an organization, depending on its size and its culture. However, it is vitally important to design the system of internal control to achieve the objectives of (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.

Simply stated, at the end of the day, a strong system of internal control (both in its design and compliance) is good business.

Internal Control—A Tool for the Audit Committee

The following tool, "Internal Control—A Tool for the Audit Committee," contains questions modeled on those found in the COSO report *Internal Control—Integrated Framework*.

Internal Control—A Tool for the Audit Committee

PURPOSE OF THIS TOOL: This tool focuses on the five interrelated components of an internal control system, as described in COSO's *Internal Control—Integrated Framework*[3] publication. Refer to "Internal Control Primer—Basics of Internal Control" earlier in this section for a discussion of the COSO components. The audit committee's role in the internal control structure in the organization focuses on internal controls over financial reporting and the various systems (human resources, computing, and other) available to support that process, and this tool is created to facilitate that role. The audit committee needs to be assured that the controls are in place and operating effectively. This can be achieved through the committee's interaction with senior management, independent auditors, internal auditors, and other key members of the financial management team.

INSTRUCTIONS FOR USING THIS TOOL: This tool is created around the five interrelated components of an internal control structure. Within each component is a series of questions that the audit committee should focus on to assure itself that controls are in place and functioning. These questions should be discussed in an open forum with the individuals who have a basis for responding to the questions. The audit committee should ask for detailed answers and examples from the management team, including key members of the financial management team, internal auditors, and independent auditors to assure itself that the system is operating as management represents. Evaluation of the internal control structure is not a one-time, but rather a continuous, event for the audit committee—the audit committee should always have its eyes and ears open for potential weaknesses in internal control and should continuously probe the responsible parties regarding the operation of the system. These questions are written in a manner such that a "No" response indicates a weakness that must be addressed.

[3] The questions in this tool are adapted from "Evaluation Tools," volume 2 of the COSO 1992 publication *Internal Control—Integrated Framework* (product no. 990012). It may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the framework are used to support the continuing work of COSO.

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Integrity and Ethical Values				
1. Does the organization have a comprehensive code of conduct or other policies addressing acceptable operating practices, conflicts of interest, and expected standards of ethical and moral behavior?	☐	☐	☐	
2. Is the code distributed to all officials and employees?	☐	☐	☐	
3. Are all officials and employees required to periodically acknowledge that they have read, understood, and complied with the code?	☐	☐	☐	
4. Do elected officials and management demonstrate through actions their own commitment to the code of conduct?	☐	☐	☐	
5. Are dealings with customers, suppliers/vendors, employees, and other parties based on honesty and fair business practices?	☐	☐	☐	
6. Does management take appropriate action in response to violations of the code of conduct?	☐	☐	☐	
7. Is management explicitly prohibited from overriding established controls? What controls are in place to provide reasonable assurance that controls are not overridden by management? Are deviations from this policy investigated and documented? Are violations (if any) and the results of investigations brought to the attention of the audit committee?	☐	☐	☐	
8. Is the organization proactive in reducing fraud opportunities by (1) identifying and measuring fraud risks, (2) taking steps to mitigate identified risks, (3) identifying a position within the organization to “own” the fraud prevention program, and (4) implementing and monitoring appropriate preventative and detective internal controls and other deterrent measures?	☐	☐	☐	

(continued)

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Integrity and Ethical Values (cont.)				
9. Does the organization use an anonymous ethics and fraud hotline, and, if so, are procedures in place to investigate and report results to the audit committee?	☐	☐	☐	
Commitment to Competence				
1. Are the level of competence and the requisite knowledge and skills defined for each job in the accounting and internal audit functions?	☐	☐	☐	
2. Does management make an effort to determine whether the accounting and internal audit functions have adequate knowledge and skills to do their jobs?	☐	☐	☐	
Governing Body and Audit Committee				
1. Are the audit committee's responsibilities defined in enabling legislation or a written policy statement of the governing body? If by policy, is the policy updated annually and approved by the governing body?	☐	☐	☐	
2. Are audit committee members independent of the organization and of management? Do audit committee members have the knowledge, government experience, and financial experience to serve effectively in their role?	☐	☐	☐	
3. Are a sufficient number of meetings held, and are the meetings of sufficient length and depth to cover the agenda and provide healthy discussion of issues?	☐	☐	☐	
4. Does the audit committee constructively challenge management's planned decisions, particularly in the area of financial reporting, and probe the evaluation of past results?	☐	☐	☐	
5. Are regular meetings held between the audit committee and the CFO, CAE (the leader of internal audit team), or their government equivalent; other key members of the financial management and reporting team; and the independent auditors? Are executive sessions conducted on a regular basis?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Governing Body and Audit Committee (cont.)				
6. Does the audit committee approve internal audit's annual audit plan?	☐	☐	☐	
7. Does the audit committee receive key information from management in sufficient time in advance of meetings to prepare for discussions at the meetings?	☐	☐	☐	
8. Does a process exist for informing audit committee members about significant issues on a timely basis and in a manner conducive to the audit committee having a full understanding of the issues and their implications?	☐	☐	☐	
9. Is the audit committee informed about personnel turnover in key functions including the audit team (both internal and the independent auditors), senior executives, and key personnel in the financial accounting and reporting teams? Are unusual employee turnover situations observed for patterns or other indicators of problems?	☐	☐	☐	
10. Does the audit committee review qualifications of external auditors and audit scope of service and make appropriate recommendations to the governing body on contracts with external auditors?	☐	☐	☐	
11. Does the audit committee monitor the performance of the external auditors and report as needed to the governing body on performance issues?	☐	☐	☐	
Management's Philosophy and Operating Style				
1. Is the accounting function viewed as a team of competent professionals bringing information, order, and controls to decision making?	☐	☐	☐	
2. Is the selection of accounting principles made in the long-term best interest of the organization?	☐	☐	☐	

(continued)

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Management's Philosophy and Operating Style (cont.)				
3. Are valuable assets protected from unauthorized access and use?	☐	☐	☐	
4. Do managers respond appropriately and timely to unfavorable signals and reports?	☐	☐	☐	
5. Are estimates and budgets reasonable and achievable?	☐	☐	☐	
Organizational Structure				
1. Is the organizational structure within the accounting function and the internal audit function appropriate for the size of the organization?	☐	☐	☐	
2. Are key managers in the accounting and internal audit functions given adequate definition of their responsibilities?	☐	☐	☐	
3. Do sufficient numbers of employees exist, particularly at the management levels in the accounting and internal audit functions, to allow those individuals to effectively carry out their responsibilities?	☐	☐	☐	
Assignment of Authority and Responsibility				
1. Is the authority delegated appropriately for the responsibilities assigned?	☐	☐	☐	
2. Are job descriptions in place for management and supervisory personnel in the accounting and internal audit functions?	☐	☐	☐	
3. Do senior managers get involved as needed to provide direction, address issues, correct problems, and implement improvements?	☐	☐	☐	
Human Resources Policies and Practices				
1. Are policies and procedures in place for hiring, training, promoting, and compensating employees in the accounting and internal audit functions?	☐	☐	☐	
2. Do employees understand that substandard performance will result in remedial action?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Human Resources Policies and Practices (cont.)				
3. Is remedial or corrective action taken in response to departures from approved policies?	☐	☐	☐	
4. Do employees understand the performance criteria necessary for promotions and salary increases?	☐	☐	☐	
Risk Assessment				
1. Does the organization consider risks from external sources such as creditor demands, economic conditions, laws and regulations, bond covenants, labor relations (for example, unions), and so on?	☐	☐	☐	
2. Does the organization consider risks from internal sources such as key employees (retention and succession planning), financing and the availability of funding for key programs, competitive compensation and benefits, information systems security, and backup systems?	☐	☐	☐	
3. How does the organization react to the previously mentioned risks?	☐	☐	☐	
4. Is the risk of a misstatement of the financial statements considered and are steps taken to mitigate that risk?	☐	☐	☐	
Control Activities				
1. Does the organization have a process in place to ensure that controls as described in its policy and procedures manuals are applied as they are meant to be applied?	☐	☐	☐	
2. Do the policy and procedures manuals document all important policies and procedures and are they reviewed and updated on a regular basis? If so, by whom?	☐	☐	☐	
3. Do supervisory personnel review the functioning of controls? If so, how is that review conducted and what happens to the results? Is appropriate and timely follow-up action taken on exceptions?	☐	☐	☐	

(continued)

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Information and Communication				
1. Is a process in place to collect information from external sources, such as economic and regulatory information, that could have an impact on the government or the financial reporting process?	☐	☐	☐	
2. Are milestones to achieve financial reporting objectives monitored to ensure that deadlines are met?	☐	☐	☐	
3. Are data and results benchmarked against similar entities and against those recognized as “best in field”?	☐	☐	☐	
4. Is necessary operational and financial information communicated to the right people in the organization on a timely basis and in a format that facilitates its use, including new or changed policies and procedures?	☐	☐	☐	
5. Is a process in place to respond to new information needs in the organization on a timely basis?	☐	☐	☐	
6. Is there a process in place to collect and document errors or complaints and to analyze, determine cause, and eliminate a problem from recurring in the future?	☐	☐	☐	
7. Is a process established and communicated to officials, employees, and others, about how to communicate suspected instances of wrongdoing by the government or its employees? Further, does a process exist to ensure that anyone making such a report is protected from retaliation for making such a report?	☐	☐	☐	
Monitoring				
1. Do elected officials, other officials, upper management, and other employees understand their obligation to communicate observed weaknesses in design or compliance with the internal control structure of the organization to the appropriate supervisory or management personnel?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Monitoring (cont.)				
2. Are interactions with external stakeholders periodically evaluated to determine if they are indicative of a weakness in the internal controls structure? (For example, consider the frequency of customer complaints about incorrect bills or correspondence regarding noncompliance from granting or oversight agencies.)	☐	☐	☐	
3. Is there follow-up on recommendations from the internal and external auditors for improvements to the internal control system?	☐	☐	☐	
4. Are personnel asked to periodically state whether they understand and comply with the organization's code of conduct?	☐	☐	☐	
5. Are personnel required to sign off, indicating their performance of critical control activities, such as performing reconciliations?	☐	☐	☐	
6. Does the internal audit team have the right number of competent and experienced staff? Is the reporting structure in place to ensure their objectivity and independence?	☐	☐	☐	
7. Do internal audit team members have access to the governing body and audit committee? Is the work of the team appropriate to the organization's needs, and prioritized with the audit committee's direction?	☐	☐	☐	

Fraud and the Responsibilities of the Government Audit Committee

PURPOSE OF THIS TOOL: A government audit committee should take an active role in the prevention, deterrence, and detection of fraud and encourage the government organization to establish an effective ethics and compliance program. The government audit committee should constantly challenge management and the auditors to ensure that the organization has appropriate antifraud programs and controls in place to identify potential fraud and that investigations are undertaken if fraud is detected. Also, the committee should take an interest in ensuring that appropriate action is taken against known perpetrators of fraud.

This tool is intended to make government audit committee members aware of their responsibilities as they undertake this important role. It highlights areas of activity that may require additional scrutiny by the audit committee.

Introduction

Fraud is a term that no government's elected officials, management, or citizens want to have associated with their jurisdiction because the impact of fraud on governments extends past monetary value and can negatively affect the government for years to come. According to the Association of Certified Fraud Examiners (ACFE), U.S. organizations lose an estimated 7 percent of annual revenues to fraud, and, according to the Government Accountability Office, 5 percent of all federal payments are fraudulent.[1] Although, traditionally, an audit committee has been associated with publicly traded companies, given the heightened level of concern over fraud and ethics, it is a natural fit for a government to utilize an audit committee to mitigate and monitor fraud. Although audit committees and their equivalents may differ widely, both within their own level of government and among the local, state, and federal levels, certain responsibilities and expectations concerning fraud prevention, deterrence, and detection are pervasive nonetheless.

An audit committee represents the highest ethical standard setter for a government organization and exemplifies the tone at the top. Also, audit committees must implement the most effective fraud controls, such as whistle-blower and ethics hotlines, training programs, and monitoring compliance with a code of ethics. Failure to exhibit ethical behavior and monitor fraud by an audit committee can affect the accountability of the government, create a negative impact on the public image of the government, and cause a decrease in the confidence of all stakeholders of the government.

Definition and Categories of *Fraud*

An understanding of fraud is essential for the audit committee to carry out its responsibilities. The term *fraud* is defined in *Black's Law Dictionary* (Ninth Edition, 2009) as

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[1] The terms GAS, for Government Auditing Standards, and GAGAS, for Generally Accepted Government Auditing Standards are used interchangeably here. Further, both are synonymous with the term Yellow Book, as noted.

> An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right. A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury . . . A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated.

The ACFE defines *occupational fraud* as

> The use of one's occupation for personal enrichment through deliberate misuse or misapplication of the employing organization's resources or assets.[3]

Categories of Fraud

The audit committee also needs to be aware that fraud affecting the organization often falls within one of three categories:

1. *Financial statement fraud.* Involves senior management's intentional misrepresentation of financial statements. The ACFE *2010 Report to the Nations on Occupational Fraud and Abuse* found that financial statement fraud, although representing less than 5 percent of the cases of fraud in its report, was by far the most costly, with a median loss of $1.7 million per incident.
2 *Employee fraud.* Involves nonsenior employee theft or improper use of company resources.
3. *External fraud.* Involves theft or improper use of resources by people who are neither management nor employees of the firm.

This categorization of fraud is useful, but not absolute. Middle management employees may intentionally misrepresent financial statement transactions, for example, to improve their apparent performance, or outside individuals may collude with organization management or employees.

There are also professional standards that indicate that in order for a fraud to occur there must be a pressure, opportunity, and rationalization present. These three areas are called the fraud triangle and can be a useful tool in evaluating the current fraud control environment.

Fraud and the Responsibilities of the Government Audit Committee or Its Equivalent

The members of the government audit committee should understand their roles of ensuring that the organization has antifraud programs and controls in place to help prevent fraud and to properly fulfill their fiduciary duties of

- monitoring the financial reporting process.
- overseeing the internal control system, including those over fraudulent activity.
- overseeing government auditors and public accounting firms engaged to perform government audits.
- reporting findings to the legislative body or other independent governing body.
- promoting the highest ethical standards

- maintaining a healthy skeptical mindset. “Skepticism throughout the [financial reporting] supply chain increases not only the likelihood that fraud will be detected, but also the perception that fraud will be detected, which reduces the risk that fraud will be attempted.” (The Center for Audit Quality, *Deterring and Detecting Financial Reporting Fraud: A Platform for Action*, p.vii)

Setting the tone to reduce the risks of fraud begins with the governing body. Depending on the type of government organization that will be applying these concepts, the governing body can consist of a legislative body, council, supervisory board, or any designee approved by that government as the responsible party for ensuring the accountability of public resources.

Create an Environment to Reduce Risk of Fraud

Often, a government organization’s elected officials and management must adhere to a code of ethics, or choose to establish one in the absence of a legal requirement to do so. An audit committee can help the governing body provide the guidance necessary to create a culture of honesty and integrity in preventing, deterring, and detecting fraud. It is important to clearly communicate to each employee acceptable behavior and expectations that foster an environment where the risks of fraud are reduced. Such a culture is rooted in a strong set of core values that provides the foundation for employees about how the organization conducts business. It also allows an organization to develop an ethical framework that discourages (1) fraudulent financial reporting, (2) misappropriation of assets, (3) circumventing internal controls, and (4) other forms of corruption.

An ethical framework should include the following:

- A code of ethics that is based on the organization’s core values and that clearly states acceptable and unacceptable behaviors
- A training program for its code of ethics that includes sessions for new hires, management, and newly elected officials, and continuing education for all employees and officials
- An adequate channel of communication, whistle-blower or ethics hotline, for employees and others to obtain advice when facing difficult ethical decisions and the reporting of known or potential unlawful activities against the government organization
- A system to monitor compliance with the code of ethics

Establish Antifraud Programs and Internal Controls

The audit committee should ensure that the government organization establishes antifraud programs and internal controls to help prevent and detect fraud. To meet its responsibilities, the audit committee should ensure that the government organization has

- designated a senior level member of the government organization to manage fraud risk.
- established policies and procedures that identify, evaluate, and mitigate the organization’s fraud risk exposure.
- maintained an effective internal control structure designed to prevent, deter, and detect fraud.
- created a system to monitor compliance with policies and procedures and controls.
- established and communicated the process for reporting potential fraudulent activities, for example, fraud hotline, website address, suggestion box, or tracking report.
- developed a process for investigating potential unlawful activities against the organization.

Whistle-Blowers

The ACFE *2010 Report to the Nations on Occupational Fraud and Abuse* found that the most effective method for detection of fraud has historically been tips. The 2010 report also indicated that in 49 percent of cases, these tips are obtained from employees through the use of whistle-blower polices and hotlines. Many federal, state, and local government organizations have whistle-blower laws and regulations. These regulations may require the organization to establish procedures for the confidential receipt, retention, and treatment of complaints received regarding suspected fraudulent activities. The audit committee should ensure that the organization has established a process to address applicable whistle-blower laws and regulations.

When Fraud Is Discovered

Many large government organizations have a structure for reporting potential fraud and resources available, such as an audit or investigative function, that gathers the evidence and coordinates with appropriate law enforcement agencies. With this structure, the government audit committee should ensure that a process is in place to receive periodic reports describing the nature, status, and eventual disposition of any fraud investigations.

With smaller government organizations, the audit committee may be directly responsible for overseeing the investigation of a potential fraud. In this circumstance, if fraud is discovered, or there is a reasonable basis to believe that fraud may have occurred, the audit committee is responsible for ensuring that an investigation is undertaken. The committee should retain professionals with experience and training in fraud investigations. Professionals such as internal or external auditors, forensic accountants, legal counsel, and law enforcement officials can provide the expertise to assist with the investigation. The audit committee should stay informed on the progress of the investigation to its conclusion.

Accounting and auditing professionals may also provide audit committees with other related services, for example (1) evaluation of controls and operating effectiveness through compliance verification, (2) creation of special investigation units, (3) incident management committees, (4) assessment of risks, (5) ethics hotlines, (6) and codes of conduct.

Government Auditors

Government auditors can serve a vital role in aiding the audit committee in determining whether the government organization is achieving its goals and objectives. Auditors that are experienced and trained in fraud prevention, deterrence, and detection can help provide assurance that the government organization's risks are effectively identified and monitored; processes are effectively controlled and tested periodically; and appropriate follow-up action is taken to address control weaknesses. If the government organization does not have an audit or oversight function trained in fraud prevention, deterrence, and detection, the organization may consider contracting with an audit firm for specialized accounting and auditing services.

The audit committee needs to ensure that the internal auditors are fulfilling their responsibilities in deterring and detecting potential fraud by following applicable professional standards: the Institute of Internal Auditors' Red Book. *Government Auditing Standards* and Statements on Auditing Standards (AICPA, *Professional Standards*) require auditors to assess the risk of material misstatements of financial statement amounts or other financial data significant to the audit objectives due to fraud and to consider that assessment in designing the audit procedures to be performed. Specifically, professional standards address auditor responsibilities in planning and performing financial statement audits, including the requirement that fraud involving senior management, and any fraud (whether caused by senior management or other employees) that causes material misstatement of the financial statements, should be reported directly to the audit committee.

When working with the external auditors, an audit committee should consider the expectation gap between the professional standards of the audit organization and what the public expects from the auditor's performance. The audit process involves a risk-based approach that involves a materiality threshold that is not structured to test all transactions and data.

Conclusion

The demands of the public, U.S. corporations, and the regulatory environment have focused attention on the increased need to fight fraud. The public is demanding greater vigilance from all parties involved in organizational governance. Audit committees are required to play a pivotal role in the prevention of fraud and to take appropriate action in the discovery of fraud. Government auditors can provide additional assistance to audit committees so they may better carry out their fiduciary responsibilities in fighting fraud and protecting the public interest.

Anonymous Submission of Suspected Wrongdoing (Whistle-Blowers): Issues for Government Audit Committees to Consider

PURPOSE OF THIS TOOL: A key defense against fraud, management override of internal controls, or other significant deviations from organizational policies is a process for anonymous submission of suspected wrongdoing (whistle-blowing), typically referred to as a hotline. This tool offers examples of questions to consider when designing an effective whistle-blower hotline or evaluating an existing hotline.

Respondents to a 2010 survey by the Association of Certified Fraud Examiners (ACFE) revealed that various forms of fraud committed in government organizations were detected 46 percent of the time by tips, the leading method for detecting fraud.[1] Further, employees are the source for 49 percent of all tips for fraud committed in all types of organizations, external sources make up at least 34 percent of all tips.[2] Accordingly, the ACFE recommends organizations that use whistle-blower hotlines focus on employee education as well as opening the system to suppliers, customers, and others.

Anonymity and confidentiality, especially from the perspective of potential whistle-blowers, is of paramount importance in an effective hotline. For this reason, the most effective hotlines incorporate the use of a telephones or Web-based portals. Hotline systems should avoid the use of emails and faxes, which even if designed to be anonymous and confidential are not likely to be so, and certainly will not be perceived so.

Many governments are fearful that promoting anonymous submissions of wrongdoing will create false or frivolous accusations against the government's key officials and others. Some governments believe the cost of operating an external confidential hotline system is not justified. Experience has shown that with an effective hotline system, frivolous complaints can be managed and that the cost of outside services is typically nominal. In addition, ACFE studies have shown that governments employing hotlines have a much smaller average loss when fraud is discovered when compared to governments that do not employ such techniques.

The following checklist offers examples of questions to consider when designing an effective whistle-blower hotline or evaluating an existing hotline. It is not intended to be all-inclusive, and some items may not apply to your government organization's operations.

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[1] Association of Certified Fraud Examiners, *2010 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2010, p. 19.
[2] Association of Certified Fraud Examiners, *2010 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2010, p. 17.

Whistle-Blower Issues for Audit Committees to Consider Tool	Yes	No	Not Sure	Comments
A. Design Effectiveness				
In assessing the design effectiveness of the hotline, a government audit committee should consider the following questions:				
1. Does the hotline have a dedicated telephone number, website, and regular mail or post office box address to expedite reports of suspected incidents of misconduct?	☐	☐	☐	
2. Does the hotline demonstrate confidentiality, including showing how caller ID or other tracking technologies cannot be used to identify the whistle-blower?	☐	☐	☐	
3. Has the government considered the use of an independent hotline operator to enhance the perception of confidentiality in addition to any real improvement?	☐	☐	☐	
4. Is an external provider is being considered? If so: How long has the provider been in business? What experience does the provider have handling business ethics complaints?	☐	☐	☐	
5. Does the hotline use trained interviewers to handle calls to the hotline rather than a voice mail system?	☐	☐	☐	
6. Is the hotline available 24 hours a day, 365 days a year?	☐	☐	☐	
7. Does the hotline have multilingual capability to support hotline callers with different ethnic backgrounds or those who are calling from different countries?	☐	☐	☐	
8. Are callers provided with a unique identification number to enable them to call back later anonymously to receive feedback or follow-up questions from investigators?	☐	☐	☐	

Whistle-Blower Issues for Audit Committees to Consider Tool	Yes	No	Not Sure	Comments
A. Design Effectiveness (cont.)				
9. Does the government have a case management system to log all calls and their follow-up, to facilitate management of the resolution process, for testing by internal auditors, and for oversight by the audit committee? For a sample tracking report that audit committees may use for this purpose, see the "Sample Whistle-Blower Tracking Report" tool in this toolkit.	☐	☐	☐	
10. Has the government established protocols for the timely distribution of each type of complaint, regardless of the mechanism used to report the complaint? Are complaints of any kind involving senior management automatically and directly submitted to the audit committee without filtering by management or other government personnel?	☐	☐	☐	
11. Does the government effectively distribute comprehensive educational materials and training programs among potential users to raise awareness of the hotline? Are these materials available in all relevant languages, given the potential user base and taking into consideration cultural differences that may require alternative approaches to receive complaints?	☐	☐	☐	
12. Does the government support outreach to potential stakeholders other than employees?	☐	☐	☐	
13. Do the government's internal auditors periodically evaluate the design and operating effectiveness of the hotline? What were the internal auditors' conclusions regarding (*a*) how the hotline reflects changes in the government's operations and in best practices; (*b*) whether the hotline is receiving satisfactory support from management, employees, and other participants; and (*c*) whether protocols established for forwarding information to the government audit committee have been followed?	☐	☐	☐	

(continued)

Whistle-Blower Issues for Audit Committees to Consider Tool	Yes	No	Not Sure	Comments
B. Educating Employees and Others About the Hotline				
In assessing whether management is actively promoting the existence and use of the hotline, a government audit committee should consider the following questions:				
1. Is confidentiality of communications made to the hotline stressed?	☐	☐	☐	
2. Is training provided to employees upon hiring and periodically thereafter?	☐	☐	☐	
3. For suppliers, is information incorporated into a vendor approval process, in purchase contracts, and on purchase orders?	☐	☐	☐	
4. Is the hotline number and other contact information provided on the government's website, intranet, newsletters, invoices, purchase orders, pay stubs, checks, and, even, vehicles?	☐	☐	☐	
C. Evaluating Communications Received				
In evaluating the communications received, a government audit committee should consider the following questions:				
1. Does the audit committee have access to all complaints?	☐	☐	☐	
2. Are all allegations appropriately investigated?	☐	☐	☐	
3. Is there a process for coding or classifying complaints received so that complaints requiring more investigation are identified and brought to the audit committee's attention?	☐	☐	☐	
4. Does the government have a process for reporting back to the whistle-blower on a timely basis, where possible, regarding the action taken?	☐	☐	☐	

Sample Whistle-Blower Tracking Report

PURPOSE OF THIS TOOL: Government audit committees may vary greatly in their responsibilities in responding to complaints, whether generated internally or externally, regarding fraud, waste, and abuse. For government audit committees with the defined role of responding to complaints, this tool could be used to track complaints received to an appropriate resolution.

Many federal, state, and local government entities have whistle-blower laws and regulations. These regulations may require the entity to establish procedures for the confidential receipt, retention, and treatment of complaints received regarding suspected fraudulent activities. The government audit committee should ensure that the entity has established a process to address applicable whistle-blower laws and regulations.

If the government audit committee is assigned the responsibility of monitoring the entity's complaint process, this tool can be used as an effective internal record-keeping device to track the types of complaints, current status, and actions taken.

INSTRUCTIONS FOR USING THIS TOOL: Before using this tool, the government audit committee should review any applicable federal, state, or local laws or regulations governing whistle-blower activities.

Sample Whistle-Blower Tracking Report

Date Submitted	Tracking Number	Description of Complaint	Submitted By: Employee (E) Citizen (C) Vendor (V) Other (O)	Current Status: Resolved (R) Under Investigation (UI) Dismssed (D) Withdrawn (WO) Pending or No Action (P)	Actions Taken	
					Date	Comments

Guidelines for Hiring the Chief Audit Executive

PURPOSE OF THIS TOOL: The internal audit function in a government organization is a key mechanism in the internal control structure. Careful efforts must be taken in hiring the right individual to lead the internal audit team (known as the chief audit executive [CAE])—one that fits the government organization's needs with the necessary technical expertise, but also one that meets other requirements (industry experience and competence, independence and objectivity, integrity, management and human relationship skills, and so on).

A critical activity of the audit committee or its equivalent is to be involved in the hiring of the CAE. In order to be effective, the CAE should have a direct and ongoing communication with the audit committee. The audit committee, therefore, needs to feel comfortable with the individual who is selected to be the CAE. This tool provides guidelines on the job responsibilities of the CAE and key qualifications needed for a CAE to be effective as well as sample questions that will assist audit committees in evaluating potential CAE candidates.

Chief Audit Executive

One of the primary roles of a CAE is to partner effectively with management and audit committees ensuring that both have a clear understanding of how their internal audit activity is accomplishing its mission and objectives. CAEs also are responsible for directing the internal audit team; ensuring the quality and execution of internal audit efforts and the adequacy and quality of their staff; reporting to senior management and the audit committee; and overseeing internal audit work performed by a third party. Increasingly, the CAE role also includes responsibility for monitoring risk management activities as well as providing reasonable assurance on the effectiveness of the organization's internal controls environment and consulting services, as requested.

CAE Qualifications

The individual selected to be CAE must possess many critical personal traits as well as professional competencies in order to perform the role successfully. The July 2006 issue of the *Journal of Accountancy* describes some of the key qualifications that audit committees and senior managers should look for when hiring a CAE. These include at least 10 years of relevant management experience; a CPA, certified internal auditor designation, or both; strong technical accounting and audit skills; internal audit expertise; a deep understanding of the industry and related business risks; and a track record of leadership and ability to stand behind tough decisions. In addition to these skills, the Institute of Internal Auditors (IIA) adds the following necessary on-the job-skills: a basic knowledge of IT; communication and listening skills; and the ability to manage people.

Among the most critical of personality traits all great CAEs possess, according to a 2009 flash survey by the IIA's Audit Executive Center, are leadership qualities; integrity; and objectivity and independence. Other key attributes identified by the IIA that are required for a CAE to be effective include being intellectually curious, a change agent, and having a focus on quality.

INSTRUCTIONS FOR USING THIS TOOL: The audit committee or its equivalent should consider asking the following questions of candidates who have passed the initial employment screening by either the government's human resources department or an outside recruiting firm. This tool is meant to prepare the audit committee for the kinds of questions that should be asked of candidates for this important position. Note that some sample questions may not be appropriate for your government. It is also noted that this tool may not be applicable given a government's charter or other governing provisions.

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
1. What do you consider to be internal audit's role within the organization?	
2. What do you see as the biggest challenges for an internal team in the short run (3–6 months), medium term (6–12 months), and over the next 2–3 years?	
3. What experience do you have in government accounting and auditing, and how do you plan to keep abreast of the significant developments relevant to internal audit in government?	
4. What professional auditing standards do you have experience working with? (Yellow Book or Red Book)	
5. What methodology would you employ to ensure an internal quality control system to monitor the internal audit activity?	
6. What approach would you take to attract and develop high quality staff?	
7. Have you worked with audit committees in the past? What processes have you put in place to keep the audit committee fully and appropriately informed? In the course of a year, what is the typical number of meetings and communications between the CAE and the audit committee (or chair)?	
8. Give some examples of situations you have faced that required special meetings with the audit committee in executive session as a result of disagreements with management. How were these situations resolved with management? Have there been situations in which management has tried to squash your recommendations or discredit your findings, and how did you respond to this? In retrospect, would you now handle these situations differently?	
9. How would you go about addressing fraud, abuse, or organizational improprieties that come to your attention?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
10. Have you worked with the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) *Internal Control—Integrated Framework*? How has the framework influenced your process in evaluating the adequacy of internal controls? How is this framework used to design your internal audits?	
11. *a.* In what kind of situations have you advised management or the audit committee on a strategic issue? *b.* How would you reconcile or have reconciled the divergent roles of internal auditor and adviser? *c.* What activities would you initiate or have initiated to position yourself as an adviser to the audit committee?	
12. In your previous employment, what type of technology platform was used? Have you been involved in a new system (enterprise resource planning or other accounting systems) implementation? What role did you play in the process and how did you make sure that the proper controls were in place when the system went live?	
13. Have you used technology in conducting internal audits, and how has it enhanced conducting the internal audit? How would you recognize a problem that might exist either in the internal audit data, or in the government's records? What would you do about it?	
14. Do you use a formal project planning process that is applied consistently for all internal audits? If so, what benefits have you derived in meeting your team's goals and objectives? What is your average report cycle time from the end of fieldwork?	
15. What role does the government's strategic and technology plans play in the development of an audit plan?	
16. How would you assess the risks the organization faces or how have you assessed the risks faced in the organization?	
17. *a.* Are you familiar with COSO's *Enterprise Risk Management—Integrated Framework*? If so, how would you apply it or have applied it? *b.* How would you use or have used IT to enhance the organization's risk monitoring ability? *c.* How would you increase the audit committee's awareness on emerging risks?	

(continued)

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
18. Have you gone out to departments, divisions, component units, or agencies to ensure that they have significant input into audit objectives and scopes? How is this achieved? How have you resolved differences of opinion in this area without compromising the goals you have established for an audit?	
19. What role have you played in assisting departments, divisions, component units, or agencies in implementation of recommendations?	
20. When you or your team conducts an internal audit, do you have a service orientation to your audit process? Do you work to improve the effectiveness and efficiency of the operations and controls in each audit area? How would you make your recommendations to management? What process would you use to resolve differences of opinion?	
21. Would you use a process for conducting a customer satisfaction survey after an internal audit is completed? How would you integrate this feedback into future audits?	
22. How would you ensure that the personnel in internal audit have the necessary skills to ensure an adequate understanding of governmental business?	
23. How would you ensure that the personnel in internal audit remain independent when reporting internally to management, in fact and in appearance, as prescribed by generally accepted government auditing standards (GAGAS)?	
24. How would you partner with management while maintaining your independence and objectivity?	
25. How many people have you managed, either as direct reports or within an organization that you might have overseen? How would you describe your management style? Have you ever participated in a 360-degree assessment process? If so, what did you learn about yourself that surprised you? How did the results of the assessment change your behavior?	
26. What is your experience with external peer reviews as prescribed by GAGAS, and how would you incorporate such a process in internal audit?	
27. What professional training have you participated regarding organizational ethics?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
Other Notes and Questions	
Refer to the Government Finance Officers Association, IIA, and other professional associations for further insight in preparing interview questions for the CAE.	

Evaluating the Internal Audit Team: Guidelines and Questions

PURPOSE OF THIS TOOL: The sample questions included in this tool are only a starting point to assist the audit committee in evaluating the performance and effectiveness of the internal audit team. Follow-up questions should be considered as appropriate.

Audit Committee Relationship With Internal Audit Team

It is in the best interest of all concerned for the audit committee and the internal audit team to maintain a strong positive relationship. The audit committee should view the internal audit team as its eyes and ears about what is going on within the government organization.

The audit committee chair and the leader of the internal audit team (the chief audit executive [CAE]) should have frequent contact between meetings of the audit committee. In fact, the CAE should have a “solid-line” (functional) reporting relationship to the audit committee (with a “dotted-line” reporting relationship to a senior executive in the government organization for administrative purposes), and, the audit committee should be consulted before the CAE is hired, fired, or reassigned.

At every audit committee meeting the committee should hold an executive session with the CAE to ask specific questions. It is best for the audit committee to ask specific, yet, open-ended questions, and to probe for more detail on answers that might be puzzling or incomplete. The CAE should be forthcoming with information, including the results of audits conducted as well as audit currently under way. The internal audit team should recognize that it is an agent of the audit committee and not management.

The CAE should be the keeper of the audit committee charter, and should consult with the committee chair and senior management in developing meeting agendas.

Periodically, the CAE should review with the audit committee the staffing needs of the internal audit team, and the competencies of the individuals filling those positions.

The audit committee should promote a positive working relationship between the CAE and the independent auditor. If possible, the independent auditor should rely on the work of the internal auditor to supplement or limit his or her own testing and work should be coordinated with the CAE to avoid duplicated efforts. Generally accepted auditing standards require that the independent auditor maintain control of the work being performed on his or her behalf, and to reperform some of the testing to reach his or her own conclusions about the work of the internal auditor.

Finally, based on its own experience, the audit committee should periodically assess the performance of the CAE and the internal audit team to ensure that they are the appropriate agents of the audit committee in the government organization. As part of the assessment, the audit committee should consult both management and external audit to provide their own assessments. The following tool includes some sample questions that the audit committee should ask itself in evaluating the effectiveness of the internal audit team.

INSTRUCTIONS FOR USING THE TOOL: The sample questions included in this tool are only a starting point to evaluate the performance and effectiveness of the internal audit team. Audit committee members should ask follow-up questions as appropriate.

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
Purpose, Authority, and Responsibility				
1. Does the internal audit function have an internal audit charter that is consistent with the definition of internal auditing, the code of ethics, and the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing* (standards)?	☐	☐	☐	
2. Is the charter periodically (at least every 2 years) reviewed by the CAE and presented to senior management and the board for approval?	☐	☐	☐	
3. Does the charter define				
a. roles and responsibilities?	☐	☐	☐	
b. expectations of management?	☐	☐	☐	
c. scope of internal audit work?	☐	☐	☐	
d. minimum resources?	☐	☐	☐	
e. access to information?	☐	☐	☐	
Recognition of the Definition of Internal Auditing, the Code of Ethics, and the Standards in the Internal Audit Charter				
1. Has the CAE discussed the definition of internal auditing, the code of ethics, and the standards with senior management and the board?	☐	☐	☐	
Independence and Objectivity				
1. Does the internal audit function appear to be objective, and what procedures are performed to ensure objectivity?	☐	☐	☐	
2. Does the CAE have direct and unrestricted access to senior management and the board? (This can be achieved through a dual-reporting relationship.)	☐	☐	☐	

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
Organizational Independence				
1. Has the CAE confirmed to the board, at least annually, the organizational independence of the internal audit activity?	☐	☐	☐	
2. Does the CAE functionally report to the board?	☐	☐	☐	
Direct Interaction With the Board				
1. Does the CAE communicate and interact directly with the board?	☐	☐	☐	
2. Does the board have confidence in the internal audit function?	☐	☐	☐	
Individual Objectivity				
1. Are impairments to independence and objectivity disclosed to the senior management and the board in accordance with the internal audit charter?	☐	☐	☐	
Proficiency and Due Professional Care				
1. Do the internal auditors possess the knowledge, skills, and other competencies needed to perform their individual responsibilities?	☐	☐	☐	
2. Does internal audit staff have appropriate certifications and qualifications, such as Certified Internal Auditor designations?	☐	☐	☐	
3. Does internal audit staff collectively have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization?	☐	☐	☐	
4. Does internal audit staff collectively have sufficient knowledge of key IT risks and controls and available technology-based audit techniques to perform assigned work?	☐	☐	☐	
Continuing Professional Development				
1. Has the audit staff enhanced its knowledge, skills, and other competencies through continued professional development?	☐	☐	☐	

(continued)

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
Quality Assurance and Improvement Plan				
1. Has the CAE developed and maintained a quality assurance and improvement program that covers all aspects of the internal audit activity?	☐	☐	☐	
Internal Assessments				
1. Has there been ongoing monitoring of the performance of the internal audit activity?	☐	☐	☐	
2. Have there been periodic reviews performed through self-assessments or by other persons within the organization with sufficient knowledge of internal audit practice?	☐	☐	☐	
External Assessments				
1. Has there been an external assessment conducted by a qualified, independent reviewer or review team from outside of the organization (in the last five years for organizations using Red Book standards; in the last three years for organizations using Yellow Book standards or for those organizations using both Yellow Book and Red Book standards)?	☐	☐	☐	
2. Has the CAE discussed the need for more frequent external assessments?	☐	☐	☐	
3. Has the CAE discussed the qualifications and independence of the external reviewer or review team, including any potential conflicts of interest?	☐	☐	☐	
Reporting on the Quality Assurance and Improvement Program				
1. Has the CAE communicated the results of the quality assurance and improvement program to senior management and the board?	☐	☐	☐	
2. Was there any reported nonconformance with the definition of internal auditing, code of ethics, or standards?	☐	☐	☐	

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
Management of the Internal Audit Function				
1. Is the internal audit function effectively managed? (Does it achieve the purpose and responsibility included in the internal audit charter; does it conform to the standard; and are the individuals who are part of the internal audit activity in conformance with the code of ethics and standards?)	☐	☐	☐	
2. Does the internal audit function provide value to the organization? (Does it provide objective and relevant assurance and contribute to the effectiveness and efficiency of governance, risk management, and the control process?)	☐	☐	☐	
Planning				
1. Is there an annual risk based audit plan that determines the priorities of the internal audit activity, consistent with the organization's goals?	☐	☐	☐	
2. Does the internal audit function demonstrate an understanding of the organization's risk environment?	☐	☐	☐	
3. Is there an annual documented risk assessment?	☐	☐	☐	
4. Was the input of senior management and the board considered in the annual documented risk assessment?	☐	☐	☐	
5. Were the expectations of senior management, the board, and other stakeholders considered for internal audit opinions and other conclusions?	☐	☐	☐	
Communication and Approval				
1. Were the internal audit activities plan and resource requirements, including significant interim changes communicated and resource limitations, communicated to senior management and the board for review and approval?	☐	☐	☐	

(continued)

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
Resource Management				
1. Are resources				
a. appropriate?	☐	☐	☐	
b. sufficient?	☐	☐	☐	
c. effectively deployed to achieve the approved plan?	☐	☐	☐	
Outsourcing				
1. To what extent is outsourcing used in the internal audit function and to whom is the internal audit function outsourced?	☐	☐	☐	
Policies and Procedures				
1. Are policies and procedures in place to guide the internal audit activity?	☐	☐	☐	
Coordination				
1. Is information shared and coordinated with other internal and external auditors to ensure proper coverage and minimize duplication of effort?	☐	☐	☐	
Reporting to Senior Management and the Board				
1. Does the CAE report periodically to senior management and the board on				
a. internal audit activity's purpose, authority, responsibility, and performance relative to its plan?	☐	☐	☐	
b. significant risk exposures and control issues including fraud risk, governance issues, and other matters needed or requested by senior management and the board?	☐	☐	☐	
2. Is internal audit appropriately prepared when reporting to senior management and the board?	☐	☐	☐	

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
Governance, Risk Management, and Control				
1. Does the internal audit activity				
a. assess and make appropriate recommendations for improving the governance process?	☐	☐	☐	
b. evaluate the effectiveness and contribute to the improvement of the risk management process?	☐	☐	☐	
c. assist the organization in maintaining effective controls by evaluating the effectiveness of internal controls and advocating continuous improvement?	☐	☐	☐	
Communication				
1. Are results of internal audit engagements communicated to appropriate parties within the organization who can ensure that results are given due consideration?	☐	☐	☐	
2. Are reports accurate, objective, clear, concise, constructive, complete, and timely?	☐	☐	☐	
3. Has internal audit attended all the board committees it was scheduled to attend?	☐	☐	☐	
4. Has internal audit made itself available for consultation outside of board meetings?	☐	☐	☐	
5. Does internal audit appropriately handle difficult or contentious issues?	☐	☐	☐	
Monitoring Progress				
1. Has a follow up process been developed to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action?	☐	☐	☐	
2. Have the results of consulting engagements been monitored to the agreed upon consent?	☐	☐	☐	
3. Are there appropriate success measures used to evaluate the performance of the internal audit function?	☐	☐	☐	

Monitoring the Internal Auditor: An Overview of the Peer Review Process for Internal Audit

PURPOSE OF THIS TOOL: This tool is intended to educate government audit committee members about how internal audit organizations are monitored to ensure that they comply with professional standards in the work they do. This monitoring process is known as the peer review process. This tool will help audit committee members understand the requirements for a peer review, what questions to ask the internal auditor concerning peer review results, and why the internal auditor's peer review should be important to an audit committee member.

Peer Review Requirements Under Applicable Standards

Both the Institute of Internal Auditor's (IIA's) *International Standards for the Professional Practice of Internal Auditing* (IIA standards) and generally accepted government auditing standards (GAGAS) require that any government audit organization that performs audits and other engagements in accordance with either or both standards undergo an external peer review. Under GAGAS, government audit organizations must undergo a peer review at least once every three years; whereas IIA standards require a peer review at least once every five years. For audit organizations conducting audits and other engagements under both sets of professional standards it is recommended that a peer review be conducted every three years and that the review be designed to determine conformance with both sets of professional standards.

A peer review of a government internal audit organization can be used by an audit committee as a tool to assess whether the internal audit activity has a system of quality control that has been suitably designed and whether the audit organization is complying with that system of quality control during the peer review year to provide the firm or organization with reasonable assurance of complying with professional standards. Additionally, external assessments performed under IIA standards that are broader in scope than reviews under GAGAS can also provide the audit committee an assessment and evaluation of the use of best practices by the organization.

There are 3 major peer review phases: (1) preparation, (2) the site visit, and (3) reporting. During the preparation phase a qualified peer review team will be engaged by the government audit organization to perform the review. Each member of the peer review team is required to be independent of the government audit organization and must be qualified to perform the review. During the site visit phase, the peer review team will evaluate the organization's internal quality control policies and procedures and select engagements to evaluate whether the firm or organization followed its internal quality control policies and procedures when performing those engagements. In addition, the reviewers meet with audit management to discuss their conclusions. The results of the peer review team's evaluation are submitted in a peer review report. IIA Practice Advisory 1312-1, *External Assessments*, and sections 3.55–.63 of GAGAS establish the applicable requirements for the scope of the review, the conduct of the review, reporting, qualifications for the peer review team, and the communication of the review's results.

Peer Review Reports

Under GAGAS the three types of opinions for a peer review report are unmodified, modified, and adverse:

1. An *unmodified opinion* is an opinion that the reviewed government audit organization's system of quality control has been designed to meet the requirements of the quality control standards for an auditing practice and the system was being complied with during the peer review year to provide the firm or organization with reasonable assurance of complying with professional standards.
2. A *modified opinion* is an opinion that the design of the organization's system of quality control created a condition in which the organization did not have reasonable assurance of complying with certain professional standards, or that the firm or organization's degree of compliance with its quality control policies and procedures did not provide it with reasonable assurance of complying with all professional standards.
3. An *adverse opinion* is an opinion that there are significant deficiencies in the design of the organization's system of quality control, pervasive instances of noncompliance with the system as a whole, or both, resulting in several material failures to adhere to professional standards on engagements.

Typically, unmodified and modified reports are accompanied by a letter of comments. A letter of comments describes matters that the peer review team believes resulted in conditions in which there was more than a remote possibility that the government audit organization would not comply with professional standards and sets forth recommendations regarding those matters. A letter of comments might not be prepared when an adverse report is issued if all deficiencies, comments, and recommendations are contained in the report itself.

Similarly under IIA standards, the three types of report opinions that are possible are conformance, nonconformance, and partial conformance.

Under both sets of standards the reviewed government audit organization responds in writing to the peer review team's comments on matters in the peer review report or in the letter of comments (called *the letter of response*). The response describes the actions taken or planned with respect to each matter in the report or the letter as well as applicable implementation dates.

We recommend that audit committees request a copy of the auditor's latest peer review report, and any letter of comments and letter of response, if the government audit organization has not already submitted them to the committee. The audit committee should discuss both the report and the letters of comment and response with the auditor.

Questions for the Auditor Regarding Peer Review

The audit committee should consider asking the following questions of its internal auditors to gain a better understanding of the auditor's peer review experience:

Evaluation of Peer Review Process of Internal Audit Team	Yes	No	Not Sure	Comments
1. Has the audit organization undergone a peer review within the last three years (for organizations following GAGAS; or both IIA standards and GAGAS) or within the last five years (for organizations following IIA standards)? If not, please explain.	☐	☐	☐	
2. What was the opinion of the peer review reports?	☐	☐	☐	
3. If the peer review report was modified (GAGAS) or not in conformance (IIA standards), explain why.	☐	☐	☐	
4. Is the firm or organization's letter of response evidence that it is committed to making the changes necessary to improve its practice? For example, did it include a specific action plan and implementation dates in response to recommendations for improvement? If not, please explain.	☐	☐	☐	
5. Did the organization correct the deficiencies noted in either the peer report or the letter of comments, or both? If not, please explain.	☐	☐	☐	
6. Were best practices observed? Were other potentially applicable best practices identified? (IIA standards)	☐	☐	☐	
7. Have identified potential applicable best practices been implemented and if not why not? (IIA standards)	☐	☐	☐	

PART IV: Audit Committee—External Auditors and Resources

Guidance for Developing a Request for Proposal for CPA Services (Governmental Organizations)

PURPOSE OF THIS TOOL: This tool provides guidance to be used by the government's audit committee or its equivalent oversight body to ensure the organization's request for proposal (RFP) is complete and contains the necessary elements for the successful procurement of professional auditing services.

Background

This tool has been prepared to assist a government's audit committee or its equivalent in the preparation or review of an RFP for professional auditing services. This guide describes the RFP contents and sample format for said services. Some governments have laws or regulations that control the processes used for RFPs for professional services. Sometimes, governments require RFPs to be submitted electronically or in some other specified format. Government audit committees need to be aware of the requirements for their government entities.

As a generic model, it should be used for reference purposes only. A government organization, most likely, will obtain the services of a team of qualified experts including legal advisers, accountants, internal auditors, procurement officers, and other technical resources to assist in the preparation of an RFP for CPA services.

The preparation of a sound RFP is important, and the quality to the RFP directly affects the submission and costs. Government audit committees need to consider the quality of the RFP because the results by the auditor may be poorly performed by the firm or government audit organization or the price may be too high for firms or government audit organizations when the work is not defined clearly in the RFP. The RFP should outline the proposal and selection process, as well as summarize the background, objectives, expectations, and requirements of the engagement to be undertaken. Therefore, the following should be remembered when writing the RFP:

- Communicate the facts and conditions surrounding the engagement to be completed
- State objectives and requirements clearly and thoroughly
- Be specific about the information needed to properly evaluate the proposal
- Require the proposal to be presented in a common format to allow for efficient and effective evaluation

A quality RFP will determine the quality of the respondents and will help to reduce the time and effort expended in the overall RFP and selection process. A quality RFP can be a factor in mitigating potential challenges associated with subsequent contract negotiations.

As a best practice, the evaluation of the RFPs should be a two stage process:

1. Evaluation of the technical competence and qualifications of the firms or audit organizations. After initial screening for qualified firms, then the evaluation team can consider the cost.
2. Consideration of the cost of the professional service.

By adopting the two step process, only qualified firms would be considered for evaluation of the cost of the audit. To facilitate this two-step process, this toolkit suggests employing a process that would first only consider the qualifications, and after the list of qualified firm or audit organizations is determined would the competitive bid become a factor. To accomplish this, it is suggested that the qualifications and the bid be separately sealed.

Because each government is different and unique in its own right, the following is offered guidance for government oversight bodies to assess the quality and comprehensiveness of the RFP document for professional auditing services.

Guidelines on the Introduction

The introduction of the RFP establishes the tone for the proposal document and provides an indication of the scope of work to be performed. The introduction should accomplish the following:

- Describe why the RFP is being released. Discuss in general terms the objective to be achieved and the reason professional CPA services are being sought.
- Discuss the term of the engagement, such as the length of time the contemplated contract covers (for example, an annual or a multiyear engagement), along with renewal options.
- Provide an overview of how the RFP is structured and describe what information or supporting documents are contained in the appendixes, attachments, or the body of the RFP document.

Guidelines When Describing the Government Organization

The objective in describing the government organization is to provide an understanding of the composition and makeup of the organizational structure and financial reporting considerations. This information should provide respondents with insight about the possible size and complexity of the work to be performed.

Depending on the information deemed relevant in describing a particular government organization, incorporate the following:

- Year of incorporation
- Charter date
- Form of government
- Term length and term limits for elected officials
- Composition of governing body
- Composition of audit committee
- Population size and other relevant demographics

- Activities and services provided by the government to its citizenry
- Accounting and reporting structure, including chart of accounts or summary description of number and types of funds
- Accounting systems or software used in accounting and financial reporting activities, including timing of changes to the system
- Basis of accounting used in daily operations (for example, generally accepted accounting principles [GAAP], budgetary basis)
- Component units and joint ventures included in the reporting entity including timing of additions or deletions
- Pension plans and other postretirement benefits other than pensions and actuarial services information
- Additional resource information (for example, budget documents, official statements, annual financial reports, policies and procedures, prior internal or external audits, and single audits), along with contact names and numbers to obtain access to this information.
- Any extraordinary changes to the governance structure

Guidelines on the Scope Of Work

This section of the RFP should describe the required services to be provided as a result of this engagement. It should describe the scope of work and any special considerations, such as the following:

- Provide a general description of the services being solicited, including the term of the engagement (for example, number of fiscal year(s) to be audited and related time frame).
- Indicate the exact scope of work to be performed, including the expected deliverables (that is, expressed opinion on the fair presentation of the government's basic financial statements in conformity with GAAP). Specific language should distinguish whether the expected deliverables are to include the following:
  - An expression of an audit opinion in conjunction with the full-scope audit of a comprehensive annual financial report (CAFR)
  - Audit report on basic financial statements only
  - Single audit report relative to state and federal financial assistance programs
  - Quality control reviews (for example, reviews related to financial assistance programs)
  - Management letter indicating deficiencies or opportunities for accounting and reporting improvements, specifically identifying any reportable condition or material weakness
  - Disclosure of irregularities and illegal acts
  - Other reports to be issued or deliverables to be completed
- Include any other special services that may be required of the auditor such as the following:
  - Reporting on the internal control system based on the auditor's assessment of the structure and control risk
  - Providing continuing education training for the government's staff
  - Conducting performance audits to assess operating effectiveness and efficiency

- Indicate the standards required in performing the auditing services, such as the following:
  - Generally accepted auditing standards as set forth by the AICPA
  - Standards for financial audits as set forth in the applicable U.S. Government Accountability Office's (GAO's) *Government Auditing Standards*, known as the Yellow Book
  - Provisions of the *Single Audit Act Amendments of 1996* and the U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*
  - Standards as set forth by local or state charter, code, or other legal mandate
- Identify any special considerations that will allow the respondent to properly assess the size and complexity of the prospective engagement, for example:
  - Participation in the Government Finance Officers Association Certificate of Achievement for Excellence in Financial Reporting program, which will require a certain level of knowledge and experience to assist governments in achieving this reporting milestone
  - Specific timelines that must be satisfied (for example, CAFR and single audit timeline requirements)
  - Preparation of the entire CAFR and certain support schedules (at minimum, any assistance from the auditors must follow the AICPA's Code of Professional Conduct (*Professional Standards*) and the independence standards as set forth in the applicable U.S. GAO's *Government Auditing Standards*)
  - Assistance in preparing official statements or other documents or disclosure related to sales of debt instruments
  - Foreseeable difficulties that may be encountered as part of the audit process

Guidelines on Proposal Content and Other Submission Requirements

This section should consist of a discussion of specific requirements and parameters to ensure the RFP proposal is submitted successfully. From this information, the respondent should have a clear understanding of what should be included in the proposal, and what steps and timelines must be met for proposal consideration. Ask the respondent, when considering proposal content, to state the following:

- Disclose qualifications and experience of the firm and staff assignment:
  - Respondent's experience in providing professional auditing service (for example, prior engagements)
  - Respondent's quality control review reports
  - Partner or senior management of the government audit organization, supervisory, and staff qualifications and experience who are assigned to the specific engagement and the procedures for changing assigned staff during the audit process
  - Audit approach (for example, statistical sampling, analytical procedures, methodology for documenting, and electronic data process use in the auditing process)
- Comply with local, state, or federal statutes and regulations:
  - Maintenance of independence as required by the applicable U.S. GAO's *Government Auditing Standards*

  - — Adherence to the AICPA's Code of Professional Conduct or other ethical code
  - — Conflict of interest (for example, ethics ordinance or code of ethics requirements)
  - — Assignment of professional services contract to a third party
  - — Minority, women, and small business participation goals and requirements
  - — License requirements to contract and practice public accounting or auditing in a specific locality
  - — Other relevant laws and statutes affecting proposal process and submission of the proposal
- Discuss whether subcontracting will be used and to what extent. If joint ventures are permissible, disclose how such business arrangements will comply with RFP requirements.

Additionally, the government should do the following:

- Identify submission criteria for proposals:
  - — Government contact name(s) and telephone number(s)
  - — Address where proposals will be accepted
  - — Required number of original and copies of the proposal document to be submitted
  - — Whether proposals are to be signed and by whom
  - — Submission date and time deadline (including time zone)
  - — How proposals are to be delivered (for example, in a sealed package marked plainly)
  - — Response format or presentation layout for the proposal (for example, title page, table of contents, transmittal letter, detailed proposal)
- Communicate other information useful to the respondent, such as the following:
  - — Basis on which government organization will or can reject proposals
  - — Public information disclosure indicating proposals are subject to open record's laws and regulations
  - — Costs that will be reimbursed by the government organization, if any
  - — Basis for contract termination, including the termination notification process and related timelines
  - — Insurance requirements and indemnification clause (for example, liability insurance or workers' compensation)
  - — Procedures to handle inquiries from potential RFP respondents

Guidelines on the Schedule of Events and Timelines

Proposal milestones and related timelines should be specifically outlined for complete understandability. This information is often presented in a table format for easy reference. Regardless of the presentation, provide potential respondents with a calendar of proposal events and dates.

Guidelines on the Proposal Evaluation

To complete the body of the RFP document, clearly outline the proposal evaluation process. A properly defined evaluation process promotes consistency and fairness in the selection process and will reduce the time spent assessing the respondents' qualifications and experience. When developing the proposal evaluation process and subsequently completing this section of the RFP document, do the following:

- Identify the composition of the selection committee (for example, audit committee)
- Disclose elements of the proposal that will be specifically evaluated (for example, technical experience and expertise)
- Indicate the methodology for scoring the proposal (for example, point system)
- Outline the steps involved in the selection process
- Incorporate a right-to-reject clause

Appendixes and Attachments

Appendixes and attachments can be used to accompany the body of the RFP in an attempt to provide added relevant information to prospective respondents. Following is a list of information that is often included in the appendixes and attachments to RFP documents:

- Glossary
- Organization chart
- List of key personnel, office locations, and telephone numbers
- Recent external and internal audit findings
- Audited financial statements
- Summary budgetary information
- Single audit reports
- Corrective action plans
- Management letters
- Respondent guarantees and warranties
- Format for schedules of professional fees and expenses
- Offering statements
- Excerpts from state and local laws and regulations
- Standard legal language to be included in the audit contract
- Previous listing of schedules prepared by client

Conclusion

The RFP is an important step in the selection process. It establishes an opportunity for dialogue regarding a certain set of procurement needs. The preceding guidance is not all-inclusive and depends upon a particular government organization and its individual requirements. Therefore, a government organization seeking professional auditing services should employ the help of a team of experts to develop the specific RFP.

Evaluating the External Auditor’s Engagement Letter: Questions to Consider

PURPOSE OF THIS TOOL: The audit committee should have some responsibility with respect to the hiring and firing of the external auditors, except in those instances in which the external auditor is a government auditor organization mandated by law or regulation to perform the audit. Regardless of whether there is responsibility for hiring and firing the external auditor, the audit committee should be responsible for either evaluating the engagement letter with the external auditor or making recommendations to the governing body about certain conditions within the engagement letter. The audit committee should discuss the audit engagement letter (service agreement) with the external auditor in discharging this responsibility. This tool provides example questions an audit committee can use to evaluate the external auditor’s engagement letter.

The engagement letter should be reviewed to ensure that the terms of the letter are consistent with those that were stated in the proposal received by the organization in response to its request for proposal in terms of scope of the audit, resources being provided by the auditor, obligations of financial management, and fees being charged. Even if the external auditor is an appointed or elected government audit organization, an engagement letter will be presented that sets forth an understanding about the audit services to be performed.

The financial management of the organization should be consulted regarding its agreement with the details of the audit engagement, including timing of the work and the level of assistance to be provided by the organization’s staff.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are a starting point to evaluating the engagement letter with the external auditors. Audit committee members should answer the following questions, consulting with the external auditor and financial management as needed.

Evaluating the Auditor's Engagement Letter	Yes	No	Not Sure	Comments
1. Does the engagement letter address the scope of work to be performed? • Audit of financial statements • Supplemental information • Compliance reports • Generally accepted auditing standards issued by the AICPA • Generally accepted government auditing standards (Yellow Book) • Office of Management and Budget (OMB) requirements—Single Audit OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* • Other requirements	☐	☐	☐	
2. Does the engagement letter include a timetable for the audit work including dates for the following: • Interim fieldwork, if applicable • Provision of year-end trial balance • Completion of client-prepared schedules • Beginning of year-end fieldwork • Delivery of draft of financial statements or Single Audit schedules • Delivery of final financial statements or Single Audit schedules • Communications with those charged with governance • Auditor's report(s) on the audit of the financial statements and single audit compliance testing • Communications about internal control scope of work, and internal control deficiencies, if applicable	☐	☐	☐	

Evaluating the Auditor's Engagement Letter	Yes	No	Not Sure	Comments
• Management's written responses to any auditor's internal control or compliance findings • Delivery of management letter, if applicable • Meetings with audit committee				
3. Does the letter discuss other parties that need to rely on the auditor's report?	☐	☐	☐	
4. Does the letter identify the persons or entities that will use the audit report and for what purpose?	☐	☐	☐	
5. Does the letter include estimates of the professional fees to be charged for the engagement?	☐	☐	☐	
6. Does the letter provide for an agreed-upon process for changes in the scope of work?	☐	☐	☐	
7. Does the letter indicate the payment terms for the fees and costs and whether there are any finance charges for late payment?	☐	☐	☐	
8. Are mediation or arbitration terms discussed should a dispute or claim arise in connection with the performance or breech of the engagement agreement?	☐	☐	☐	
9. Does the letter contain a severability clause to address the possibility that a portion of the letter may be determined to be invalid?	☐	☐	☐	
10. Does the engagement letter require a written acceptance by the organization?	☐	☐	☐	
11. Does the letter include discussion of assistance that is expected to be provided during the audit by the organization's personnel?	☐	☐	☐	
12. Does the letter address how adjustments below the auditor's materiality threshold will be handled? (For example, does it address how the adjustments will be communicated to management for possible recording in the subsequent year's financial statements?)	☐	☐	☐	

(continued)

Evaluating the Auditor's Engagement Letter	Yes	No	Not Sure	Comments
13. Does the letter address the use of e-mail communications and related disclaimers regarding privacy?	☐	☐	☐	
14. Does the letter address the provision of a safe environment by the organization for the audit staff?	☐	☐	☐	
15. Does the letter address access to records and documents of the organization by the audit staff?	☐	☐	☐	
16. Does the letter address the auditor's record retention policy?	☐	☐	☐	
17. Does the letter address how the auditor will respond to circumstances that create a potential or actual conflict of interest?	☐	☐	☐	
18. Does the letter address how the auditor will respond to outside inquires related to the audit engagement?	☐	☐	☐	
19. Does the letter discuss the auditor's privacy policy regarding the organization's financial information?	☐	☐	☐	
20. Does the letter include a schedule of information to be provided by the organization, such as permanent file documents and schedules prepared by the organization's staff in connection with the audit engagement?	☐	☐	☐	
21. Does the letter discuss nonaudit services the auditor cannot provide the organization and nonaudit services that may be provided?	☐	☐	☐	
22. If the letter indicates that nonaudit services are excluded from this engagement, does the letter provide that nonaudit services are subject to a separate written understanding before any additional services are commenced?	☐	☐	☐	

Evaluating the Auditor's Engagement Letter	Yes	No	Not Sure	Comments
Other Comments, Additional Questions				

Discussions to Expect From the External Auditors

PURPOSE OF THIS TOOL: Auditing standards issued by the AICPA and Government Accountability Office (GAO) require that the auditor communicate, either orally or in writing, certain information to those charged with governance. This section discusses the type of information external auditors are likely to communicate to an audit committee.

External Auditors in the Public Sector

The auditing standards use the phrase *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. External auditors, in the wake of well-documented audit failures, are required to increase their documentation and communication efforts as they relate to their interactions with those charged with governance, which includes the audit committee. The following sections list matters that must be communicated to those charged with governance by the external auditors, so audit committees are likely to receive these communications. However, this list is not meant to indicate that this is all that the auditor is communicating to the audit committee.

In the public sector, external auditors of government organizations may include an elected or appointed auditor, inspector general, or a public accounting firm. In addition, at the federal level the GAO may be statutorily required to act as the external auditor in certain circumstances. If a public accounting firm is used as the external auditor, it may be the result of being under contract with the elected or appointed auditor or inspector general. The communication guidance discussed in this section relates to whichever of the above parties is acting as the external auditor.

External Auditor's Responsibility Under Generally Accepted Auditing Standards

It is important for audit committees to understand what an audit is and what it is not. Usually, audit committees are most concerned about the system of internal control and that the financial statements are free of material misstatement. The external auditor should make sure the audit committee understands the level of responsibility that the auditor assumes for the system of internal control and the financial statements under generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS). It is also important that the external auditor makes sure that the audit committee understands that an auditor is responsible for forming and expressing an opinion about whether the financial statements are presented fairly, in all material respects. Included in this discussion is the understanding that (1) the audit is designed to obtain reasonable, rather than absolute assurance, about the financial statements, and (2) the audit does not relieve management or those charged with governance of their responsibilities for the financial statements.

Significant Accounting Policies

The external auditor should determine that the audit committee is informed about all significant accounting policies and how they are applied in the governmental organization. To make sure, the audit committee should expect that the auditors will communicate the following:

1. All significant accounting policies, including those that applied for the first time during the year
2. How those accounting policies are applied in the organization
3. Methods the organization used to account for significant unusual transactions
4. The effect of significant accounting policies in controversial or emerging areas for which there is lack of authoritative guidance or consensus
5. The existence of alternative policies that management had the option to apply, and why a certain policy was chosen

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management. These estimates are based on management's judgments (which are normally based on management's knowledge and experience about past and current events) and assumptions about future events. In some cases, for example, pensions or self-insurance activities, management uses actuaries to make estimates based on historical financial and nonfinancial data and assumptions about future events. (See the "Significant Issues, Estimates, and Judgment: Management's Report to the Audit Committee" tool for additional information.)

The external auditor should address the following issues with the audit committee:

1. The process used by management in formulating particularly sensitive accounting estimates
2. The basis for the auditor's conclusion about the reasonableness of those estimates

For example, for pension obligation estimates, the audit committee should discuss with management the appropriateness of the methods, assumptions, and data the actuary used and the results of analyzing the accuracy of prior year's estimates. The audit committee should also ask the external auditor about his or her observations and testing of management's process, methods, assumptions, and data used to make the estimates. In addition, the audit committee should ask the external auditor about the results of any alternative measures he or she calculated, and how those alternative calculations compared to management's estimates.

External Auditor's Judgments About the Quality of the Organization's Accounting Principles

Although objective criteria for evaluating the quality of an organization's accounting practices have not been established, the auditor's judgments about the quality, not just the acceptability of the organization's accounting principles as applied in its financial statements, including disclosures, should be discussed. The discussion should be open and frank, and tailored to the organization's specific circumstances. It should include the following topics:

1. Consistency of the organization's accounting principles and their application
2. Clarity of the financial statements and related disclosures
3. Completeness of the financial statements and related disclosures
4. Any items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements, examples of which follow:

   a. Selection of new accounting policies or changes to current ones
   b. Estimates, judgments, and uncertainties
   c. Unusual transactions
   d. Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded

5. A discussion of accounting practices that are not specifically addressed in the accounting literature, for example, those that may be unique to a specific industry.

Audit Adjustments

The external auditor should inform the audit committee about all audit adjustments arising from the audit that could, in the auditor's judgment, have a significant effect on the organization's financial reporting process. The audit team will keep track of those proposed adjustments for later discussion with management. Management will evaluate those proposed adjustments and decide whether the adjustment should be booked to the account balances as proposed. Bear in mind, however, that the external auditor may find it necessary to qualify the audit report if management does not record the adjustments that the auditor deems necessary to record.

As part of his or her communications, the external auditor should

1. inform the audit committee about proposed adjustments arising from the audit that could either individually or in the aggregate have a significant effect on the organization's financial reporting process.
2. address whether the adjustments were recorded by management.
3. determine whether the proposed adjustments may not have been detected except through the auditing procedures performed (meaning that the organization's own internal control system did not detect the need for the adjustment).
4. explain about uncorrected misstatements or unadjusted amounts aggregated by the auditor during the current engagement and pertaining to the most recent period presented in the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Other Information Contained in Audited Financial Statements

Although the notes to the financial statements are an integral part of the financial statements and therefore are included in the scope of the auditing procedures, other information prepared by management that generally accompanies financial statements is not necessarily included in the scope of the auditing procedures. Common examples include Management's Discussion and Analysis of the Financial Condition and Results of Operations; Budgetary Comparison Statements; and statistical or other supplementary information.

The external auditor should discuss the responsibility, if any, that he or she has for other information in documents containing audited financial statements, any procedures performed, and the results.

Disagreements With Management

Disagreements may arise between the external auditor and management over the application of accounting principles to specific transactions and events, as well as the basis for management's judgments about accounting estimates, or even the scope of the audit or disclosures to be made in the financial statements or footnotes. Differences of opinion based on incomplete facts or preliminary information that are later resolved are not considered disagreements for this purpose.

When meeting with the audit committee, the external auditor should discuss any disagreements with management, whether or not resolved, about matters that individually or in the aggregate could be significant to the organization's financial statements or the auditor's report.

Consultation With Other Accountants

Sometimes, management of the government organization may consult with other accountants about accounting and auditing matters. If the external auditor is aware that such consultation has occurred, he or she should discuss with the audit committee his or her views about the significant matters that were the subject of the consultation. The audit committee may wish to ask management whether it has consulted with other accountants about accounting and auditing matters. In this regard, the audit committee should be concerned about possible "opinion shopping" by management on critical issues.

Major Issues Discussed With Management Before Retention

The external auditor should discuss with the audit committee any major issues that were discussed with management in connection with the initial or recurring retention of the auditor. This includes any discussions regarding the application of accounting principles or auditing standards. For some government organizations, an audit organization is mandated by federal or state law to perform the government organization's audit. Although auditor retention is not an issue, the external auditor should nonetheless discuss with the audit committee any major issues regarding the auditor's application of accounting principles or auditing standards.

Difficulties Encountered in Performing the Audit

The external auditor should inform the audit committee about any serious difficulties encountered in working with management during the audit. Examples include, but are not limited to the following:

1. Unreasonable delays by management in allowing the commencement of the audit
2. Unreasonable delays or refusals by management in providing needed information to the auditor
3. Unreasonable timetable set by management for the conduct of the audit
4. Unavailability of client personnel
5. Failure of client personnel to complete client-prepared schedules on a timely basis

Illegal Acts

The external auditor has the responsibility to assure himself or herself that the audit committee is adequately informed about illegal acts that come to the auditor's attention (this communication need not include matters that are clearly inconsequential). The communication should describe (1) the act, (2) the circumstances of its occurrence, and (3) the effect on the financial statements.

What is an illegal act for purposes of this communication? AICPA professional auditing standards define it as violations of laws or government regulations attributable to the government organization, or acts by management or employees on behalf of the organization. Illegal acts do not include personal misconduct by the organization's personnel unrelated to the government's business activities.

In addition, GAGAS and the U.S. Office of Management and Budget's Bulletin No. 01-02, *Audit Requirements for Federal Financial Statements*, require the external auditor to report noncompliance with laws and regulations disclosed by the audit, except for those instances of noncompliance that are clearly inconsequential. In meeting this requirement, the auditor reports all instances of fraud and illegal acts unless they are clearly inconsequential and reports significant violations of provisions of contracts or grant agreements and abuse. In some circumstances, auditors are required to report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse directly to parties external to the audited organization.

Internal Control Matters

See also the tool "Internal Control: A Tool for the Audit Committee" elsewhere in this toolkit.

Professional auditing standards issued by the AICPA and U.S. GAO require the external auditor to communicate matters relating to the organization's internal control that are observed by the auditor during the conduct of a financial statement audit. These matters should be discussed with the audit committee because they represent significant deficiencies in the design or operation of the internal control system, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

Fraud

See also the tool "Fraud and the Responsibilities of the Government Audit Committee" elsewhere in this toolkit.

AICPA professional auditing standards require the external auditor to ask the audit committee about its views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the organization. These standards also require that the independent auditor bring any evidence of fraud to the attention of the appropriate level of management (generally seen as one level higher than the level at which a suspected fraud may have occurred), even in the case of an inconsequential fraud, such as a minor defalcation by a low-level employee. The external auditor should reach an understanding with the audit committee regarding when (nature and scope) an inconsequential fraud conducted by a low-level employee should be brought to the audit committee's attention.

Fraud involving senior management, and any fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements must be reported to the audit committee by the external auditor.

Evaluating the External Auditor: Questions to Consider

PURPOSE OF THIS TOOL: In some cases, the audit committee (or its equivalent) may have the responsibility to hire, fire, and evaluate the external auditor. In other cases, the government audit organization may be required by legislation, or may choose to conduct and report the audit results. When the audit committee (or its equivalent) has the responsibility to hire, fire, and evaluate the external auditor, the audit committee should answer a series of questions about its relationship with the external auditor and should ask key executives in the government organization for their comments as well.

In considering information gathered through the process of evaluating the external auditors, it is important that the audit committee give consideration to the source of the information. For example, if the CFO or controller comments that he or she believes the auditor went too far in certain areas that would probably carry less weight in your deliberations than if the CFO or controller comments that certain areas were not tested adequately or that auditor independence had been breached. As with all deliberative processes, the different perspectives and motivations of those having input into the deliberations should be considered.

The internal auditor can be used to fulfill the audit committee's responsibility to evaluate the external auditor. As a member of the accountability community, the internal auditor is able to have more informed professional judgments regarding the quality of the work as well as the independence necessary to the audit function. The audit committee can then be used to assess the adequacy of the internal auditor's assessment.

Any communications with the external auditors undertaken in the evaluation process should be conducted with tact and acknowledgment of the need to maintain the open flow of communication between the external auditors and the audit committee.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are only a starting point in evaluating the performance and effectiveness of the external auditors. Audit committee members should ask follow-up questions as appropriate and required.

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for Audit Committee Members				
1. Did the auditor meet with the audit committee when requested?	☐	☐	☐	
2. Did the auditor address issues of "tone at the top," and antifraud programs and controls in place in the government organization?	☐	☐	☐	
3. Did the auditor inform the audit committee of any risks of which the committee was not previously aware?	☐	☐	☐	
4. Did the auditor adequately discuss issues of the quality of financial reporting, including the applicability of new and significant accounting principles? Did the auditor adequately discuss issues relating to the government's conformance with local laws, regulations, and oversight requirements?	☐	☐	☐	
5. Did the auditor communicate issues freely with the audit committee, or did the auditor seem protective of management?	☐	☐	☐	
6. Does it appear that management exercises undue influence on the external auditor?	☐	☐	☐	
7. Does it appear that the external auditor is reluctant or hesitant to raise issues that would reflect negatively on management?	☐	☐	☐	
8. Is the audit committee satisfied with the planning and conduct of the audit, including the financial statements and internal control over financial reporting (as applicable)?	☐	☐	☐	
9. Review all audit-related and nonaudit services conducted by the external auditor in the prior year. Is the audit committee satisfied that the external auditor remains independent and objective both in fact and appearance?	☐	☐	☐	

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for Audit Committee Members (cont.)				
10. If a CPA firm is used for the external audit, understand the size of the firm and its total revenues firm-wide, for the office(s) providing a substantial amount of services to the government, and the book-of-business of the partner-in-charge of the audit. Is the firm, the office, or the partner dependent on the government engagement for a material percentage of its fee income? If so, the audit committee should consider whether this impairs the appearance of independence with respect to the government.	☐	☐	☐	
11. If a government audit organization is used for the external audit, is the mandate or other reasons the government audit organization performed the audit understood?	☐	☐	☐	
12. Is the audit committee satisfied with its relationship with the auditor? In making this determination, the audit committee should consider (*a*) whether the partner-in-charge of the audit or the assigned executive level staff of the government audit organization participated in audit committee meetings; (*b*) whether the auditor was frank and complete in the required discussions with the audit committee; (c) whether the auditor was frank and complete during executive sessions with the audit committee; and (d) whether the auditor was on time in the delivery of services to the government.	☐	☐	☐	
13. If applicable, was the audit fee fair and reasonable in relation to what the audit committee knows about fees charged to other government organizations, and in line with fee benchmarking data the audit committee might have available?	☐	☐	☐	

(continued)

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Questions for Audit Committee Members (cont.)				
14. Did the external auditor provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting? How constructive are the key issues communicated in any issued management letter and other disclosures on audit findings and recommendations?	☐	☐	☐	
Following are some questions the audit committee (or its equivalent) should ask different individuals in the government organization to assist in evaluating the performance of the independent auditors.				
Chief Audit Executive				
1. From your perspective in working with the external auditor, are you satisfied with the scope, nature, extent, and timing of the testing performed by the external auditor?	☐	☐	☐	
2. Did the external auditor work with you to ensure the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources?	☐	☐	☐	
3. *a.* Are you satisfied with the knowledge, skills, and abilities of the staff assigned to do the audit work?	☐	☐	☐	
b. Are you satisfied with the engagement leadership assigned, including the partner(s), senior leadership of the government audit organization, manager(s), and fieldwork leaders?	☐	☐	☐	
4. *a.* Did the external auditor work with the internal auditors according to the plan?	☐	☐	☐	
b. Was the cooperative work conducted in the spirit of professionalism and mutual respect?	☐	☐	☐	
5. Are you satisfied that the external auditor remains independent of the government in spite of any audit-related or nonaudit services the auditor provides to the government?	☐	☐	☐	

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
Chief Audit Executive (cont.)				
6. *a.* Are you aware of any other information that might impair the independence of the independent audit firm or government audit organization?	☐	☐	☐	
b. Are you aware of any individuals on the audit team that might not be independent with respect to the government for whatever reason?	☐	☐	☐	
7. *a.* If the choice were yours, would you hire the firm or government audit organization to conduct next year's audit?	☐	☐	☐	
b. What changes would you make?	☐	☐	☐	
CFO and Controller				
1. From your perspective in working with the external auditor, are you satisfied with the scope, nature, extent, and timing of the testing performed by the external auditor?	☐	☐	☐	
2. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work? Did the auditor appear to have sufficient knowledge of the most recent generally accepted government auditing standards as set forth by the Government Accountability Office, as well as AICPA auditing standards?	☐	☐	☐	
3. Are you satisfied with the engagement leadership assigned, including the partner(s), senior leadership of the government audit organization, manager(s), and fieldwork leaders?	☐	☐	☐	
4. *a.* If the choice were yours, would you hire the firm or government audit organization to conduct next year's audit?	☐	☐	☐	
b. What changes would you make?	☐	☐	☐	
5. If the audit was performed under contract, did the auditor comply with the requirements as set forth in the request for proposal and subsequent contract for auditor services?	☐	☐	☐	

(continued)

Evaluation of the External Auditors	Yes	No	Not Sure	Comments
External Auditor				
1. What were the results of the firm's peer review?	☐	☐	☐	
2. Does the audit organization have a quality control system for monitoring compliance with independence requirements?	☐	☐	☐	
3. Does the audit organization have a quality control system for monitoring compliance with continuing professional education requirements?	☐	☐	☐	
Other Comments, Further Questions				
1. Does your firm belong to any Audit Quality Centers?	☐	☐	☐	
2.	☐	☐	☐	
3.	☐	☐	☐	
4.	☐	☐	☐	

Single Audits—Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*

PURPOSE OF THIS TOOL: Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, was issued pursuant to the Single Audit Act of 1984 and subsequent amendments, along with the Compliance Supplement. These documents provide guidance for implementing single audit requirements for the audits of states, local governments, and nonprofit organizations that expend $500,000 or more in federal awards, including grants and other assistance, in a fiscal year. Each of these entities are required to obtain an annual *single audit*, which includes an audit of the entity's financial statements, a schedule of the expenditure of federal awards, and a review of related internal controls.

This tool is intended to aid state and local governments and other governmental entities in complying with the requirements and expectations of the Single Audit Act, as well as to assist with compliance of the provisions of the act.

The Single Audit Act requires that nonfederal entities that expend $500,000 or more in a year in federal awards have a single or program-specific audit in accordance with the provisions of the act's audit requirements. The determination of when an award is expended should be based on when the award activity occurs. Expenditures include cash transactions, loans, loan guarantees, federally restricted endowment funds, and various other types of noncash assistance, such as interest subsidies. A program-specific audit may be elected only when an auditee expends federal awards under one federal program (excluding research and development, which is considered as one major program) and the federal program's laws, regulations, or grant agreements do not require the auditee to have a financial statement audit.

Government organizations receiving grant programs, from the state and federal governments or other funding sources, are often held to a high standard of accountability and transparency. Additionally, other federal and state laws and regulations may apply to such grant programs, such as the Improper Payment Act and various state statutory and regulatory requirements

Requirements and Responsibilities

Recipients of federal awards are required to

- maintain a system of internal control over all federal programs in order to demonstrate compliance with pertinent laws and regulations.
- identify all grant programs by Catalog of Federal Domestic Assistance number and title, awarding agency, year of award, and any pass-through entities if applicable.
- ensure that audits mandated under OMB Circular A-133 are performed and filed with appropriate federal entities as required.

- follow up on any audit findings, questioned costs, or compliance issues. This involves specific responses and, when necessary, taking corrective action that will resolve current or previous findings.
- complete the official data collection and single audit submission form that is prepared in conjunction with the independent auditor. The reporting package is submitted electronically, with the data collection form electronically signed by both the auditee and the auditor. The recipient organization is legally responsible for the accuracy and timely submission of these forms even if the auditor prepares the forms.

If the organization has any subrecipients (for example, organizations that the federal awards are passed on to), there are additional monitoring procedures that must be performed.

Auditors of recipients of federal awards are required to

- plan and conduct the audit in accordance with generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS).
- determine if the organization-wide and federal awards financial statements are presented fairly in accordance with GAAS and GAGAS.
- determine if the Schedule of Expenditures of Federal Awards is presented fairly in relation to the organization's financial statements as a whole.
- perform tests that demonstrate an understanding of the recipient's internal controls in order to support a *low assessed risk* for major programs.
- determine that the recipient has complied with laws, regulations, and grant agreements through review and testing procedures.
- follow up on the status of previous audit findings.

Awarding agencies have the following responsibilities in the audit process:

- Ensure that audits are completed and filed on time
- Provide technical assistance to auditors and recipients who may have audit questions
- Issue a management decision on financial and compliance audit findings within six months after an audit report has been submitted
- Ensure that recipients follow up on audit findings and develop and implement a corrective action plan if necessary

Reporting

The auditor's report may be in the form of either combined or separate reports. The auditor's report will state that the audit was conducted in accordance with OMB Circular A-133 and include the following:

- An opinion (or disclaimer of opinion) about whether the financial statements and schedules of expenditures are fairly presented in accordance with GAAP
- Report on the status of internal controls relative to the financial statements and major programs
- Compliance report that opines on each of the direct and material compliance requirement for each major federal program

- Schedule of findings and questioned costs
- List of major programs using the required risk-based methodology
- Determination concerning federal programs about whether the recipient of the federal award is a *high risk* or *low risk*

The specific requirements and responsibilities of federal agencies and nonfederal recipients are detailed in OMB Circular A-133 and the Compliance Supplement (see the circular and the Compliance Supplement available at www.whitehouse.gov/omb/grants_circulars). Federal agencies are required to apply the provisions of Circular A-133 to all nonfederal entities that receive and expend federal awards either directly from federal awarding agencies or as subrecipients who receive federal awards from a pass-through entity. Other OMB circulars, including allowable costs and cost allocations, are at this website as well.

Monitoring the External Auditor: An Overview of the Peer Review Process for External Audit Organizations

PURPOSE OF THIS TOOL: This tool is intended to educate government audit committee members about how CPA firms and government audit organizations are monitored to ensure that they comply with professional auditing standards in the work they do. This monitoring process is known as the peer review process.

Generally accepted government auditing standards (GAGAS) require any CPA firm or government audit organization that performs audits and attestation engagements in accordance with those standards to undergo an external peer review. In fact, CPA firms and government audit organizations must undergo a peer review at least once every three years. This tool will help audit committee members understand the requirements for a peer review, how to interact with the independent auditor concerning peer review results, and why the independent auditor's peer review should be important to an audit committee member.

Peer Review of a CPA Firm and Government Audit Organization[1]

A peer review of a CPA firm or government audit organization can be used by an audit committee as a tool to assess whether the government organization's independent auditor

1. has a system of quality control that has been designed to meet the requirements of the AICPA's Statements on Quality Control Standards (SQCSs) (AICPA, *Professional Standards*) and the U.S. Government Accountability Office's (GAO's) *Government Auditing Standards* for the audit and attestation engagements it performs?
2. is complying with that system of quality control during the peer review year to provide the firm or organization with reasonable assurance of complying with professional standards?

The AICPA's standards regarding quality control provide requirements in the quality control areas of leadership responsibilities for quality within the firm or government audit organization (the "tone at the top"); relevant ethical requirements; acceptance and continuance of client relationships and specific engagements; human resources; engagement performance; and monitoring. Professional standards include generally accepted auditing standards, generally accepted accounting principles, *Government Auditing Standards*, and other standards that the auditor is citing.

A peer review team will be engaged by the external audit organization to perform the review. Each member of the peer review team is required to be independent of the external audit organization and

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[1] The term *peer review* is commonly used to describe the formal process for monitoring CPA firms and government audit organizations. The process is also known as a quality control review or quality assessment review. In addition to the AICPA, organizations such as the Association of Local Government Auditors, National State Auditors Association, and the Institute of Internal Auditors have established review programs for monitoring government audit organizations.

must be qualified to perform the review. The AICPA SQCSs and GAGAS establish the requirements for the peer review team and the conduct of the review. The peer review team will evaluate the external audit organization's internal quality control policies and procedures and select audits and attestation engagements to evaluate whether the organization followed its internal quality control policies and procedures when performing those engagements. The results of the peer review team's evaluation are submitted in a peer review report.

Peer Review Reports

There are four types of peer review reports, as follows:

1. A conclusion that the audit organization's system of quality control has been suitably designed and complied with to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects
2. A conclusion that the audit organization's system of quality control has been suitably designed and compiled with to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects with the exception of a certain deficiency or deficiencies that are described in the report
3. A conclusion, based on the significant deficiencies that are described in the report, that the audit organization's system of quality control is not suitably designed to provide that audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects or the audit organization has not compiled with its system of quality control to provide the audit organization with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects
4. A statement that due to significant limitations or other circumstances, the peer reviewers are unable to conclude about the effectiveness of the audit organization's system of quality control

External audit organizations that comply with *Government Auditing Standards* are required to make its most recent peer review report publicly available. For example, an audit organization may satisfy this requirement by posting the peer review report on a publicly available website or to a publicly available file designed for public transparency of peer review results. Also, the audit committee should be given a copy of the peer review report of the external audit organization.

For any deficiencies or significant deficiencies included in the peer review report of other written communication, the peer review team generally will include, either in the peer review report or in separate written communication, a detailed description of the findings and recommendations related to the deficiencies or significant deficiencies.

The reviewed external audit organization responds in writing to the peer review team's comments on matters in the peer review report and any separate written communication (called *the letter of response*). The response describes the actions taken or planned with respect to each matter in the report and the written communication.

We recommend that audit committees request a copy of the auditor's latest peer review report, and any separate written communication and letter of response, if the external audit organization has not already submitted them to the committee. The audit committee should discuss both the report and the letters of comment and response with the auditor. If a report includes deficiencies or significant deficiencies, the audit committee should discuss the reasons as part of its evaluation of the external auditor, and to assist in its assessment, where applicable, of whether it should engage or continue to engage the auditor.

Common Misconceptions About Peer Review

1. *Fiction:* A peer review team evaluates every engagement audited by the external audit organization.

   Fact: A peer review is performed using a risk-based approach. A peer review team must review enough engagements to obtain reasonable assurance that the reviewed firm or organization is complying with its quality control policies and procedures. Therefore, it is possible that the review would not disclose all weaknesses in the system of quality control or all instances of lack of compliance with it.

2. *Fiction:* A report that does not include deficiencies or significant deficiencies provides assurance with respect to every engagement conducted by the firm or organization.

   Fact: Every engagement conducted by a firm or organization is not included in the scope of a peer review, nor is every aspect of each engagement reviewed. The peer review includes reviewing all key areas of engagements selected.

3. *Fiction:* If a firm or organization receives written communication on its system of quality control, it is inadequate.

   Fact: The criterion for including an item in written communication is whether the item resulted in the creation of more than a remote possibility that the firm or organization would not comply with professional standards on auditing engagements. Because this is a very low threshold, many peer reviews result in inclusion of written communication on deficiencies.

Questions for the Auditor Regarding Peer Review

The audit committee should consider asking the following questions of its independent auditors to gain a better understanding of the auditor's peer review experience.

Question	Yes	No	Not Sure	Comments
1. Has the external audit organization undergone a peer review within the last three years? If not, please explain.	☐	☐	☐	
Notes:				
2. What do the findings and recommendations in the written communications mean?	☐	☐	☐	
Notes:				
3. Is the external audit organization's letter of response evidence that it is committed to making the changes necessary to improve its practice? If not, please explain.	☐	☐	☐	
Notes:				
4. If the peer review report included an exception to compliance with professional standards, explain why.	☐	☐	☐	
Notes:				
5. Did the external audit organization correct the deficiencies noted in either the peer review report, the written communications, or both? If not, please explain.	☐	☐	☐	

Question	Yes	No	Not Sure	Comments
Notes:				
6. Was our external government organization selected for review during the peer review? If so, were any negative responses noted?	☐	☐	☐	
Notes:				
7. Was the engagement partner or key government audit official (and other key engagement team members) selected for review during the peer review? If so, were any negative responses noted on audits performed by them?	☐	☐	☐	
Notes:				

Points to Consider When Engaging External Experts and Advisers

PURPOSE OF THIS TOOL: The audit committee of a government organization may, on occasion, need the services of counsel or a professional consultant in the course of carrying out its duties. This tool is intended to assist audit committees in understanding the process of engaging external experts and advisers if needed.

When selecting external experts and advisers for an engagement within the government organization, the audit committee should not only consider the education, training, and experience of the specialists and staff assistants actually performing the work, but it should determine that the service provider (1) has a reputation for reliability, integrity, and objectivity; (2) is free of conflicts of interest with respect to the members of the audit committee and the government organization; and (3) has the expertise and resources necessary to do the work it is under consideration to do, among other considerations. The selection of external experts and advisers should also follow the procurement policy and procedures applicable to the government organization.

Although the nature of every engagement will be different, the initial steps the audit committee (or its designee) should undertake when engaging external resources include the following:

1. Identify the type of work or service that needs to be done, including the scope.
2. Determine that the expert or adviser has the competence and experience to perform the requested service. Check references with other clients of the service provider.
3. Determine whether the expert or adviser has a conflict of interest with respect to the government organization and members of the audit committee. For example, such a conflict might arise if the expert or adviser has a relationship with the external auditor. Additionally, depending on the nature of the service to be offered, a conflict could arise if the expert or adviser has a relationship with a member of the governing body, elected officials, or a member of the government organization's management or labor. Be aware of other potential conflicts of interest that may distract, or undermine, the work or the objectivity and credibility of the final work product.
4. Determine if the expert or adviser has sufficient resources to perform the work in the time frame specified by the audit committee.
5. Evaluate the scope of work to be performed and other issues, including the proposed plan for payment of fees and expenses.
6. Make sure all parties (including management and the expert or adviser) understand that the audit committee is the owner of the service relationship. Make sure that management understands that the expert or adviser is working on behalf of the audit committee and the audit committee expects management to be fully cooperative and forthcoming with respect to any information that may be requested.
7. Determine the criteria that will be used to measure the expert or adviser's work and document those criteria in an agreement with the service provider.
8. Follow the applicable procurement policy and procedures in obtaining the external resources.

As with any relationship, communication and managing expectations are important.

Appendix A: Resources for Audit Committees

PURPOSE OF THIS APPENDIX: Audit committees can take advantage of the Internet and find a wealth of resources to assist them in discharging their responsibilities. This tool provides an overview of organizations and websites that contain topical resources for audit committee members to investigate.

The following is a sampling of organizations and websites that can assist audit committee members in learning more about government accountability and their roles, responsibilities, and functions.

AICPA www.aicpa.org

The AICPA is the national professional association for all CPAs. This includes CPAs working as independent auditors, accountants, or consultants in public practice, business and industry (CFOs, controllers, internal auditors, and others), government, not-for-profit organizations, and the academic community.

Additional resources from the AICPA website:

- AICPA standards information—www.aicpa.org/Publications/AuthoritativeStandards/Pages/AuthoritativeStandards.aspx
- AICPA accounting and auditing information—www.aicpa.org/InterestAreas/AccountingAndAuditing/Pages/AccountingandAuditing.aspx
- AICPA Governmental Audit Quality Center information—www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx
- AICPA peer review information—www.aicpa.org/InterestAreas/PeerReview/Pages/PeerReviewHome.aspx

The AICPA has developed this *Audit Committee Toolkit: Government Organizations* to aid audit committee members in performing their functions. See also the AICPA Audit Committee Effectiveness Center at www.aicpa.org/ACEC.

Association of Certified Fraud Examiners www.cfenet.com

The Association of Certified Fraud Examiners (ACFE) is a global professional organization dedicated to fighting fraud and white-collar crime. With chapters around the globe, the ACFE is networked to respond to the needs of antifraud professionals everywhere. The ACFE offers guidance on fraud prevention, detection, and investigation, as well as internal controls.

See also the ACFE's *2010 Report to the Nations on Occupational Fraud and Abuse* at www.acfe.com/rttn/2010-rttn.asp.

Association of Government Accountants www.agacgfm.org

The Association of Government Accountants (AGA) is an educational organization dedicated to enhancing public financial management. The AGA serves the professional interests of financial managers, from local, state, and federal governments to public accounting firms responsible for effectively using billions of dollars and other monetary resources every day. The AGA conducts independent research and analysis on all aspects of government financial management for the purpose of advocating improvement in the quality and effectiveness of government fiscal administration.

Committee of Sponsoring Organizations of the Treadway Commission www.coso.org

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private-sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. Originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, COSO has released numerous influential publications, including *Internal Control—Integrated Framework* and *Enterprise Risk Management—Integrated Framework*.

Ethics and Compliance Officer Association www.theecoa.org

The Ethics and Compliance Officers Association (ECOA) is the professional association exclusively for managers of ethics, compliance, and business conduct programs. The ECOA provides ethics officers with training and a variety of conferences and meetings for exchanging best practices in a frank, candid manner.

Ethics Resource Center www.ethics.org

The Ethics Resource Center (ERC) is a nonprofit, nonpartisan educational organization whose vision is a world in which individuals and organizations act with integrity. The ERC's mission is to strengthen ethical leadership worldwide by providing leading-edge expertise and services through research, education, and partnerships. Especially useful are the resources on business and organizational ethics.

Government Finance Officers Association www.gfoa.org

The Government Finance Officers Association (GFOA) serves the state, provincial, and local finance officers in the United States and Canada and is dedicated to the sound management of government financial resources. The GFOA administers a broad range of services and programs in the major functional areas of government financial management, including accounting, auditing, and financial reporting; budgeting and financial planning; capital finance and debt administration; cash management and investments; and financial management. Guidance, publications, and programs are available from the GFOA website.

Institute of Internal Auditors www.theiia.org

The Institute of Internal Auditors (IIA) is a dynamic international organization that meets the needs of a worldwide body of internal auditors. The IIA focuses on issues in internal auditing, governance, and internal control; IT audit; education; and security worldwide. The IIA provides internal audit practitioners, executive management, boards of directors, and audit committees with standards, guidance, best practices, training, research, and technological guidance for the profession.

The *International Professional Practices Framework* (also known as the Red Book) is the conceptual framework that organizes authoritative guidance promulgated by the IIA: www.theiia.org/guidance/standards-and-guidance/

IT Governance Institute www.itgi.org

Established by the Information Systems Audit and Control Association and Foundation in 1998, the IT Governance Institute (ITGI) exists to assist enterprise leaders in understanding and guiding the role of IT in their organizations. The ITGI helps senior executives to ensure that IT goals align with those of the business, deliver value, and perform efficiently, while IT resources are properly allocated and risks mitigated. Through original research, symposiums, and electronic resources, the ITGI helps ensure that boards and executive management have the tools and information they need to effectively manage the IT function.

National Association of College and University Business Officers www.nacubo.org

The National Association of College and University Business Officers (NACUBO) represents college and university administrative and financial officers through a collaboration of knowledge and professional development, advocacy, and community to establish excellence in higher education business and financial management. The NACUBO's website includes tools, publications, and guidance for college and university financial management, including guidance on how colleges and universities might implement relevant portions of the Sarbanes-Oxley Act as a best practice.

Association of Local Government Auditors www.governmentauditors.org

Among the primary objectives of the Association of Local Government Auditors (ALGA) is improving the quality of auditing in local government, providing a forum for the discussion of issues concerning auditing in local government, and upholding the highest standards of professional ethics. The ALGA provides information, guidance, and opportunities for local government auditors about audit standards, related training, peer reviews, and other audit issues.

National Association of State Auditors, Comptrollers and Treasurers www.nasact.org

The National Association of State Auditors, Comptrollers and Treasurers (NASACT) is an organization for state officials who work in the financial management of state government. NASACT assists state leaders to enhance and promote effective and efficient management of government resources. NASACT's website provides information regarding, among other things, efforts to improve financial management practices at all levels of government, shares expertise and ideas that promote effective financial management, and develops and promotes an exchange of industry best practices.

U.S. Government Accountability Office www.gao.gov

The U.S. Government Accountability Office (GAO) is an independent, nonpartisan agency that works for Congress. With its core values of accountability, integrity, and reliability, ultimately, the GAO works to ensure that government is accountable to the American people. The GAO issues *Government Auditing Standards* (also known as the Yellow Book), which contains standards for audits of government organizations, programs, activities, and functions. These standards, often referred to as generally accepted government auditing standards, are to be followed by public accounting firms and audit organizations that audit governments and not-for-profit organizations when required by law, regulation, agreement, contract, or policy. The GAO is scheduled to publish a revised edition of the Yellow book in September, 2011.

See also *Government Auditing Standards* (also known as the Yellow Book) at www.gao.gov/new.items/d07731g.pdf and www.gao.gov/yellowbook.

U.S. Office of Management and Budget www.whitehouse.gov/omb/index.html

The U.S. Office of Management and Budget's (OMB's) mission is to assist the president in overseeing the preparation of the federal budget; supervise its administration in executive branch agencies; and coordinate the administration's procurement, financial management, information, and regulatory policies. In each of these areas, the OMB's role is to help improve administrative management and, therefore, has an impact on all levels of government. State, local, and special-purpose governments are required to follow the OMB's financial management rules and guidance if they receive federal program monies either directly or indirectly. The OMB website includes information about these rules and guidance for those charged with responsibility for a government's compliance with financial management laws and regulations.

Appendix B: Glossary of Acronyms

ACFE	Association of Certified Fraud Examiners
AICPA	American Institute of Certified Public Accountants
CAE	Chief audit executive (leader of internal audit team)
CAFR	Comprehensive Annual Financial Report
CAQ	The Center for Audit Quality
CEO	Chief executive officer
CFO	Chief financial officer
CIO	Chief information officer
COSO	Committee of Sponsoring Organizations of the Treadway Commission
ERM	Enterprise risk management
GAAP	Generally accepted accounting principles
GAAS	Generally accepted auditing standards
GAGAS	Generally accepted government auditing standards (also known as Yellow Book)
GAO	U.S. Government Accountability Office
GAQC	Governmental Audit Quality Center
GASB	Governmental Accounting Standards Board
GFOA	Government Finance Officers Association
IA	Internal audit
IBNR	Incurred, but not reported
IC	Internal control
IIA	Institute of Internal Auditors
IPPF	*International Professional Practices Framework* (also known as Red Book)
IRS	Internal Revenue Service
IT	Information technology
MD&A	Management's Discussion & Analysis
OCBOA	Other comprehensive basis of accounting
OMB	U.S. Office of Management and Budget
PCAOB	Public Company Accounting Oversight Board
RFP	Request for proposal
SAS	AICPA's Statement on Auditing Standards
SEC	U.S. Securities and Exchange Commission
SQCS	AICPA's Statement on Quality Control Standards
TPA	Third-party administrator