2015

AICPA audit committee toolkit : government organizations

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 expertise required of financial experts, as the ideal audit committee member. With the goal of improving corporate governance, the center will provide guidance to corporate management and boards of directors regarding best practices in appointing and managing the audit committee function.

The center is divided into four main sections: Audit Committee Toolkit, Audit Committee Matching System, Guidance and Resources, and Spotlight Area.

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, along with a **Spotlight Area** for current topics of interest, are available to you at the Audit Committee Effectiveness Center website: **aicpa.org/audcommctr**.

The AICPA Audit Committee Toolkit, Government Organizations, Third Edition, is accompanied by a download containing the complete toolkit in Microsoft Word so that you can customize the tools to fit your audit committee's needs.

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THE AICPA **AUDIT COMMITTEE TOOLKIT** Government Organizations, 3rd Edition

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NOTICE TO READERS

The AICPA Audit Committee Toolkit material is designed to provide illustrative information with respect to the subject matter covered. It does not establish standards or required practices. The AICPA Audit Committee Toolkit 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 authors, publishers, and sponsors are not engaged in rendering legal, accounting, or other professional service. If you require legal advice or other expert assistance, you should seek the services of a competent professional. The authors, publisher, and sponsors make no representations, warranties, or guarantees as to, and assume no responsibility for the content or application of the material 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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We are pleased to recognize the efforts of the following leaders on the task force:

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Walter Kelly, CPA, CGFM, CFE-retired	Co-Chair

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Preface

Since it was launched in late 2003, the AICPA Audit Committee Effectiveness Center[1] has earned a reputation as a respected source for audit tools, forms, and information by both AICPA membership and the business public. The center's two main features—The Audit Committee Toolkit series and the Audit Committee Matching System—are part of the AICPA's continuing efforts to support public interest in audit-related issues.

This 3rd edition of the *Audit Committee Toolkit: Government Entities* focuses solely on government entities and is designed for use by the following groups:

- All government entities, regardless of size
- Board and audit committee members of government entities
- CEO, CFO, chief audit executives, and other key staff positions of government entities
- External and internal auditors

This edition features updates and revisions that reflect significant changes and updates to the COSO framework and regulations and standards that have occurred since the last edition. This toolkit has been organized into the following subgroups:

- Audit Committee Administration
- Audit Committee Key Responsibilities
- Audit Committee Performance Evaluations
- Audit Committee Other Tools (risk management and resources)

This edition of the *Audit Committee Toolkit: Government Entities* is accompanied by a download of Microsoft Word files of all the tools so you can modify and customize them to fit your audit committee's needs. Visit www.cpa2biz.com/governmenttoolkit to access the files.

The Audit Committee Matching System (ACMS) offers a way to find CPAs who are willing to serve on corporate boards and audit committees. This free service is available to any organization that needs the CPA skillset in those roles. We encourage AICPA members to register on ACMS, and anyone can visit the online center to search the database using defined criteria. The AICPA offers no screening of candidates or companies—each party must perform its own due diligence on the other party.

The AICPA is grateful to CNA for its continued sponsorship of the Audit Committee Effectiveness Center. It is through their support that we are able to publish this book.

If you have questions on how to use the tools contained in this book, suggestions for new or additional tools, or other feedback, please write to us at acms@aicpa.org.

[1] You can visit the center online at www.aicpa.org/FORTHEPUBLIC/AUDITCOMMITTEEEFFECTIVENESS/Pages/ACEC.aspx.

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PART I: Audit Committee Administration

Chapter 1

Audit Committee Member Roles and Responsibilities

Overview: Audit committee roles and responsibilities depend on the governing body and management structure of a government entity and, as presented here, are not intended to be tailored to all types of government structures. As such, the content presented in this chapter is a best practice for government entities.

This tool uses the term *governing body* to describe those in government entities that have the ultimate authority and responsibility for accountability of that government's public resources. At the federal, state, and local levels of government, the governing body 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 tool also refers generically to chief executive officers, chief financial officers, and chief audit executives for positions in government entities that are responsible for management, financial and accounting, and internal audit matters.

Government entities are faced with ongoing challenges related to the governance of their organization, risks associated with achieving their organization's objectives, and compliance with revised and emerging laws and regulations. Responsibilities are ultimately identified by the governing body and assigned to various governing committees, including the audit committee. Delegation of responsibilities and roles of the audit committee varies from entity to entity and continues to evolve. Beyond their responsibility for ensuring reasonably accurate and transparent information to legislatures and other interested parties, audit committee members are being asked to address increasing challenges.

Audit committees generally consist of a minimum of three independent members, at least one of whom is a "financial expert.[1] Other key qualifications may include risk management expertise, and broad government, business, or leadership experience. Audit committee responsibilities vary from organization to organization.

The following information provides areas to consider as an audit committee's responsibilities are defined, assigned, and implemented. In addition to the items discussed, your government entity should consult concurrently with your identified experts, such as legal, accounting, auditing, risk management, or compliance.

[1] A financial expert is an individual who possesses, among other attributes: (*a*) an understanding of generally accepted accounting principles (in this case, the accounting standards issued by the Governmental Accounting Board (GASB) or the Federal Accounting Standards Advisory Board (FASAB)) and financial statements; (*b*) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves; (*c*) experience preparing, auditing, analyzing, or evaluating fi-nancial statements that present a breadth, depth, and level of complexity of accounting issues that can reasonably be expected to be raised by the government entity's financial statements, or experience actively supervising one or more persons engaged in such activi-ties; (*d*) an understanding of internal control and the procedures for financial reporting; and (*e*) an understanding of audit committee functions.

The audit committee assists the governing body in its oversight of

- integrity of the organization's financial statements;
- internal control including internal control over financial reporting;
- independent auditor's qualifications, independence, and performance;
- internal audit function's qualifications, independence, and performance;
- the organization's risk management and overall governance process; and
- the organization's ethics and compliance program, which includes legal and regulatory requirements.

Specific responsibilities assigned to an audit committee are set forth in an audit committee charter (see chapter 2, "Audit Committee Charter Matrix," in this toolkit for more information) that is approved by the governing body. An audit committee charter should address the audit committee process, procedures, and responsibilities. Audit committee responsibilities can vary by government entity due to factors such as the size of the entity, the type of entity, and the complexity of the government entity's service or business model.

The following illustrative lists, which are not intended to be complete, address the overall audit committee process, procedures, and oversight responsibilities, as well as best practices for audit committee members.

Audit Committee Process and Procedures

- Develop an audit committee charter and obtain approval from the governing body.
- Conduct an annual review of the audit committee charter.
- Set an agenda for the audit committee meetings based on the audit committee charter and other relevant issues.
- Ensure meeting minutes are prepared and approved by the audit committee.
- Provide audit committee reporting responsibilities to the governing body.
- Educate the other governing body members on the understanding of financial statements, financial statements risks, and internal control over financial reporting.
- Prepare an annual audit committee report.
- Conduct an annual self-assessment of effectiveness and efficiency of the audit committee.
- Conduct regularly scheduled and documented meetings with the independent external auditor,[2] chief audit executive (leader of the internal audit function), as well as the general counsel, head of the governing body, senior management (for example, the CEO and CFO), and others as needed. These meetings are generally conducted in an executive session at the conclusion of each regularly scheduled meeting.
- Consider the development of an annual calendar based on the audit committee charter.

[2] The independent auditor may be mandated by law or regulation to perform audits for external reporting purposes. In turn, an Office of Inspector General (OIG) or similar government entity may contract an independent public accountant to perform the audit.

Oversight of the Financial Reporting Process

- Review critical accounting policies, practices, judgments, estimates, significant issues, significant transactions, adjustments, unusual items, complex issues, and business arrangements.
- Review annual and interim financial statements including management's discussion and analysis and budgetary comparisons for structural compatibility and period to period consistency.
- Review annual audited financial statements including any federal Office of Management and Budget (OMB) reports.[3]
- Obtain explanations from management on all significant variances.
- Question management and the independent auditor about significant financial reporting issues.
- Review comparative data from other comparative government entities to perform reasonableness tests of the entity's results.
- Facilitate the resolution of disagreements between management and the independent auditor regarding financial reporting issues.
- Determine when a subject matter expert is required and hire advisers when needed. (See chapter 7, "Engaging Independent Counsel and Other Advisers," in this toolkit for more information.)
- Review management letters containing the independent auditor's recommendations and management's responses to those recommendations.
- Determine that adequate procedures are in place for reviewing the government entity's disclosure of financial information extracted or derived from its financial statements and assess periodically the adequacy of these procedures.
- Understand complex accounting and reporting topics and how management addresses them.
- Understand significant judgments and estimates used by management and their effect on the financial statements, such as fair-value accounting and related assumptions.
- Review new accounting and reporting requirements, and assess how pending financial reporting and regulatory developments may affect the organization.
- Discuss succession planning for the CFO and other key staff.

Oversight of Financial Reporting

- Oversee the adequacy of the entity's system of internal controls.
- Determine if the entity has adopted an internal control framework, such as the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal*

[3] An example of an OMB report includes financial statements required by Title 2 of the Code of Regulation Section C: Subpart F, *Audit Requirements* (*Circulars A-133 and A-50*) published December 26, 2013 [Previously, these financial statements were required by OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations*].

Control—Integrated Framework (released May 14, 2013) and the Government Accountability Office (GAO) *Standards for Internal Control in the Federal Government* (revised September 10, 2014) or "Green Book,"[4] in the establishment of their system of internal control.

- Review the development and the implementation of a sub-certification process over internal control and compliance with related laws, regulations, or other requirements.

Oversight of the Independent Auditor

- Review the audit plan and the scope of audit to be conducted by the independent auditor.
- Provide pre-approval of all audits, permitted non-audit services, and proposed fees.
- Appoint or replace the independent auditor, including the periodic rotation of the audit partner.[5]
- Conduct evaluations of the independent auditor. Meet periodically with legal, IT, actuarial, and other specialists.

Oversight of the Internal Audit Function

- Approve the internal audit department charter.
- Ensure that the internal audit department follows the Institute of Internal Auditors International Standards for the Professional Practice of Internal Auditing, and maintains an effective quality assessment and improvement program.
- Concur in the appointment of the chief audit executive (CAE).[6]
- Review the internal audit department's planning and risk assessment process.
- Review and approve the internal audit department's annual (or periodic) audit plan and scope of audits to be conducted.
- Conduct evaluations of the CAE.
- Ensure that the CAE reports functionally to the audit committee and administratively to senior management such as the head of the governing body.
- Discuss succession planning for the CAE and other key staff.

Oversight of Risk Management

- Oversee the system of risk assessment and risk management as determined by the governing body. The audit committee should be focused primarily on financial risk. Compliance or regulatory risks as well as single audit and any other engagements performed by the external auditor may also be reviewed by the audit committee.

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[4] The use of the COSO Framework is not a requirement in federal, state, or local government; though, using it is a best practice. The use of the GAO's Green Book, however, is a requirement for the federal government. Although not required in state and local government, using the Green Book is a best practice because it is specifically tailored to a government environment.

[5] This may not apply if the independent auditor is mandated by law or regulation to perform audits for external purposes and may be overseen by an OIG or similar entity.

[6] This may not apply if the CAE is an elected official.

- Oversee and respond to enterprise risk management activities.
- Periodically reassess the list of top enterprise risks, determining who in the senior leadership team is responsible for each risk.

Oversight of Ethics and Compliance

- Oversee the system for compliance with legal and regulatory requirements (for example, OMB circulars, budgeting, HHS regulations, and the like).
- Ensure that management exhibits ethical behavior and reported violations receive action.
- Ensure that a code of conduct has been developed, reviewed, and updated as needed, and that all employees are given the code of conduct, understand it, and receive training on a regular basis.
- Ensure that a chief ethics and compliance officer or equivalent has been appointed and has sufficient personnel and resources commensurate with the entity's needs.
- Review the government entity's procedures for reporting problems, including whistleblower hotline and other communication methods.
- Establish a process for audit committee special investigations, including but not limited to whistleblower allegation, anti-fraud plan compliance, discovery of error, and illegal acts.
- Ensure that the chief ethics and compliance officer or equivalent has direct access to the governing body or one of its committees (or similar bodies).

Limitation of Audit Committee's Role

While the audit committee's responsibilities are set forth in its charter, it is not responsible for planning or conducting audits. The independent auditor is responsible for planning and conducting audits. Neither is the audit committee responsible for (1) preparing and fairly presenting the government entity's financial statements in accordance with generally accepted accounting principles, (2) maintaining effective internal control over financial reporting, and (3) ensuring the government entity is in compliance with applicable laws, regulations, and other requirements. These responsibilities are management's, and the independent auditor and the audit committee have independent and complementary oversight responsibilities for determining that the related objectives of management's responsibilities, as described, are achieved.

Chapter 2

Audit Committee Charter Matrix

Overview: Preparing an audit committee charter is a best practice for government entities because it creates a clear awareness of the committee's key responsibilities. However, the charter is often prepared and forgotten except for its annual review. This matrix 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. Users of the tool should put their own charters 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. The audit committee charter presented in the first column of the following matrix is just an example of a best practice charter. It includes the requirements of the Sarbanes-Oxley Act of 2002 (the Act) and stock exchange requirements, which are not government requirements, but may want to be considered as a best practice.

Purpose

An entity's governing body appoints the audit committee to, among other things,

a. oversee the accounting and financial reporting process and the audit of the entity's financial statements by an independent auditor, and

b. monitor compliance with the conflict of interest policy and the whistleblower policy adopted by the governing body. Each member shall be free of any relationship that, in the opinion of the governing body, would interfere with his or her individual exercise of independent judgment.

Reporting

The audit committee reports directly to the governing body.

Committee Membership

The audit committee shall consist of no fewer than three members, each of whom should be independent, as hereafter defined. One member shall be designated as a financial expert.[1] The members of the audit committee shall be appointed annually by the governing body. Audit committee members may be replaced by the governing body at any time. The governing body shall designate the chairperson of the audit committee.

1 A financial expert is a person who has the following attributes: (*a*) an understanding of generally accepted accounting principles and financial statements; (*b*) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (*c*) experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; (*d*) an understanding of internal controls and procedures for financial reporting; and (*e*) an understanding of audit committee functions.

Committee Authority and Responsibilities

The audit committee shall meet as often as it determines necessary or appropriate to fulfill its responsibilities, but no fewer than twice annually—once to review the audit plan and once to review the audited financials, and related documents, and to review the audit engagement, special investigations, financial irregularities and internal control failures. The chairperson shall preside at each meeting and, in the absence of the chairperson, one of the other members of the audit committee shall be designated as the acting chair of the meeting. The chairperson (or acting chair) may direct appropriate members of management and staff to prepare draft agendas and related background information for each audit committee meeting. To the extent practical, any background materials, together with the agenda for the meeting, should be distributed to the audit committee members in advance of the meeting. All meetings of the audit committee shall be held pursuant to the laws or rules of the government entity with regard to notice and waiver thereof, and written minutes of each meeting, in the form approved by the audit committee, shall be duly filed in the entity's records. The audit committee shall make regular reports to the governing body. The audit committee may form and delegate authority to subcommittees consisting of one or more members when appropriate.

In performing its functions, the audit committee shall undertake those tasks and responsibilities that, in its judgment, would contribute most effectively to and implement the purposes of the audit committee. In addition to the general tasks and responsibilities noted above, the following are the specific functions of the audit committee:

- The audit committee shall annually retain or renew the appointment of an independent auditor to conduct the audit, and, upon completion, must review the results of the audit and any related management letter.
- Review with the independent auditor the scope and planning of the audit prior to its commencement.
- Upon completion of the audit, review and discuss the following with the independent auditor:
  —Any material risks and weaknesses in internal controls identified by the independent auditor
  —Any restrictions placed on the independent auditor's scope of the activities or access to requested information
  —The adequacy of the entity's interim and annual accounting and financial reporting process
  —Any recommendations made
- Assess the performance and independence of the independent auditor on an annual basis.
- Solicit observations on staff skills, qualifications and performance related to audited functions.
- Report to the governing body on the committee's activities, and recommend the results of audit findings for approval.
- Oversee corrective actions implemented to address issues identified in the required communication and management letter.

Additional Responsibilities

- Review audit plans for the upcoming year and discuss with external audit firm and internal audit.
- Monitor compliance with the conflict of interest policy and the whistleblower policy adopted by the entire governing body, as such policies may be modified from time to time and which reflect any changes made in state law from time to time. Act as external point of contact for any whistleblowing issues, and if necessary, initiate special investigations of policies, procedures and practices.
- Conduct executive sessions at least annually with the individual conducting the internal audit function (generally the CAE) and management.
- Review presentation of financial information in the annual report for consistency with the audited financial statements before the annual report is printed.
- Review with management and internal audit the internal control process, and risk management and mitigation process.
- Periodically review audit-related policies.

Definitions

Affiliate. An affiliate of the government entity is a person or entity that is directly or indirectly through one or more intermediaries, controlled by, in control of, or under common control of the government entity.

Financial Interest. A person has a financial interest if such person would receive, directly or indirectly, an economic benefit from any transaction, agreement, compensation agreement involving the entity including:

- Having an ownership or investment interest in any entity with which the government entity has a transaction or arrangement.
- Having a compensation arrangement with the entity or with any organization or individual with which the entity has a transaction or arrangement, including direct and indirect remuneration as well as gifts or favors that are substantial in nature (inexpensive gifts or services that have a retail value of no more than $10 individually, and no more than $50 in the aggregate annually are not considered "substantial") or a potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the entity is negotiating a transaction or arrangement.
- Accepting payments, loans, services or gifts from anyone doing or seeking to do business with the entity.
- Is an officer or director of any organization doing or seeking to do business with the entity.

Independent Governing Body Member. A member of the governing body that is not, and has not within the last three years been, (*a*) an employee of the entity or any affiliate, and does not have a relative who is or has been within the last three years a key employee of the entity or any affiliate; (*b*) an individual who has received or has a relative who received (more than $10,000 in direct compensation from the entity or any affiliate within any of the last three fiscal years (other than reimbursement of reasonable expenses or reasonable compensation for serving as a director); or (*c*) an employee of, or an individual who has a substantial financial interest in, any entity that has made payments to or received payments from the entity or an affiliate for property or services (which, in any of the last three fiscal years, exceeds the lesser of $25,000 or 2 percent of such entity's consolidated gross revenues) and does not have a relative who is an officer of or has a substantial financial interest in any such entity.

Key Employee. Any person who is, or has within the last five years been, in a position to exercise substantial influence over the affairs of the entity including, without limitation, any employee with responsibilities similar to those of any person designated as president, chief executive officer, chief operating officer, treasurer, or chief financial officer.

Government Audit Committee Charter Matrix for the Year Ending: ___________

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
1. Each member of the audit committee shall be appointed by the governing body and shall be independent in order to serve on this committee. (Note that this is a best practice and not a requirement for governments.)	Test for independence. Although a best practice, the independence requirement does not apply to governments.	Indicate in the audit committee minutes whenever a new member is appointed; acknowledge that independence has been verified.	Affirm annually and whenever a change in status by any audit committee member occurs.	
2. At least one member of the audit committee shall be designated as a *financial expert*. (See chapter 3, "Audit Committee Financial Expert Considerations and Decision Tree," in this toolkit.)	Ascertain that at least one member of the audit committee meets the requirements of a financial expert. Although a best practice, the independence requirement does not apply to governments.	Indicate in audit committee meeting minutes which member of the audit committee is designated as the financial expert.	Affirm annually, unless there is a change in status.	
3. Review the audit 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 or regulations.	Review the charter each year. Assess the appropriateness of each point in the charter in light of the previous years' experience. Assess the completeness of the charter in light of new best practices and new legal or regulatory requirements.	Report to the governing body on the appropriateness of the audit committee charter and any revisions recommended.	Review annually, unless changes are needed during the course of the year.	

(continued)

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
4. The audit committee shall meet as deemed appropriate, but at least twice per year, as well as each time the government entity proposes to issue a press release with its quarterly or annual earnings information. These meetings may be combined with regularly scheduled meetings, or more frequently as circumstances may require. The audit committee may ask members of management or others to attend the meetings and provide pertinent information as necessary.	In-person meetings should be held at least once each quarter. All members are expected to attend each meeting in person, or via telephone conference or videoconference. 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.	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 prior to the next meeting.	
5. Conduct executive sessions with the independent auditors, government entity head, chief audit executive (CAE), general counsel, chief information officer (CIO) and anyone else as desired by the committee.	Establish these sessions in conjunction with quarterly meetings or as necessary. (See chapter 12, "Guidelines and Questions for Conducting an Audit Committee Executive Session," in this toolkit.)	Develop action steps to be taken if appropriate.	Review quarterly and as necessary.	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
6. The audit committee shall be authorized to hire outside counsel or other consultants as necessary. This may take place any time during the year. (See chapter 7, "Engaging Independent Counsel and Other Advisers," in this toolkit.)	Requests for proposals (RFPs) should be used, if time permits.	Report submitted by outside counsel or consultant.	Review as needed.	
7. Review and concur in the appointment, replacement, reassignment, or dismissal of the CAE. (See chapter 6, "Guidelines for Hiring the Chief Audit Executive (CAE)," in this toolkit.)	Meet in executive session at each meeting with the CAE to allow assessment and feedback. Hold special meetings as may be necessary to address appointment, reassignment, or dismissal of CAE. The audit 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 independent auditors to discuss the performance of the 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.	

(continued)

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
8. Appoint the independent auditors to be engaged by the government entity, establish the audit fees of the independent auditors, and pre-approve any non-audit services provided by the independent auditors before the services are rendered. Review and evaluate the performance of the independent auditors and review with the full governing body any proposed discharge of the independent auditors. (See the tools and guidance in chapter 4, "Sample Request for Proposal Letter for Independent Auditor Services and Qualifications (Government Entity)," in this toolkit.)	At least once each year, discuss each of these items with management, the CAE, and the governing body. Review total audit fee in relation to any non-audit services being provided by the independent auditor. Discuss the audit committee's review of the independent auditors with the governing body. Ascertain that the independent auditors do not perform any non-audit service that is prohibited by generally accepted auditing standards or Generally Accepted Government Auditing Standards (the "Yellow Book"). Consider establishing pre-defined acceptable services the independent auditor may engage in based upon regulations.	Report on and recommend the performance and fees paid to the independent auditors. Review the scope of *all* services provided by the independent audit firm throughout the entity.	Review soon after year-end, so that the recommendation for the appointment of the independent auditor can be met for the following year.	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
9. Ascertain that the lead (or concurring) independent audit partner does not serve in that capacity for more than five of the government entity's fiscal years (best practice). In addition, ascertain that any partner other than the lead or concurring partner does not serve more than seven years at the partner level on the government entity's audit committee.	Establish when the five-year limit will be reached for the current lead independent audit partner. At least a year prior to that time, discuss transition plans for the new lead independent audit partner. Although a best practice, the partner rotation requirements do not apply to government entities.	Document these discussions in audit committee meeting minutes.	Review annually with the independent auditors.	
10. Review with management the policies and procedures with respect to officers' expense accounts and perquisites, including their use of government assets, and consider the results of any review of these areas by the internal auditor or the independent auditors.	Review policies and procedures annually. Discuss with the CAE the need for testing by either the internal auditors, independent auditors, or other parties.	Report issues, if any, to the governing body.	Review policies and procedures at a regularly scheduled meeting, and discuss audit plan. Review any significant findings as they arise.	

(continued)

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
11. Consider with management the rationale for employing audit firms and other outside specialists other than the principal independent auditors.	Establish a policy for the audit committee to pre-approve engaging auditors other than the principal independent auditors. Use RFPs for engaging auditors or other professionals for non-audit or other services that the independent auditor cannot perform. Review compliance with the policy by management. (See chapter 4, "Sample Request for Proposal Letter for Independent Auditor Services and Qualifications (Government Entity)," in this toolkit.)	Document auditor selection criteria. Also, use a decision matrix to evaluate and document the third party selection. Prepare an engagement letter for each engagement.	Continually review the policy and the government entity's compliance with it. Other auditors may need to be hired at any point during the year.	
12. Make inquiries to management, the CAE, and the independent auditors about significant risks or exposures facing the government entity; assess the steps management has taken or proposes to take to minimize such risks to the entity; and periodically review compliance with such steps.	Create a portfolio that documents the material risks that the entity faces in developing an enterprise risk management strategy. Update as events occur. Review with management and the CAE quarterly or sooner if necessary, to make sure it is up to date.	Submit a risk report including mitigation strategies, quantifiable risks, and insurance to cover risks such as property loss or fraud.	Review at least once each year, and more frequently if necessary.	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
(See the tools and guidance included in chapter 8, "Internal Control: Guidelines and Tool for the Audit Committee," chapter 9, "Fraud and the Responsibilities of the Audit Committee: An Overview," and chapter 19, "Enterprise Risk Management: A Tool for Strategic Oversight," in this toolkit.)				
13. Review the audit scope and plan of the internal auditors and the independent auditors with the independent auditor, the controller of the government entity, and the CAE. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.	Meet with the independent audit partner, the controller, and CAE to discuss the scope of the previous year's audit and lessons learned. Later, discuss planned scope for audit of current year.	Document the meeting in the audit committee meeting minutes.	At the second quarter meeting each year, review the scope of the previous year's audit, and the inter-relationship between the internal and independent auditors with respect to the scope of the independent auditors' work.	

(continued)

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
			No later than the third quarter meeting each year, review the plans for the audit of the current year.	
14. Review with management and the CAE • significant findings on internal audits during the year, and management's responses thereto. • any difficulties the internal audit team encountered in the course of their audits, including any restrictions on the scope of their work or access to required information. • any changes required in the scope of their internal audit. • the internal auditing department budget and staffing.	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 CAE. Discuss internal audit's compliance with the Institute of Internal Auditors' (IIA) standards, including the requirement for a peer review once every five years.			

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
• the internal auditing department charter. • internal auditing's compliance with IIA's Standards for the Professional Practice of Internal Auditing (standards).				
15. Inquire of the government entity head, CFO, independent auditor, CIO, general counsel, and anyone else desired by the audit committee, regarding the *financial condition* of the government entity from a subjective as well as an objective standpoint.	Discuss *financial condition* with the government entity head, CFO, CIO, independent auditor, general counsel, and other executives. Identify any issues addressed, and their resolution.	Include in agenda for executive sessions. (See chapter 12, "Guidelines and Questions for Conducting an Audit Committee Executive Session," in this toolkit.)	Review, as necessary, but at least annually.	
16. Review with the independent accountants and the CAE • the adequacy of the government entity's internal controls including computerized information system controls and security.	Review key internal controls with the CAE, and understand how these controls will be tested during the year.	Report to the governing body on issues relating to internal controls, with emphasis on management's ability to override and related monitoring and testing.	Submit a comprehensive report to the governing body at the second quarter meeting each year.	

(continued)

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
• any related significant findings and recommendations of the independent auditors and internal audit services together with management's responses thereto. (See the tools and guidance included in chapter 8, "Internal Control: Guidelines and Tool for the Audit Committee," chapter 9, "Fraud and the Responsibilities of the Audit Committee: An Overview," and chapter 14, "Responding to the Identification of a Material Weakness in Internal Control: A Checklist for the Audit Committee," in this toolkit.)	Review these plans with the independent 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.		Update on anything new, or any changes to the internal control system, at every meeting.	
17. Review with management and the independent auditor the effect of any new regulatory and accounting initiatives.	Independently, through professional reading and CPE, keep up to date on new developments related to the industry, and the environment in which the government entity operates, including any regulatory or statutory requirements to which it may be subject.	Record discussion and any action steps in audit committee meeting minutes.	Review as necessary.	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
	Discuss with management and the independent auditors in meetings.			
18. Review with each public accounting firm that performs an audit • all critical accounting policies and practices used by the government entity. • all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management of the government entity, the ramifications of each alternative, and the treatment preferred by the organization. (See the tool in chapter 11, "Issues Report from Management," in this toolkit.)	Discuss each matter and related matters that may come to the attention of the audit committee or the independent auditors through this process. Create an action plan and follow-up plan as necessary.	Submit reports and documentation of discussions and resolution of disagreements.	Review, at least annually, and in conjunction with the year-end audit.	

(continued)

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
19. Review all material written communications between the independent auditors and management, such as any management letter or schedule of unadjusted differences.	Discuss each item with the independent 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 independent audit.	
20. Review with management and the independent auditors • the government entity's annual financial statements and related footnotes. • the independent auditors' audit of the financial statements and their report thereon. • the independent auditors' judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting.	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 independent 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. (See the tool in chapter 13, "Independent Auditor Communications with Audit Committee," in this toolkit.)	Submit reports and documentation of discussions, resolution of disagreements, or action plan for any item requiring follow up.	Review at the completion of the independent audit.	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
• any significant changes required in the independent auditors' audit plan. • any serious difficulties or disputes with management encountered during the audit. • matters required to be discussed by AU-C section 260, *The Auditor's Communication With Those Charged with Governance* (AICPA, *Professional Standards*), as amended, related to the conduct of the audit.				
21. Review with the general counsel and the CAE legal and regulatory matters that, in the opinion of management, may have a material impact on the financial statements, related government entity compliance policies, and programs and reports received from regulators.	Discuss whether the government entity is in compliance with 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 each meeting.	

(continued)

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
22. Periodically review the government entity's code of conduct to ensure that it is adequate and up to date. Review with the CAE and the government entity's general counsel the results of their review of the monitoring of compliance with the entity's code of conduct.	Review results with the CAE and general counsel. Consider any adjustments that may be necessary to the government entity's code of conduct. 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 was done. Recommend changes to the code of conduct to the governing body as needed.	Review annually at the fourth-quarter meeting. Review any significant findings as they arise.	
23. Review the policy and procedures for the receipt, retention, and treatment of complaints received by the government entity regarding illegal or unethical behavior, violations of law, regulation, rule or policy of the entity, accounting, internal accounting controls, or auditing matters that may be submitted by any party internal or external to the entity. Review any such complaints that might have been received, current status, and resolution, if one has been reached.	Review procedures with the CAE or other assigned appropriate person 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 timely. (See also the tool in chapter 10, "Whistleblower Policy: Complaint Reporting, Anti-retaliation Procedures, and Tracking Report," in this toolkit.)	Review an original of each complaint received, no matter the media used to submit. Discuss the status or resolution of each complaint. Review a cumulative list of complaints submitted to date to review for patterns or other observations.	Review at each meeting.	

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
24. The audit committee will perform other functions as assigned by law, the government entity's charter or bylaws, or the governing body.	Monitor developments in the regulatory, legislative, and legal environments, and respond to any new requirements as needed.		Review new business at all meetings.	
25. The audit committee will evaluate the independent auditors and internal auditors.	Use information from executive sessions conducted throughout the year. Use a formal assessment tool for each group. (See the tools and guidance in chapter 15, "Evaluating the Internal Audit Function: Questions to Consider," and chapter 16, "Evaluating the Independent Auditor: Questions to Consider" in this toolkit.)	Submit recommendations for changes in process and procedures. For independent auditors, request RFPs, if changes are being considered.	Review after completion of the annual audit.	
26. The audit committee will review its effectiveness.	The audit committee will conduct a self-assessment and 360-degree evaluation of all members. (See the tools and guidance in chapter 17, "Conducting an Audit Committee Self-Evaluation: Questions to Consider," in this toolkit.)	Discuss recommendations for improving the effectiveness of the audit committee with the governing body. Record in the governing body's meeting minutes.	Review annually.	

(continued)

Audit Committee Charter	Steps to Accomplish the Objective	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
27. Create an audit committee calendar for the ensuing year or review and approve the agenda submitted by the CAE.	Complete the "Audit Committee Charter Matrix." (Use this tool as a sample and tailor it to your organization.)		Review at the final meeting before the upcoming year.	

Chapter 3

Audit Committee Financial Expert Decision Tree

Overview: Although there is no explicit requirement for a government audit committee to include a member having some level of financial expertise, it is considered a best practice. In addition, it should be the goal of the government entity's audit committee that all its members have some level of experience in financial matters and an understanding of the entity's mission, programs, and the sector in which it operates. Following are guidelines for evaluating audit committee members and a decision tree that illustrates how the audit committee might evaluate a candidate for consideration as a financial expert. These are recommended in providing best governance practice in this area.

Audit Committee Financial Expertise

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

- An understanding of generally accepted accounting principles, generally accepted auditing standards, and financial statements
- The ability to assess the general application of such principles and standards in connection with the accounting for estimates, accruals, 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 government entity's financial statements or experience actively supervising (that is, direct involvement with) one or more people engaged in such activities
- An understanding of internal controls and procedures for financial reporting
- An understanding of audit committee functions (roles and responsibilities)
- A general understanding of the financial issues and specific knowledge of the government sector (for example, federal, state, or local government)
- A general knowledge of any current relative concerns or regulatory issues surrounding the government entity's specific sector
- An understanding of the past three to five years of the government entity's financial history

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

- Do laws or regulations governing the government entity include certain requirements of audit committees regarding independence, oversight (that is, the criteria for the government entity's audit), governance, committee activities, or other criteria?
- Have one or more individuals completed a program of learning 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?
- Do one or more individuals have experience with government accounting standards?
- 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 or people performing one or more of these functions?
- Do one or more individuals have experience overseeing or assessing the performance of companies, or public accountants with respect to the preparation, auditing, or evaluation of financial statements?
- Do one or more individuals have other relevant financial experience (for example, service on boards of not-for-profits, health care entities, higher education institutions, and the like)?
- Do one or more individuals have experience serving on audit committees of other government entities?

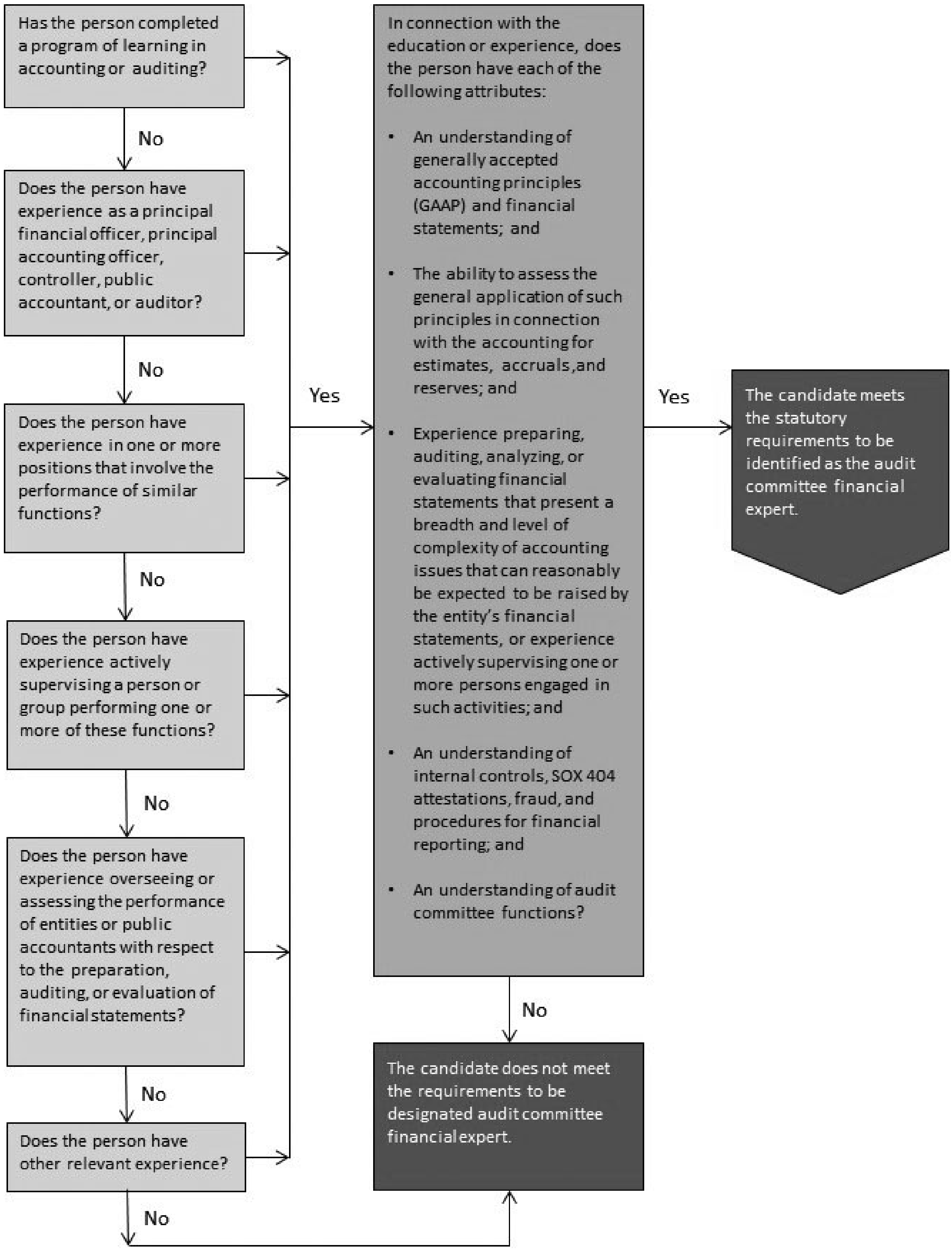
Alternative Approaches

Based on the public awareness and environment surrounding the government sector, best practice should include that some (at a minimum), if not all, members of an entity's audit committee possess an adequate level of government financial knowledge and expertise. This may need to be accomplished by recruiting new independent board members.

However, 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, some options might be considered:

- Engage a financial professional to provide financial expertise as a consultant to the audit committee. Such an individual must otherwise be independent with respect to the entity (that is, must have no other financial arrangements with the government entity).
- Pursue a training program for audit committee members to develop the financial expertise. Such training can include participation in professional development classes or programs offered by the AICPA, associations, or the specific sector in which the government entity participates, or in-house training programs led by members of the government entity's financial management team.
- Potential volunteers with financial expertise often have limited time to commit to an entity. They might, for example, have time to attend one or two meetings per year, but not monthly board meetings. Therefore, it may be beneficial, if bylaws allow it, to open up membership of the audit committee to persons who are not also members of the board of directors or trustees. This can be particularly helpful for smaller government entities.
- Establish a relationship with a peer or otherwise comparable government entity to have the CFO for one entity provide financial expertise to the other. Such arrangements can be reciprocal or involve multiple entities.

Audit Committee Financial Expert



Chapter 4

Sample Request for Proposal Letter for Independent Auditor[1] Services and Qualifications (Government Entity)

Overview: This tool contains sample language that may be used by a government entity's management team to request proposal letters from qualified independent auditors when seeking a new service provider. As such, the sample letter may be subject to audit committee review or discussion. Separate requests for proposal (RFPs) could be used for audit services and any additional services (for example, compilations or consulting engagements).

Additional useful information in the RFP process is included in chapter 5, "AICPA Peer Reviews of CPA Firms: An Overview," and chapter 17, "Evaluating the Independent Auditor: Questions to Consider," in this toolkit. Consideration of the information included in these sections is critical to successfully evaluating the RFP process.

Because the RFPs may require significant time investments from both the government entity, to prepare them, and the independent auditor, to respond fully, the government entity may first want to send requests for qualifications to determine the most qualified independent auditors from which to request RFPs.

Audit committees may wish to review the following AICPA Practice Aid and guidance that provides helpful information in planning, developing the request for proposal, and evaluating the proposals received:

- Procuring Governmental Audit Services. This document is available at www.aicpa.org/interestareas/governmentalauditquality/resources/auditeeresourcecenter/downloadabledocuments/rfppracticeaid.pdf.
- Why Audit Quality is Important for Auditees? This document is available at: www.aicpa.org/interestareas/governmentalauditquality/resources/auditeeresourcecenter/pages/whyauditqualityisimportantforauditees.aspx.

[1] Independent auditors in a government entity may be required to complete and report on certain audits as a consequence of consti-tutional or statutory requirements over which the auditor has no control. In other jurisdictions, auditors in a government entity may compete with other independent auditors for audit services.

[*Government Entity Letterhead*]

[*Current Date*]
[*Managing Partner and/or Government Audit Organization Director*]
[*CPA Firm and/or Government Audit Organization*]
[*Street Address*]
[*City, State, Zip*]

Dear Sir or Madam:

Our organization is accepting proposals from independent auditors to provide an audit for our government entity in the fiscal year X ending [*date*]. We invite your independent audit organization to submit a proposal to us by [*date*] for consideration. Note that the audit committee of the government entity's governing body (audit committee) is generally the decision-maker in the hiring of the government entity's auditor.[2] The government entity is acting at the direction of the audit committee in sending this request for proposal (RFP) to you. A description of the government entity, the services needed, and other pertinent information follow.

Background of X Government Entity

X Government Entity is a department within the State of Y, which is responsible for providing [specified] services to citizens of the State. Appropriations for this component unit are between $250 million and $350 million annually, and the government entity employs 1,575 employees in 5 locations. The government entity also receives $200 million in grant funds from the federal government. Because the government entity receives over $750,000 in federal grant funds, the audit is subject to the requirements of the Single Audit Act of 1996 and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (Circular A-133). This Act and the Circular require the audit be conducted in accordance with *Government Auditing Standards*. The government entity has a June 30 fiscal year-end, with a requirement to file an audited financial statement with the Federal Audit Clearinghouse by March 31 of the following year. Because the government entity usually submits its report for the Government Finance Officers Association (GFOA) Certificate of Achievement for Excellence in Financial Reporting (CAFR Program), the report and financial statements need to be submitted to GFOA by December 31 of each year.

Services to Be Performed

Your proposal is expected to cover the following services:

1. Annual audit to be completed in accordance with aforementioned legal and regulatory requirements, filing requirement(s), and meetings with audit committee as necessary
2. Quarterly reviews of internally prepared interim financial statements
3. Auditor evaluation of and reporting on the internal control over financial reporting, as required by state statute
4. Attendance at and reporting to the audit committee twice each year

[2] See footnote 1.

Key Personnel

Following is a list of key persons you may wish to contact with respect to this engagement.

Mr. Green	[Head of X government entity]	1-123/555-7890
Ms. Brown	CFO	1-123/555-7891
Mr. Black	General Counsel	1-123/555-7892
Mr. White	Controller	1-123/555-7893
Mr. Plain	[Position responsible for overseeing the strategic direction of the entity]	1-123/555-4567
Ms. Trane	Audit Comm. Chair	1-456/555-0123

For control purposes, we ask that you coordinate requests for additional information, visits to our site, review of prior financial statements, and/or appointments with the Head of X, CFO, and Audit Committee Chair through our controller, Mr. White.

Relationship With Prior Independent Auditor

Because the audit requirement for X government entity was established over 20 years ago, these services have been provided by XYZ independent auditors. However, that audit organization is no longer able to provide the services to our X government entity. In preparing your proposal, be advised that management will give you permission to contact the prior auditors.

You may use this section to disclose whether the decision to change auditors is a function of changes in the government entity, changes in the independent audit organization, or result of a period review of your satisfaction with the services provided. You may describe other aspects of your relationship with the prior auditor that you are willing to disclose at this stage in the proposal process here. Independent auditors may request additional information, which you may choose to disclose only if the requesting independent auditor signs a nondisclosure agreement.

Other Information

Use this space to discuss other information that an independent audit organization may need to make an informed proposal on the accounting and/or auditing work that you require. As mentioned earlier, you should only disclose information here that you are comfortable disclosing; additional information may be available to the independent audit organization interested in making serious proposals only after signing a nondisclosure agreement.

Your Response to This Request for Proposal

In responding to this request, please provide the following information:

> These are sample questions that you may consider asking. You should tailor these questions to your circumstances, and delete or add additional questions as appropriate.

Background on the Independent Auditor

1. Detail your independent auditor's experience in providing auditing services to government entities, as well as associations of a comparable size to X government entity.
2. Provide information on whether you provide services to any related government entities.
3. Discuss the independent auditor's independence with respect to X government entity.[3]
4. Discuss commitments you will make to staff continuity, including your staff turnover experience in the last three years.
5. Identify the five largest government entity clients your independent auditor has lost in the past three years and the reasons. Also, discuss instances when loss of the government entity client was due to an unresolved auditing or accounting matter. Explain your strategies to resolve the issue(s).
6. Identify the partner, manager, and in-charge accountant (or equivalent positions if the independent auditor is within the government) who will be assigned to this audit if you are successful in your bid, and provide biographies for these individuals. Indicate any complaints that have been leveled against them by the state board of accountancy or other regulatory authority, if any. Indicate any corrective actions that have been taken by the independent auditor with respect to these individuals.
7. Describe how your independent auditor will approach the audit of the government entity, including the use of any association or affiliate member firm personnel and the areas that will receive primary emphasis. Also, discuss the independent auditor's use of technology in the audit. Finally, discuss the communication process used by the firm to discuss issues with the management and audit committees.
8. If the audit is reimbursable, furnish current standard billing rates for classes of professional personnel for each of the last three years, including an expense policy describing how incidental costs (for example, travel and mileage) are billed.
9. If professional advice is reimbursable, describe how you bill for questions on technical matters that may arise throughout the year.
10. Provide the names and contact information of at least two to three other government entity clients of a similar size and level of the partner and manager who will be assigned to our government entity.
11. Describe how and why your independent auditor is different from other independent auditors being considered, and why our selection of your audit organization as our independent auditors is the best decision we could make.
12. Describe how your independent auditor will prioritize the work you do for X government entity.

[3] *Government Auditing Standards* should be used as criteria for determining independence if the audit is required to be performed in accordance with the Single Audit Act, or other audit requirement that mandates the use of *Government Auditing Standards*.

13. Include a copy of your audit organization's most recent Peer Review report, any separate written communication explaining deficiencies or significant deficiencies noted in the peer review, and any audit organization's response to any deficiencies reported, either in the peer review report or in a separate written communication.
14. Describe the independent auditor's approach to the resolution of technical disagreements (*a*) among engagement personnel, and (*b*) between the independent auditor and the government entity client.
15. Explain how you monitor and maintain your independence on an ongoing basis.
16. Finally, please submit information on the independent auditor's liability insurance coverage.

Experience in Our Industry

Use this space to ask questions about the independent auditor's experience providing services to other government entity clients, as well as providing services to governments within the similar level of government.

Expected Approach to This Audit as Also Noted Previously

1. Identify the partner, manager, and in-charge accountant (or equivalent positions if the independent auditor is within the government entity) who will be assigned to this audit if you are successful in your bid, and provide biographical material for each. Indicate any complaints against them that have been leveled by the state board of accountancy or other regulatory authority, if any. Indicate any corrective actions that have been taken by the independent audit organization with respect to these people.
2. Describe how your independent audit organization will approach the audit of the organization, including the use of any association or affiliate member audit organization personnel.
3. If the audit is reimbursable, set forth your fee proposal for the 20XX audit with whatever guarantees you offer regarding fee increases in future years. Provide your proposed fee for the quarterly review work that will be required. Ensure that the fee as proposed is sufficient to cover the work that you expect to perform if you are awarded this audit

Evaluation of Proposals

The Audit Committee of the X government entity will evaluate proposals on a qualitative basis. This includes a review of the independent audit organization's peer review and related materials, interviews with senior engagement personnel to be assigned to our government entity, results of discussions with other government clients, and the independent auditor's completeness and timeliness in its response to us. Finally, please submit information on the independent auditor's liability insurance coverage

If you choose to respond to this request, please do so by [*Date indicated earlier in the letter*]. Please let us know if you choose not to respond to this RFP.

Sincerely,

Ms. Brown, CPA Chief Financial Officer	Ms. Trane Chair Audit Committee

Chapter 5

AICPA Peer Reviews and PCAOB Inspections of CPA Firms: An Overview

Overview: The tool in this chapter is designed to educate audit committee members about the AICPA practice-monitoring programs (also known as peer review) over the accounting and auditing practices of the majority of U.S. CPA firms. This chapter is also intended to assist audit committee members in understanding the obligations and oversight of CPA firms. In addition, CPA firms that audit public companies regulated by the U.S. Securities and Exchange Commission (SEC) are subject to periodic inspections by the Public Company Accounting Oversight Board (PCAOB). See the section "PCAOB Inspection" of this tool for a discussion of PCAOB inspection and related questions for the audit committee. While this toolkit is focused on government entities, the audit committee can still gain insight from a CPA firm's PCAOB report. It is important to note that the AICPA Peer Review Programs and the PCAOB Inspection Program are not substitutes for each other.

Peer Review of a CPA Firm

This chapter is intended to help audit committee members understand the purpose of a CPA firm's peer review and the importance of the review's results to the audit committee, and how to interact with the firm concerning its peer review. A peer review is required of a CPA firm by the AICPA as a member, by most state boards of accountancy, and by generally accepted government auditing standards if a CPA firm audits government entities or entities that receive government awards.

A peer review of a CPA firm can be used by an audit committee as a tool to assess whether the CPA firm it hires or is considering hiring

1. has a system of quality control for its accounting and auditing practice that has been designed to meet the requirements of the AICPA's Statements on Quality Control Standards (SQCSs), and
2. is complying with that system of quality control during the peer review period to provide the firm with reasonable assurance of complying with professional standards

Peer reviews only include an evaluation of the CPA firm's non-SEC practice. The CPA firm's SEC practice is covered by a PCAOB inspection discussed in detail in the section "PCAOB Inspection" later in this chapter.

The AICPA's standards regarding a system of quality control provide requirements in the areas of auditor independence, integrity, and objectivity; audit personnel management; acceptance and continuance of audit clients and engagements; audit engagement performance; and firm quality control monitoring. Professional standards are literature, issued by various organizations, that contain the framework and rules that a CPA firm is expected to comply with when designing its system of quality control and in performing its work.

A CPA firm (reviewed) will engage another (reviewing) CPA firm to perform the peer review. However, the reviewing CPA firm must be independent of the reviewed CPA firm, qualified to perform the review, and approved by the administering entity to perform the review. The administering entity is the independent body responsible for administering, evaluating, and accepting peer reviews, and includes its peer review committee). For many CPA firms, the National Peer Review committee or State CPA Societies administer the peer reviews depending on whether the CPA firm audits SEC companies.

Peer Review Reports

The reviewed CPA firm may receive one of three types of peer review report ratings: *pass, pass with deficiencies*, or *fail*:

1. A *pass* report should be issued when it is concluded that the firm's system of quality control for the accounting and auditing practice has been suitably designed and was complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.
2. A report rating of *pass with deficiencies* should be issued when the firm's system of quality control for the accounting and auditing practice has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting 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 report with a peer review rating of *fail* should be issued when significant deficiencies exist and the firm's system of quality control is not suitably designed to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects, or the firm has not complied with its system of quality control to provide reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects.

If deficiencies are found, a peer review report rating of *pass with deficiencies* or *fail* is used and the reviewed CPA firm is expected to identify and take corrective measures to prevent the same or similar types of deficiencies from occurring in the future. Such measures could include making appropriate changes in the firm's system of quality control or having personnel attend training in specific areas. These measures should be described in a letter addressed to the administering entity, responding to the deficiencies or significant deficiencies and related recommendations identified in the report. In reviewing the CPA firm's response to the deficiencies noted in the peer review report, the administering entity may ask the firm to agree to certain other actions (referred to as "corrective actions") it deems appropriate in the circumstances, such as the submission of a monitoring report, a revisit by the reviewer, or joining an applicable audit quality center.

If during the peer review the reviewing CPA firm finds a matter that does not rise to the level of a deficiency, resulting in the reviewed CPA firm receiving a peer review report rating of *pass with deficiencies* or *fail*, the reviewer will complete a Finding for Further Consideration (FFC) form. The reviewing CPA firm will make a recommendation to the reviewed CPA firm to correct the finding for which the reviewed CPA firm will be asked to respond. The administering entity will evaluate whether the reviewed CPA firm's responses to those recommendations appear comprehensive, reasonable, and feasible. The administering entity will determine if a finding should require an implementation plan from the reviewed CPA firm in addition to the plan described in its response to the findings on the FFC form.

We recommend that the audit committee request a copy of the CPA firm's most recently accepted peer review report and discuss the results with the firm. If the CPA firm received a peer review report rating of *pass with deficiencies* or *fail*, the audit committee should discuss the results and corrective actions as part of its assessment of whether it should engage or continue to engage the CPA firm.

Common Misconceptions of Peer Review

A peer review is an evaluation of work performed by the CPA firm and may have limitations.

1. *Fiction:* A peer review evaluates every engagement audited by a CPA firm.

   Fact: A peer review is performed using a risk-based approach. In addition to other procedures performed, a peer reviewer selects a reasonable cross-section of the firm's engagements so that the reviewer has a reasonable basis to determine whether the reviewed firm's system of quality is designed in accordance with professional standards and if the reviewed firm is in compliance with it. 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 pass rating provides assurance with respect to every engagement conducted by the firm.

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

Questions for the CPA Firm Regarding Peer Review

The following questions may be helpful to the audit committee to gain a better understanding of the CPA firm and its peer review reports.

Question	Yes	No	Comments
1. Has the firm previously or currently been subject to peer review? If not, please explain.	☐	☐	
2. Were there any deficiencies or finding for further consideration noted as part of the peer review? Explain what the deficiencies or findings mean.	☐	☐	
3. Does the firm's letter of response demonstrate that the firm is committed to making the changes necessary to improve its practice? If not, please explain.	☐	☐	
4. Was the peer review report a rating of pass with deficiencies or fail? Explain.	☐	☐	
5. Was our entity's audit selected for review during the peer review? If so, were any matters from our audit noted? Explain.	☐	☐	
6. Did our audit's engagement partner (and/or other key engagement team members) have other audit engagements selected for review during the peer review? If so, were any matters noted?	☐	☐	

PCAOB Inspection

The Sarbanes-Oxley Act of 2002 (the Act) established the Public Company Accounting Oversight Board (PCAOB) to oversee the audits of issuers as defined in the Act. The Act also amended the Securities Exchange Act of 1934 to rest responsibility for the appointment, compensation, and oversight of any listed public company's auditor with a committee of independent directors. PCAOB established an inspection program to assess the degree of compliance of each registered public accounting firm and firm personnel with the Act. PCAOB also issued Release No. 2012-003, *Information for Audit Committees about the PCAOB Inspection Process*, in August 2012, to assist audit committees understand the inspections and gather information about the CPA firms.

All firms auditing public company clients are required to register with the PCAOB. Registered public accounting firms auditing more than 100 issuers are subject to annual inspection by the PCAOB. All other registered firms are subject to an inspection every three years. The PCAOB inspection focuses on a firm's SEC practice only.

The PCAOB inspection focuses on the firm's audit practice with respect to SEC registrant organizations. Following the inspection, the PCAOB will issue a report in two parts: (1) a public report that includes a description of the inspection procedures and description of issues identified in the course of reviewing selected audit engagements without identification of the specific client engagements; and (2) a non-public report addressing criticisms of or potential defects in the firm's system of quality control. The non-public report could be made public if the criticisms or defects are not addressed by the firm to the satisfaction of the PCAOB within 12 months of the date of the inspection report.

Questions for the Audit Committee Regarding the PCAOB Inspection

Although the PCAOB inspection does not include a CPA firm's other clients such as private company practices, it can still provide useful information to the audit committee of a not-for-profit entity. If the firm performs public company audits in addition to not-for-profit or government entity audits, a PCAOB inspection report will be available. This report can provide insight about the firm in general, and the following questions are ones that the audit committee should consider asking its auditors.

Question	Yes	No	Comments
1. Did the PCAOB identify deficiencies in audits that involved auditing or accounting issues similar to issues presented in our entity's audit?	☐	☐	
2. Has the firm taken actions necessary to correct the deficiencies noted? What was the audit firm's response to the PCAOB findings?	☐	☐	
3. Was the engagement partner (and other key engagement team members) selected for the PCAOB inspection? If so, were any negative comments noted on audits managed by them?	☐	☐	
4. Is the firm addressing (or has it addressed) the matters that were included in the non-public report from the PCAOB? Does the firm anticipate that the matters will be resolved, or is there a risk that the non-public report will become public after 12 months?	☐	☐	
5. Is there anything else of note related to the PCAOB inspection that we should be aware of?	☐	☐	

Chapter 6

Guidelines for Hiring the Chief Audit Executive (CAE)

Overview: The internal audit function is a key component in providing assurance to the effectiveness of an entity's internal control structure. As a result, careful efforts must be taken in hiring the right Chief Audit Executive (CAE), one who fits the entity's needs with the necessary technical expertise, but also one who meets other requirements, such as industry experience, temperament, integrity, management and human relationship skills.

Background: An internal audit function aids government entity audit committees in carrying out their oversight and fiduciary responsibilities through its focus on governance, risk management, and internal control. Appointing a CAE is thus a critical undertaking for any organization. The Institute of Internal Auditors (IIA), the standard setting organization for internal auditors, provides guidance on the appointment of the CAE.

Role of the Audit Committee in Hiring and Evaluating the CAE

In most entities, the CAE will report functionally to the audit committee and administratively to a senior executive of the entity, such as the CEO.

A critical activity of the audit committee is to be involved in the hiring of the CAE of the entity. Given the CAE's high degree of interaction with senior management and the audit committee, it is imperative that the CAE demonstrates the attributes and skills appropriate for such interactions.

CAE Qualifications

Candidates for a CAE position should have strong management and leadership skills and have distinguished themselves professionally by earning either a CPA or a Certified Internal Auditor (CIA) credential.[1] A strong knowledge of internal audit, technical skills and experience is also an advantage. When evaluating the qualifications of candidates for a CAE position, the following competencies should be considered:

- CPA with active status
- Experience conducting independent audits in accordance with professional standards
- Experience preparing report for senior management recommending corrective action
- Experience communicating results of audits and investigations to boards or audit committees (or both)

[1] It is strongly encouraged that all CAEs, either before appointment or within a reasonable time period after appointment, demonstrate a strong understanding of the roles and responsibilities of internal audit, the Institute of Internal Auditor's International Professional Practices Framework, and audit technical skills through attainment of the Certified Internal Auditor® (CIA®) designation.

- Knowledge and ability to remain abreast of current industry and professional auditing standards
- Ability to accurately assess and evaluate situations
- Good judgment and strength of character
- Uncompromising ethics and integrity
- Intellectual curiosity
- A focus on quality and professionalism
- Business acumen
- Excellent verbal and written communication skills
- Open and unbiased strong listening skills
- Persuasion and collaboration skills that balance diplomacy with assertiveness
- Critical thinking skills
- Excellent facilitation, problem-solving, and consensus building skills
- Excellent people management skills

Instructions for this tool: The audit committee should consider asking the following questions of candidates who have passed the initial employment screening by either the entity's human resources department or an outside recruiting firm. Note that some sample questions may not be appropriate for your organization or the candidate.

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
1. What do you consider to be internal audit's role within the entity's mission?	
2. What do you see as the biggest challenges for an internal audit team in the short term (3 to 6 months), medium term (6 to 12 months), and over the next 2 to 3 years?	
3. Have you used technology in conducting internal audits, and how has it enhanced conducting the internal audit? Describe your experience with data analytics.	
4. What experience do you have in this industry, and how do you plan to keep abreast of the significant developments relevant to internal audit in this industry?	
5. 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/communications between the CAE and the audit committee (chair)?	
6. Give some examples of situations you have faced that required special meetings with the audit committee (or open meetings as restricted to purpose within jurisdictions) 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 what was your response? In retrospect, would you now handle these situations differently?	

(continued)

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
7. Have you worked with an Internal Control Framework (e.g., COSO or Green Book)? How has it influenced your process in evaluating the adequacy of internal controls? How is this framework used to design your internal audits?	
8. In your previous organization, what type of technology platform was used? Have you been involved in an enterprise resource planning (ERP) system 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?	
9. 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?	
10. What is the process that you use to develop the priorities of the internal audit function?	
11. What roles do the entity's strategic and technology plans play in the development of an audit plan?	
12. What input do you seek to develop your 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?	
13. 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?	
14. 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?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
15. How would you ensure that the personnel in internal audit have the necessary skills to ensure an adequate understanding of the organization?	
16. 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?	
17. Describe a situation in which you were able to use persuasion to convince someone to see things your way?	
18. Describe a situation where you came up with an innovative solution to a challenge your organization was facing?	
Other Notes and Questions:	

Chapter 7

Engaging Independent Counsel and Other Advisers

Overview: An audit committee may need the expertise from outsiders other than the independent auditor. The tool in this chapter addresses considerations to assist audit committee members in understanding the process of engaging independent counsel and other advisers if needed.

When selecting independent counsel or other advisers (expert or adviser) for an engagement within the government entity, 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) maintains integrity and objectivity; (2) is free of conflicts of interest with respect to the members of the audit committee and the government entity; (3) has the expertise and resources necessary to do the work it is under consideration to do; and (4) has a reputation for reliability, among other considerations. Inherent in the selection process is the audit committee's ethical responsibilities to avoid situations involving the appearance or actual conflict of interest or loss of objectivity (for example, the audit committee should avoid the appearance of "opinion shopping" or obtaining a predetermined outcome).

Although the nature of every engagement will be different, the initial steps the audit committee (or its designee) should undertake when engaging external resources, while not all-inclusive, include the following:[1]

1. 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.
2. Determine whether the expert or adviser has a conflict of interest with respect to the government entity. Such a conflict might arise if the expert or adviser has a relationship with the external auditor, or the subject of the engagement, or if he or she provides service to a competitor. 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, or a member of the entity's management. Be aware of other potential conflicts of interest that may distract, or undermine, the work to be done.
3. Determine if the expert or adviser has sufficient resources to perform the work in the time frame specified by the audit committee.
4. Evaluate the scope of work to be performed and other issues, including the proposed plan for payment of fees and expenses.
5. Obtain expert or adviser consent to issue a written report of the results of the effort and, during the engagement retention process, obtain a sample or intended format of the report contents. This is particularly helpful if an audit adviser is hired by the audit

[1] In a government environment, these considerations are typically part of the formal procurement process.

committee and the audit adviser reviews the work of the incumbent auditor to address an issue. In this situation, the audit adviser is usually requested to sign a document that prevents the adviser from reporting issues discovered regarding the independent auditor's position or documentation of the issue.

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's or adviser's work and document those criteria in an agreement with the service provider.
8. Execute an engagement letter specifying the scope of services to be performed and the terms of the engagement.
9. Ensure that the external counsel or adviser clearly understands the reporting relationship(s) and to whom he or she will report and share the findings of the engagement.

As with any relationship, communication and expectations management are important and should be clearly established prior to the start of an engagement.

PART II: Key Responsibilities

Chapter 8

Internal Control: Guidelines and Tool for the Audit Committee

Overview: This chapter is intended to give the audit committee basic information about internal control systems, including their purpose and limitations, how to most effectively use them in the entity, and the requirements of management with respect to controls over financial reporting. Note that the primary responsibility of the audit committee with respect to internal controls is the system of internal controls over financial reporting and over compliance with laws, regulations, contracts, grant agreements, and abuse, and, if applicable, operations.

Internal Control Primer

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* (framework).[2] The COSO framework was cited as an example of a "suitable control framework" by the SEC, along with similar frameworks issued by Canadian and UK-based organizations, and has become widely used by U.S. companies, both public and private, and not-for-profit entities. The COSO framework was updated and re-published in 2013 to reflect consideration of the dramatic changes in business and operating environments since its original release. Senior executives adopted internal controls to help them effectively manage the entities they run to achieve profitability goals and missions. The framework now provides an updated and comprehensive principles-based approach to understanding internal control.

The COSO framework defines internal control as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance." The nature, extent, and formality of an entity's system of internal control will vary because the entities are different in terms of organizational size; products and services offered (public, private, or not-for-profit); customer base; and regulatory requirements. Therefore, the internal control process should be tailored to fit that entity's operating environment. The process consists of ongoing tasks and activities effected by people that are able to provide reasonable but not absolute assurance of operating effectiveness. As such, the system of internal controls may range from highly formal and structured to informal and less structured and may still be effective.

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

[2] The COSO publication *Internal Control—Integrated Framework* (Product Code Numbers 990025P and 990025E), 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.

Standards for Internal Control in the Federal Government (known as the Green Book),[3] provides an overall framework for establishing and maintaining an effective system of internal control. The term "internal control" in the Green Book covers all aspects of an entity's objectives (operations, reporting, and compliance). The Green Book may be adopted by state, local, and quasi-governmental entities, as a framework for a system of internal control. Management of a government entity determines, based on applicable laws and regulations, how to appropriately adapt the standards presented in the Green Book as a framework for the government entity.

The COSO framework sets forth three categories of objectives:

1. Operations objectives refer to the effectiveness and efficiency of the entity's operations, which includes operational and financial performance goals and safeguarding of resources.
2. Reporting objectives pertain to the reliability of financial reporting and its preparation and includes published financial statements and their related derived data such as earnings releases.
3. Compliance objectives involve the adherence to laws and regulations to which the entity is subject.

The COSO framework introduced the five components of internal control. The Green Book adapts these components for a government environment. According to COSO and the Green Book, internal control consists of five interrelated components as follows:

1. *Control environment.* The control environment is the foundation of the system of internal controls and sets the tone for the organization. It provides the discipline, structure, and expectations for carrying out internal control across the organization. The governing body and senior management establish the tone at the top regarding the importance of internal control and expected standards of conduct and how directions are provided and responsibilities and authorities are assigned. The control environment also comprises the employees' integrity, ethical values, knowledge, and management's philosophy and operating style, including how employees are developed.
2. *Risk assessment.* Risk assessment involves an ongoing process for identifying, analyzing, and managing risks to help the entity achieve its objectives. Management should be cognizant of the ever-changing conditions in the entity's internal and external environments, including economic, regulatory, and operating conditions, and adopt mechanisms to effectively manage business risks.
3. *Control activities.* Control activities are the actions established by policies and procedures to help ensure that management directives are carried out. Control activities are the actions to mitigate risks and are performed at all levels of the entity and at various stages within business processes. Control activities can prevent or detect errors and may be manual or automated. These activities include, but are not limited to, approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.

[3] This document (GAO-14-704G, September 2014) is available through GAO's website (www.gao.gov).

4. *Information and communication.* Information is necessary for people to carry out their responsibilities so an entity can achieve its objectives. It must be identified, captured, and communicated to people in the right format and at the right time. Communications occur both externally and internally. Within an organization, information must be communicated in all directions to allow employees to carry out day-to-day activities. Communication enables employees to understand internal control responsibilities and their importance to the achievement of objectives.
5. *Monitoring Activities.* Monitoring activities consist of ongoing assessments, separate evaluations, or a combination to assess the quality of the system of internal control. They are used to ascertain whether each of the five components of internal control, including controls to effect the principles within each component, is present and functioning. The ongoing assessments are the activities of managers and supervisors to continually evaluate control requirements. On the other hand, separate evaluations are used periodically to determine whether controls are established and functioning as intended. While assessments are done at different times, deficiencies should be identified and communicated to staff and management in a timely manner, with serious matters reported to senior management and to the governing body.

The five components of the system of internal control are intertwined with the organization's operating activities, and are most effective when controls are built into the organization's infrastructure, becoming part of the very essence of the organization.

Internal Control Effectiveness

An effective system of internal controls provides an entity with reasonable assurance of achieving its objectives. An effective system of internal controls reduces, to an acceptable level, the risk of not achieving an entity's objectives. Effective internal control requires that each of the five components is present and functioning; it also requires that the components operate together in an integrated manner. Internal control can be judged as effective if the governing body and management have reasonable assurance of achieving an entity's operations, reporting, and compliance objectives, as follows:

1. The organization
   - achieves effective and efficient operations when external events are considered unlikely to have a significant impact on the achievement of objectives or when the organization can reasonably predict the nature and timing of external events and mitigate the impact to an acceptable level; and
   - understands the extent to which operations are managed effectively and efficiently when external events may have a significant impact on the achievement of objectives, and the impact cannot be mitigated to an acceptable level.
2. The organization prepares reports in conformity with applicable laws, rules, regulations, and standards established by legislators, regulators, and standard setters, or with the entity's specified objectives and related policies.
3. The organization complies with applicable laws, rules, and regulations.

Internal Control Limitations

Even though a system of internal control is important to an organization in achieving its objectives, an effective system of internal controls 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 in achieving its objectives, but it cannot turn a poor manager into a good one. Internal control cannot ensure success, or even survival.

Internal control is not an absolute assurance to management and the governing body that the organization has achieved its objectives. It can only provide reasonable assurance, due to limitations inherent in a system of internal controls. For example, breakdowns in the internal control structure can occur due to simple error or mistake, as well as faulty judgments that could be made at any level of management.

In addition, controls can be circumvented by collusion or by management override. Otherwise, effective internal controls cannot be relied upon to prevent, detect, or deter fraudulent financial reporting perpetrated by senior management. The audit committee must evaluate whether there are oversight mechanisms in place and functioning that will prevent, deter, or detect management override of internal controls.

Roles and Responsibilities

Everyone in the organization plays an important role in the system of internal controls.

Governing Body and Audit Committee

Members of the Governing Body. The governing body is responsible for overseeing the system of internal controls, and plays a key role in setting expectations about integrity and ethical values, transparency, and accountability for the performance of internal control responsibilities. Governing body members should be objective, capable and inquisitive, with a willingness to commit the time necessary to fulfill their governance responsibilities. To fulfill its responsibilities, the governing body should seek input about potential deficiencies in controls from external and internal auditors.

Audit Committee. The audit committee plays a critical oversight role in the reliability of the financial statements and the system of internal controls over financial reporting in addition to the processes in place to design, implement, and monitor the entity's broader system of internal controls. Audit committee members should understand how management is carrying out its internal and external reporting responsibilities and, when necessary, verify that timely corrective actions are taken.

Senior Management

Head of the Agency. The head of the agency has ultimate responsibility and ownership of the system of internal controls, with accountability to the governing body. The individual in this role sets the tone at the top that affects the integrity and ethics and other factors that create the positive control environment needed for the internal control system to thrive. The head of the agency maintains visibility and control over the risks the government entity faces, and reviews deficiencies that impact the system of internal controls. The day-to-day design and operation of the system of internal controls is delegated to key senior managers in the entity, under the leadership of the head of the agency.

CFO. Much of the internal control process flows through the accounting and finance area of the organization under the leadership of the CFO. In particular, controls over financial reporting fall within the domain of the chief financial officer. The audit committee should use interactions with the CFO as one of several important tools to obtain or increase their comfort level on the completeness, accuracy, validity, and maintenance of the system of internal control over financial reporting.

In a government entity, executives and senior management should, among other things, set the appropriate "tone at the top" for the entity's control environment by doing the following:

- Ensuring that executives and management at all levels of the entity understand their role in cultivating the proper level of control awareness and play an integral part in establishing and maintaining internal control
- Mandating accountability through properly established policies and procedures and monitoring compliance on an ongoing basis
- Designing internal control so that risks are effectively managed and that material weaknesses are identified and reported to the appropriate level of management in a timely manner
- Requiring disclosure to the entity's auditors and the audit committee of (*a*) all significant deficiencies in the design or operation of internal controls that could adversely affect the entity's ability to record, process, summarize, and report financial data, as well as any material weaknesses in internal control; and (*b*) any fraud, whether or not material, that involves management or other employees who have a significant role in the entity's internal control

Day-to-Day Internal Controls Functions

Controller. The controller has many of the key control activities for financial reporting. It is important for the controller to understand the need for a system of internal control, to be committed to carrying out the requirements, and to communicate its importance within the organization. Further, the controller must demonstrate the commitment for the controls through his or her actions. This function monitors trends, provides guidance, and keeps the organization informed of relevant requirements. It is important that this functions coordinates and share issues among his or her peers to help the organization achieve its objectives.

Internal Audit. Internal audit is responsible for evaluating the effectiveness of the system of internal control and contributing to its ongoing effectiveness. Because internal audit generally reports directly to the audit committee and the most senior levels of management, it often plays a significant role in monitoring the effectiveness of a system of internal control in the government entity.

External Audit. The external auditor is engaged by the organization to audit the reliability of financial reporting and, in certain reporting jurisdictions, the effectiveness of internal control over financial reporting and compliance. In carrying out these responsibilities, the external auditor will communicate deficiencies in internal control to management to be acted upon and, depending on significance, to the audit committee. When hiring external auditors, the organization still retains full responsibility for the system of internal control, therefore, the audit committee should ensure that management (or an Office of Inspector General or equivalent, if applicable) has processes to evaluate the work performed by the external auditors as it relates to internal control.

Other Personnel. The system of internal control is only as effective as the employees throughout the organization who must comply with it. Employees should understand their roles in the system of internal controls, the importance of supporting controls through their own actions, and encouraging compliance by colleagues throughout the organization.

Internal Control Over Financial Reporting

Internal controls exist throughout an organization and may cover the organization as whole or may cover individual functions or transactions. Frequently used terms when discussing internal controls include the following.

Entity-level controls. Entity-level controls permeate all levels of the organization, and they establish the "tone at the top." Examples include the following:

- Controls related to the control environment
- Controls over management override
- The risk assessment process
- Centralized processing and controls, including shared service environments
- Controls to monitor results of operations
- Controls to monitor other areas, including activities of the internal audit function, the audit committee, and self-assessment programs
- Controls over the period-end financial reporting process
- Policies that address significant business control and risk management practices

Compensating controls. Compensating controls address potential concerns about limited segregation of duties. These controls include managers reviewing system reports of detailed transactions; selecting transactions for review of supporting documents; overseeing periodic physical counts of physical inventory, equipment, or other assets and comparing them with accounting records; and reviewing reconciliations of account balances or performing them independently. The lack of segregation of duties is not automatically a material weakness, or even a significant deficiency, depending on the compensating controls that are in place.

Deficiency. 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 misstatements on a timely basis.

> Example: A member of the accounting department has been assigned responsibility to perform reconciliations on all bank accounts on a monthly basis. This person also has responsibility for opening the mail and preparing the daily deposit to the bank. The person's manager is required to review each completed reconciliation, but the manager does not sign off consistently on the reconciliation indicating review. In this scenario, two internal control deficiencies exist: (1) the lack of segregation of duties because one individual is preparing the cash deposit and reconciling the cash accounts, and (2) the lack of documentation of a control because the manager did not sign-off the reconciliation indicating a completed review.

Significant Deficiency. A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the entity's financial reporting. Alone or with other deficiencies, a significant deficiency results in more than a remote likelihood that a misstatement of the financials that is more than inconsequential in amount will not be prevented or detected.

> Example: The organization is funded by a variety of grant agreements and contracts, making it necessary for the accounting department to review each grant agreement and contract to ensure proper revenue recognition. Because each grant agreement and contract is not always reviewed, revenue has been misstated on occasion. It is unlikely that any single grant agreement or contract could result in a material misstatement of revenue, and there are controls in place to ensure that material misstatements do not occur. However, a misstatement that is more than inconsequential yet less than material could result, creating a significant deficiency in internal control.

Material Weakness. A deficiency, or a combination of deficiencies, in internal control over financial reporting, 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.

Examples of weaknesses that likely would be considered material depending on the circumstances include the following:

- Ineffective oversight by the audit committee over the external financial reporting process, and internal controls over financial reporting
- Material misstatements in the financial statements not identified initially by internal controls
- Significant deficiencies that have been communicated to management and the audit committee but that remain uncorrected after a reasonable period of time
- Restatement of previously issued financial statements to correct a material misstatement
- For larger, more complex entities, ineffective internal audit functions
- For complex entities in highly regulated industries (for example, healthcare), an ineffective regulatory compliance function
- Fraud of any magnitude on the part of senior management
- An ineffective control environment

The severity of a deficiency depends on two factors: (1) whether there is a reasonable possibility that the entity's controls will fail to prevent or detect a misstatement of an account balance or disclosure, and (2) the magnitude of the potential misstatement resulting from the deficiency or deficiencies. It is important to note that the severity of a deficiency does not depend on whether a misstatement actually occurred but rather on a reasonable possibility that the entity's controls will fail to prevent or detect a misstatement. In determining whether a deficiency rises to the level of resulting in a misstatement of an account balance, risk factors need to be considered. These risk factors include, but are not limited to the following:

- The nature of the financial statement accounts, disclosures, and assertions involved
- The susceptibility of the related assets or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant
- The interaction of the deficiencies
- The possible future consequences of the deficiency (for example, reduced grant or government funding)

For additional guidance, refer to AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*).[4]

The audit committee needs to be advised and updated regularly on the external auditor's consideration of internal controls as part of the financial statement audit, and should have a clear understanding of the expected outcome. If the auditor identifies internal control deficiencies, management should have a plan in place to correct weaknesses, and the audit committee should already be engaged in the review and approval of that plan.

Conclusion

This chapter is intended to provide an overview of the basic information about internal control including its purpose and limitations, key terms, and responsibilities of the audit committee, especially as they relate to internal control over financial reporting. The concepts are not complex, but sometimes the application of the controls can be a challenge in a government entity, depending on its size and the culture. The audit committee plays an important role in establishing an appropriate control environment or the "tone at the top" of the government entity.

While the objective of reliable financial reporting may be paramount for the audit committee of a not-for-profit entity, an effective system of internal controls also encompasses compliance, operational, and non-financial reporting objectives. Establishing an integrated process that includes all five components of the internal control framework and is the primary means of having reasonable assurance that these three important objectives are being met. Simply stated, a strong system of internal control, both in its design and operation, is good business.

[4] See also AU-C section 265, *Communicating Internal Control Related Matters Identified in an Audit*; PCAOB Auditing Standards No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*; and International Standards on Auditing 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*.

Internal Control—Checklist of COSO Essentials for the Governing Body

Purpose of this tool: This checklist provides an understanding of key governing body-level responsibilities within each of the five interrelated components of an entity's system of internal controls, as described in the *COSO Internal Control—Integrated Framework* (2013) and the Green Book. Refer to the "Internal Control Primer" section of this chapter for a discussion of the COSO components. The audit committee's role within the framework focuses on internal controls over financial reporting and the processes in place to design, implement, and monitor the entity's broader system of internal controls. It is also responsible to aid the governing body in its oversight of internal controls, risk management and overall governance process. This can be achieved through the committee's interaction with senior management, independent auditors, external and internal auditors, and other key members of the financial management team.

Instructions for using this tool: Within each component is a series of questions that the audit committee should evaluate to assure itself that board-level 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, which should include key members of the financial management team, internal auditors, and external auditors. **This governing body-level tool should be used in conjunction with the *COSO Internal Control—Integrated Framework* (2013) and the Green Book to determine if all components and related principles of an entity's internal control system are present, functioning, and operating together in an integrated manner.** Evaluation of the internal control structure is not a one-time event, but rather a continuous process for the audit committee. The audit committee should always have its eyes and ears open to the ever-changing risks that the business faces, especially the risks to reliable financial reporting, and should continually probe the responsible parties regarding the operation of the system and potential weaknesses in internal control. These questions are written in such a manner that a "No" response indicates a weakness that should be addressed.

COSO Framework	Yes	No	Not sure	Comments
Control Environment—Demonstrates Commitment to Integrity and Ethical Values				
1. Do comprehensive standards of conduct exist to address acceptable business practice, conflicts of interest, and expected standards of ethical and moral behavior for the entity? Is the governing body accountable for the definition and application of the standards?	☐	☐	☐	
2. Are the standards of conduct regularly communicated and reinforced to all levels of the entity, outsourced service providers, and business partners? Are management's efforts to communicate the standards both sufficient and effective in creating awareness and motivating compliance? See also chapter 9, "Fraud and the Responsibilities of the Audit Committee," in this toolkit.	☐	☐	☐	
3. Do the governing body and management demonstrate through actions and behaviors their commitment to the standards of conduct? Is there consistency at all levels of the entity? Is appropriate action taken in response to violations to the standards of conduct?	☐	☐	☐	
Control Environment—Exercises Oversight Responsibility				
4. Does the governing body define, maintain, and periodically evaluate periodically the skills and expertise needed among its members to enable them to ask probing questions of senior management and take commensurate actions?	☐	☐	☐	
5. Does the governing body set the expectations for the performance, integrity, and ethical values of senior management?	☐	☐	☐	

COSO Framework	Yes	No	Not sure	Comments
Control Environment—Exercises Oversight Responsibility				
6. Does the governing body assume oversight responsibility for management's design, implementation, and conduct of internal control?	☐	☐	☐	
Control Environment—Establishes Structure, Authority, and Responsibility				
7. Has the governing body established appropriate oversight structures and processes (board and committees) for the entity? Is the organizational structure within the accounting function appropriate for the size of the entity?	☐	☐	☐	
8. Does the governing body retain authority over significant decisions and review management's assignments and limitations of authorities and responsibilities?	☐	☐	☐	
Control Environment—Demonstrates Commitment to Competence				
9. Do governing body committees contain members who have the requisite level of skills and expertise commensurate with the committee's responsibilities?	☐	☐	☐	
10. Are governing body oversight effectiveness reviews commissioned periodically, with opportunities for improvement identified and addressed?	☐	☐	☐	
11. Is the governing body effective in exercising its fiduciary responsibilities to external stakeholders (as applicable) and due care in oversight (for example, prepare for and attend meetings, review the entity's financial statements and other disclosures)?	☐	☐	☐	
12. Does the governing body or its committee evaluate the performance, integrity and ethical values of senior management and address shortcomings? Is the governing body informed about turnover of key personnel?	☐	☐	☐	

(continued)

COSO Framework	Yes	No	Not sure	Comments
Control Environment—Demonstrates Commitment to Competence				
13. Do succession plans, contingency plans, or both exist for the CEO and other key personnel to assign key responsibilities in internal controls?	☐	☐	☐	
Control Environment—Enforces Accountability				
14. Does the governing body challenge senior management by asking probing questions about the entity's plans and performance, and require follow-up and corrective actions, as necessary?	☐	☐	☐	
15. Does the governing body act to address competence, internal control, and standards of conduct shortcomings among the head of the agency, the entity, and its outsourced service providers?	☐	☐	☐	
16. Does the governing body or its committee align executive compensation, incentives, and rewards appropriately, including consideration of related pressures, with the fulfillment of internal control responsibilities in the achievement of objectives?	☐	☐	☐	
Risk Assessment				
1. Does the governing body consider significant risks to the achievement of objectives from external sources, such as creditor demands, economic and regulatory conditions, labor relations, and sustainability? Does the entity identify related issues and trends?	☐	☐	☐	

COSO Framework	Yes	No	Not sure	Comments
Risk Assessment				
2. Does the entity consider significant risks to the achievement of objectives from internal sources, such as business continuity, retention of and succession planning for key employees, financing and the availability of funding for key programs, competitive compensation and benefits, and information systems security and disaster recovery? Does the entity identify related issues and trends?	☐	☐	☐	
3. Does management have a process in place to proactively assess risk of significant changes, such as entering a new market, disruptive innovations, economic/geo-political shifts, fraud, and management override of internal controls?	☐	☐	☐	
4. Does the governing body apply an appropriate level of skepticism and challenge management's assessment of risks? Is the risk of misstatement of the financial statements considered, and are steps taken to mitigate that risk?	☐	☐	☐	
Control Activities				
1. Does the governing body assume the responsibility to oversee senior management effectively in its performance of control activities?	☐	☐	☐	
2. Does the governing body have necessary assurance from management, internal and external auditors, and others (as appropriate) that control activities are designed effectively and operating to address all significant risks to the preparation of reliable financial statements?	☐	☐	☐	

(continued)

COSO Framework	Yes	No	Not sure	Comments
Control Activities				
3. Does the governing body make specific inquiries of management regarding the selection, development, and deployment of control activities in significant risk areas and remediation as necessary? Does the entity design control activities proactively to address emerging significant risk areas?	☐	☐	☐	
Information and Communication				
1. Do the governing body and management have an effective level of communication in place to enable fulfillment of their roles with respect to the entity's objectives and to enable consistency in direction and tone at the top?	☐	☐	☐	
2. Does the governing body receive the necessary operational and financial information relating to the entity's achievement of objectives on a timely basis and in a format that facilitates its use? Does the board review and discuss this information?	☐	☐	☐	
3. Does the governing body apply critical judgment effectively to scrutinize information provided and present alternative views?	☐	☐	☐	
4. Does the governing body review disclosures to external stakeholders for completeness, relevance, and accuracy?	☐	☐	☐	
5. Does the governing body receive communications regarding relevant information from third party assessments?	☐	☐	☐	
6. Do open communication channels exist to allow relevant information to flow to the board from internal and external sources including stakeholders, auditors, regulators, and employees?	☐	☐	☐	

COSO Framework	Yes	No	Not sure	Comments
Information and Communication				
7. Is there an effective process established and publicized periodically to political officials, employees, and others to allow open communication of suspected instances of wrongdoing by the entity or employees? See also the tool titled "Whistleblower Complaint Reporting Common Practices Checklist" in chapter 10, "Whistleblower Policy: Complaint Reporting, Anti-retaliation Procedures, and Tracking Report," in this toolkit.	☐	☐	☐	
Monitoring Activities				
1. Does the governing body understand the nature and scope of monitoring activities including ongoing assessment and/or separate evaluations to enable an effective determination of whether the components of internal control continue to function over time?	☐	☐	☐	
2. Does the governing body inquire of management, internal and external auditors, and others (as appropriate) to understand the presence and nature of any management overrides of controls?	☐	☐	☐	
3. Does the governing body receive regular communications from management regarding its evaluation of internal control and the status of remediation of deficiencies?	☐	☐	☐	
4. Does the governing body engage with management, internal and external auditors, and others (as appropriate) to evaluate the adaptability of the entity's strategies and internal control framework to evolving business, infrastructure, regulations, and other factors?	☐	☐	☐	

Chapter 9

Fraud and the Responsibilities of the Audit Committee: An Overview

Overview: An audit committee should take an active role in the prevention and deterrence of fraud, in addition to implementing and maintaining an effective ethics and compliance program. Effective audit committees challenge management constantly, and the auditors should take steps continually to ensure that the government entity has appropriate antifraud programs and controls in place. With those controls, management will be able to identify potential fraud and undertake investigations when instances of fraud are detected. The audit committee should take an interest in ensuring that appropriate action is taken against known perpetrators of fraud.

This chapter is intended to make audit committee members, including members of the governing body of the government entity, aware of their responsibilities as they undertake this important role. This chapter also highlights areas of corporate activity that may require additional scrutiny by the audit committee.

Since the recent financial scandals, and with the passage of the Sarbanes-Oxley Act of 2002, the public's expectations have been raised about all parties involved in organizational governance, including the audit committee, management, independent auditors, internal auditors, regulators, and law enforcement. The audit committee's role has been elevated greatly as a result of such fraud discoveries and by recent legislation.

Regulations such as the U.S. Foreign Corrupt Practices Act of 1977 (FCPA), the 1997 Organisation for Economic Co-operation and Development Anti-Bribery Convention, the U.S. Sarbanes-Oxley Act of 2002, the U.S. Federal Sentencing Guidelines of 2005, and similar legislation throughout the world have increased management's responsibility for fraud risk management.[1]

Fraud can be costly to all types of organizations, including government entities. According to the Association of Certified Fraud Examiners (ACFE), U.S. organizations lose an estimated 5 percent of annual revenues to fraud.[2]

Definition and Categories of Fraud

An understanding of fraud is essential for the audit committee to carry out its responsibilities. According to *Black's Law Dictionary* (Tenth Edition, 2014, p.775), *fraud*

> … a knowing misrepresentation or knowing concealment of a material fact made to induce another to act to his or her detriment. A reckless misinterpretation made without justified

1 IIA, AICPA, ACFE. *Managing the Business Risk of Fraud: A Practical Guide*. 2008, p. 5.
2 ACFE, *2014 Report to the Nation on Occupational Fraud and Abuse*, Austin, TX: ACFE, 2014, p. 8.

> belief in its truth to induce another person to act. Additional elements in a claim for fraud may include reasonable reliance on the misrepresentation and damages resulting from this reliance. Unconscionable dealing; the unfair use of the power arising out of the parties' relative positions and resulting in an unconscionable bargain
>
> … consists of some deceitful practice or willful device, resorted to with intent to deprive another of his right, or in some manner to do him an injury. As distinguished from negligence, it is always positive, intentional.... Fraud, in the sense of a court of equity, properly includes all acts, omissions, and concealments which involve a breach of legal or equitable duty, trust, or confidence justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another.[3]

The AICPA defines *fraud* as "an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit."

Fraud affecting the organization generally falls within one of three categories:

1. *Financial statement fraud*, where an employee intentionally causes a misstatement or omission of material information in the organization's financial reports (for example, recording fictitious revenues, understating reported expenses or artificially inflating reported assets).
2. *Corruption*, where an employee misuses his or her influence in a business transaction in a way that violates his or her duty to the employer to gain a direct or an indirect benefit, such as schemes involving bribery or conflicts of interest.
3. *Asset misappropriation*, where an employee steals or misuses the organization's resources (for example, theft of organization cash, false billing schemes, or inflated expense reports).

These fraud schemes can arise from the following sources within an entity:

- *Executive fraud*, which involves senior management's intentional misrepresentation of financial statements, or theft or improper use of entity resources.
- *Management fraud*, which involves middle management's intentional misrepresentation of financial statement transactions, for example, to improve their apparent performance.
- *Employee fraud*, which involves non-senior employee theft or the improper use of entity resources.
- *External fraud*, which involves theft or the improper use of resources by people who are neither management nor employees of the entity. Outside individuals may, for example, collude with management or employees.

3 Black's Law Dictionary: thelawdictionary.org/fraud/

Roles of the Audit Committee in the Prevention, Deterrence, Investigation, and Discovery or Detection of Fraud

The members of the audit committee should understand their role of ensuring that the government entity has a strong internal control environment in place, including the design and implementation of programs and controls to prevent and detect fraud. The audit committee also needs to be prepared to aid in the discovery of fraud, investigate, and report on its findings to the governing body or head of the government entity. The components of a robust fraud control program should include (1) a fraud risk assessment,[4] (2) fraud reporting mechanisms and protocols, (3) investigation protocols, (4) a disciplinary action policy applied consistently, and (5) a process to identify and report conflicts of interest, usually in the form of an annual conflict of interest questionnaire completed by all employees.

The audit committee should ensure that the government entity has implemented an effective ethics and compliance program, and that it is tested periodically. The design of the internal control system should consider the risk of fraud explicitly. Since the occurrence of significant frauds can be attributed frequently to an override of internal controls, the audit committee plays an important role by validating the accuracy of information received by applying skepticism and ensuring that internal control both addresses appropriate risk areas and is functioning as designed.

Internal auditors can serve a vital role in aiding in fraud prevention and deterrence. Internal audit staff who are experienced and trained in fraud prevention and deterrence can help to provide assurance that (1) risks are effectively identified and monitored, (2) organizational processes are effectively controlled and tested periodically, and (3) appropriate follow-up action is taken to address control weaknesses. The audit committee needs to ensure that internal auditors are carrying out their responsibilities in connection with potential fraud.

According to the ACFE, the most effective method for detecting fraud historically has been tips.[5] In many cases, these tips are obtained through the use of whistleblower policies and hotlines. Government entities should use the specific requirements for audit committees as outlined in the Sarbanes-Oxley Act as a best practice. Sarbanes-Oxley section 301 requires audit committees of listed companies to establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.[6] For federal agencies, the Whistleblower Protection Act and the Whistleblower Protection Enhancement Act of 2012 provide specific requirements for whistleblower protection. Other government entities may have laws or regulations that establish specific requirements applicable in that specific government entity.

[4] The COSO publication *Internal Control—Integrated Framework*, Principle 8, (page 78) describes the assessment of fraud risk as one of the fundamental concepts of internal control within an organization.

5 ACFE. *2014 Report to the Nation on Occupational Fraud and Abuse*. Austin, TX: ACFE, 2014, p. 19.

6 *See also* IIA, AICPA, ACFE. *Managing the Business Risk of Fraud: A Practical Guide.* 2008, p. 11, for guidance regarding the roles of management and staff.

In many organizations, the audit committee is significantly involved in the primary investigation and review of the whistleblower complaints and reporting. In addition, some organizations have designated the audit committee chair or an audit committee member as the individual who initially receives whistleblower reports. See also the tool in chapter 10, "Whistleblower Policy: Complaint Reporting, Anti-retaliation Procedures, and Tracking Report," in this toolkit.

Governance Considerations

To set the appropriate tone at the top, elected government officials should first ensure that the elected officials themselves are governed properly. This encompasses all aspects of governance.

The elected government officials also have the responsibility to ensure that management designs effective fraud risk management documentation to encourage ethical behavior and to empower employees, customers, and vendors to insist those standards are met every day. In order to understand fraud risks relative to the entity's mission and operations, the governing body should do the following:

1. Maintain oversight of the fraud risk assessment by ensuring that fraud risk has been considered as part of the entity's risk assessment and strategic plans. This responsibility should be addressed under a periodic agenda item at board meetings when general risks to the entity are considered.
2. Monitor management's reports on fraud risks, policies, and control activities, which include obtaining assurance that the controls are effective. The board should also establish mechanisms to ensure it is receiving accurate and timely information from management, employees, internal and external auditors, and other stakeholders regarding potential fraud occurrences.
3. Oversee the internal controls established by management.
4. Set the appropriate tone by actively promoting the ethical values of the entity by insisting that ethical behavior is an integrated part of all key executives' job descriptions, hirings, evaluations, and succession-planning processes.
5. Have the ability to retain and pay outside experts where needed.
6. Provide external auditors with evidence regarding the governing body's and the head of the government entity's active involvement and concern about fraud risk management.
7. Monitor and assess reports of fraud in comparable organizations.

The governing body and the head of the government entity may choose to delegate oversight of some or all of such responsibilities to management or a committee established by the governing body. These responsibilities should be documented in the applicable job description or committee charters. The governing body should ensure it has sufficient resources of its own and approve sufficient resources in the budget and long-range plans to enable the entity to achieve its fraud risk management objectives through their delegees.

Expertise of Forensic Accounting Consultants

In some situations, it may be necessary for an organization to look beyond the independent audit team for expertise in the fraud area. In such cases, CPA and certified fraud examiner (CFE) forensic accounting consultants can provide additional assurance or advanced expertise, since they have special training and experience in fraud prevention, deterrence, investigation, and detection. Forensic accounting consultants may also provide fresh insights into the organization's operations, control systems, and risks. Forensic accounting consultants, however, cannot act as insurers to prevent or detect fraud.

Many forensic accountants have obtained specific training in the identification and detection of fraud and may have additional designations such as certified fraud examiner. More information about certified fraud examiners may be located at the ACFE's website, www.acfe.com.

When Fraud Is Discovered

Fraud can be discovered through many sources, including internal or external auditors (including an Office of Inspector General (OIG) or similar entity), forensic accounting consultants, employees, and vendors. Establishing a confidential hotline can also be an important source of information leading to fraud discovery, as part of a government entity's overall ethics, compliance, and fraud prevention program. Although a confidential hotline (typically in an OIG or similar entity) is something that could be accomplished internally, a variety of outside service providers can be engaged to provide this service for the government entity.

If fraud or improprieties are asserted or discovered, the audit committee—through the independent external auditors, internal auditors, forensic accounting consultants, or others as appropriate—should investigate, and, if necessary, retain legal counsel to assert claims on the government entity's behalf. See the tool in chapter 7, "Engaging Independent Counsel and Other Advisers," in this toolkit. Forensic accounting consultants, in particular, may be needed to provide the depth of skills necessary to conduct a fraud investigation, and if it is desirable, for an independent assessment.

If fraud is discovered while working with an OIG or similar entity, 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. Criteria should be in place describing the audit committee's level of involvement, based on the severity of the offense. Audit committees will also want to obtain information about all violations of the law and the organization's policies.

Forensic accounting consultants frequently can also provide audit committees with other related advisory services, namely, (1) evaluations of controls designs and operating effectiveness through compliance verification; (2) creation of special investigations units (SIUs); (3) incident management committees; (4) disclosure risk controls; and (5) ethics hotlines and a code of conduct, if they are not already in place.

The audit committee can engage the incumbent audit firm to carry out a forensic/fraud investigation. It is important to recognize, however, that the audit firm would be precluded from serving subsequently as an expert witness in such circumstances. Audit committees should therefore consider the use of forensic professionals who are not affiliated with the audit firm, since they would not be subject to such constraints. If fraud is discovered and an investigation is necessary, the entity's general counsel or an outside law firm should be engaged to determine how best to proceed with the investigation. In addition, if CPA forensic accountants are engaged by the entity's general counsel, rather than the audit committee, they may attain attorney-client privilege status potentially, which is not otherwise available under normal circumstances.

Conclusion

Reactions to recent corporate and not-for-profit scandals have led the public and stakeholders to expect government entities to take a "no fraud tolerance" attitude. Good governance principles demand that a government entity's governing body and oversight committees ensure overall high ethical behavior in the organization, regardless of its status as public, private, government, or not-for-profit; its relative size; or its industry. The governing body's role is critically important because major frauds have historically been perpetrated by senior management in collusion with other employees. Vigilant handling of fraud cases within a government entity sends a clear message to the public, stakeholders, and regulators about the governing body and management's attitude toward fraud risks and about the government entity's fraud risk tolerance. Audit committees are required to play a pivotal role in the prevention and deterrence of fraud, and to take appropriate action in the discovery of fraud. Independent public accountants, hired by audit committees, and internal auditors will continue to play an important part in the process. CPA forensic accounting consultants and certified fraud examiners (CFEs) have emerged as vital recognized allies. Qualified forensic accounting consultants have the education, training, and experience to provide additional assistance to audit committees so that they may carry out their fiduciary responsibilities more effectively in the fight against fraud.

Chapter 10

Whistleblower Policy: Complaint Reporting, Anti-retaliation Procedures, and Tracking Report*

Overview: Audit committees of many government entities ensure that an effective process is in place to report any complaints received by the entity, whether generated internally or externally, regarding violations or suspected violations of laws or organizational policies. Having a whistleblower policy in place is a compliance best practice. An effective whistleblower policy and process is part of strong organizational governance by providing a means to address unethical or illegal activities.

Federal agencies are covered by the Whistleblower Protection Act and the Whistleblower Protection Enhancement Act of 2012. For Federal agencies, these laws should be the foundation for creating a whistleblower program. State and local government entities may have similar laws or regulations that define their respective whistleblower programs.

Reasons for a Whistleblower Policy

A vigorous whistleblower policy and procedure is a government entity's key defense against management override. The audit committee can help create strong antifraud controls by encouraging the development of a culture in which employees view whistleblowing as a valuable contribution to a workplace of integrity and their success. Federal law prohibits retaliation against anyone "blowing the whistle" with respect to a violation of federal law or regulation. To be effective, the reporting mechanisms must demonstrate confidentiality so potential whistleblowers are assured that their concerns will be considered properly, and that they will not be subject to retribution. Successful whistleblowing and anti-retaliation procedures require strong leadership from the audit committee, the governing body, and management at all levels within the government entity.

The audit committee plays a vital part in assuring that employees are required to promptly report any known or suspected violations of policies and procedures, laws, rules, or regulations by which the entity is governed. The audit committee must also ensure that employees are confident in the investigation process and are protected from retaliation.

* Note: This tool is included for illustrative purposes only. It 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. It is provided with the understanding that the author and publisher are not engaged in rendering legal, accounting, or other professional service. If legal ad-vice or other expert assistance is required, the entity should seek out the services of a competent professional.

Whistleblower Complaint Reporting Common Practices Checklist

Purpose of this tool: This checklist may be used by the audit committee members when evaluating the design and operating effectiveness of the whistleblower complaint reporting process. These questions are written in a manner such that a "No" response indicates areas where additional thought or action is recommended for an effective program.

	Yes	No	Not sure	Comments
Policy Components				
1. Has the entity developed and effectively communicated a complaint reporting policy to employees and external service providers?	☐	☐	☐	
2. Does the policy describe the following: *a.* A statement of purpose and the nature of concerns within the policy's scope? Does the policy support and clarify how it differs from the entity's normal complaint procedures?	☐	☐	☐	
b. The parties involved in the receipt, handling, and disposition of complaints, including the audit committee?	☐	☐	☐	
c. The duty of all employees to promptly report any known or suspected violations?	☐	☐	☐	
d. The multiple channels for reporting a concern? Are these various methodologies clearly communicated?	☐	☐	☐	
e. The confidentiality safeguards that an individual who makes a report can expect?	☐	☐	☐	
f. The steps to follow to make an anonymous report, as well as the related handling procedures?	☐	☐	☐	
g. The definition of good faith, credible reporting? Does the policy address the handling of vague complaints received from an anonymous source?	☐	☐	☐	

	Yes	No	Not sure	Comments
Policy Components				
h. The steps used to receive, investigate, and track reported issues?	☐	☐	☐	
i. The retention requirement for complaints?	☐	☐	☐	
j. The statement that violations can be reported without fear of retaliation, the process to report retaliation, and the process the entity will use to investigate suspected retaliation?	☐	☐	☐	
k. Additional procedures if the violation is in regard to the leader of the entity (for example, the president, executive director, or head of the agency)?	☐	☐	☐	
l. Procedures that government body members should follow to make a complaint?	☐	☐	☐	
3. Is the policy widely publicized and periodically recommunicated so that all members of the governing body, employees, and volunteers who provide substantial services to the entity have awareness?	☐	☐	☐	
Procedural Components				
1. Is more than one communication channel available to employees, such as telephone, Web, or email? Do channels have sufficient ease of use and provide for confidentiality and anonymity?	☐	☐	☐	
2. Are the communication channels through which an issue must flow effective in ensuring that issues reach the audit committee for consistent evaluation?	☐	☐	☐	

(continued)

	Yes	No	Not sure	Comments
Procedural Components				
3. Is there a mechanism in place that assures automatic submission of any issue involving senior management, the board, or an audit committee member directly to the audit committee without filtering?	☐	☐	☐	
4. Are all employees aware of the primary persons to whom they should report a matter? In the event the primary persons are absent or included in the potential complaint activity, have alternative persons been delegated to resolve the complaint?	☐	☐	☐	
5. Is there a process that allows an individual to receive information about the disposition of his or her report at an appropriate level?	☐	☐	☐	
6. Are issues documented, tracked, investigated, and resolved in a timely manner?	☐	☐	☐	
7. Are all issues received through the whistleblower channels reported to the audit committee for discussion?	☐	☐	☐	
8. Is the documentation for all issues maintained per a retention policy?	☐	☐	☐	
9. Are internal audits performed regularly on the whistleblower program to assure the design and operating effectiveness of the defined protocols?	☐	☐	☐	
10. Are employees required to sign a form annually attesting to adherence to the whistleblower policy?	☐	☐	☐	
11. Are all reports disposed of prudently and are all those involved advised of final disposition?	☐	☐	☐	

Sample Procedures for Handling Complaints (Whistleblower Policy)

Purpose of this tool: This tool could be used by the audit committee and management to document policies, procedures, and confidentiality requirements that a person with a complaint should follow to report and for the entity to track complaints received to an appropriate resolution.

Statement of Purpose

The government entity strives to conduct all of its activities according to high ethical standards. Adherence to this goal is imperative. The audit committee of the government entity's governing body has adopted these procedures for handling complaints to assist the governing body in meeting its ethical and legal obligations.

Employee Complaints

Employees are required to report any known or suspected violation of the organization's policies and procedures, laws, rules, or regulations by which our government entity is governed. The government entity requires any employee to report any matter which he or she views as questionable. Generally, such concerns should be raised initially with a supervisor, the director of Human Resources or through the complaint hotline. However, if an employee is unsuccessful in resolving a concern through such channels or believes that the concern will not be adequately addressed through such channels, the employee should contact a member of the audit committee. The names, telephone numbers, and e-mail addresses of the current members of the audit committee are listed on our government entity's intranet.

Any employee who learns of or is asked to participate in potentially non-compliant activities must report the matter immediately to his or her supervisor or to the director of Human Resources. If the potential non-compliant activity involves the supervisor and/or the director of Human Resources, the information should be reported to the general counsel or the complaint hotline. Complaints involving the chief executive officer, chief operating officer, chief financial officer, or general counsel should be made directly to the audit committee or the complaint hotline. Governing body members should also report any non-compliant activity directly to the audit committee.

Employees may submit their complaints in writing to the director of Human Resources. Given the sensitivity of such matters, we request that you label the correspondence "Confidential." Employees may submit concerns on a confidential, anonymous basis. If an employee does not want to be identified with the submission, he or she should not include his or her name in the correspondence, but, instead, indicate prominently on the submission that it is a "Confidential, Anonymous Employee Submission."

Employees may report their complaints confidentially to the complaint hotline. The complaint hotline number is XXX-XXX-XXXX. The complaint hotline telephone number shall be visibly posted in a manner consistent with employee notifications in locations frequented by the organization's employees. Employees may make reports anonymously. No caller will be required to disclose his or her identity, and no attempt will be made to trace the source of the call or the identity of the caller when the caller requests anonymity. If the call is anonymous, the caller should leave sufficient information that the complaint may be fully investigated.

If a caller has revealed his or her identity, confidentiality will be maintained to the extent practicable by law. Callers should be aware, however, that it may not be possible to preserve anonymity if they identify themselves, provide other information which identifies them, the investigation reveals their identity, or they inform people that they have called the complaint hotline. Callers should also be aware that under certain circumstances the organization is legally required to report certain types of crimes or potential crimes and infractions to external governmental agencies.

Governing Body Complaints

Any governing body member who has a concern regarding what he or she views as questionable should bring these concerns to the attention of the audit committee.

A governing body member serving on the audit committee should contact the audit committee chair immediately and raise any such concerns so they can be discussed no later than at the first audit committee meeting held after he or she becomes concerned. It may also be prudent to convene a special meeting of the audit committee to discuss these concerns.

Processing, Tracking, and Investigating Complaints

The person who receives a report of a suspected violation shall document the complaint noting name and position of person providing the information (if provided), date reported, and brief description of the issue. This information should then be forwarded to the director of Human Resources or the appropriate channels. If the potential complaint involves the director of Human Resources or if the director of Human Resources is unavailable, the information should be reported to the general counsel. Any complaints related to the chief executive officer, chief operating officer, chief financial officer, general counsel, or a board member should be reported without delay to the chair of the audit committee.

The person receiving the complaint will assign the complaint a tracking number, log the complaint into the complaint tracking report, and immediately begin an investigation. The investigator will appropriately document the complaint, the investigation, and the resolution. A written report summarizing all of the complaints reported, investigatory findings, and any corrective actions taken will be presented to the audit committee semi-annually.

Retention of Complaints

Each investigator will maintain the complaint log and maintain a file of materials related to complaints on behalf of the organization. These materials will be retained for a period of five years, or for a longer period if required by law.

Non-Retaliation/Non-Retribution

The government body will not tolerate any form of retaliation against any employee (1) who submits a good faith complaint or (2) who assists in an investigation of challenged practices.

All employees of the government entity are strictly prohibited from engaging in any act or conduct of behavior which results in, or is intended to result in, retaliation or retribution against any employee for reporting his or her concerns relating to a possible violation.

If an employee believes in good faith that he or she has been retaliated against for initiating a report or complaint or for participating in any investigation related to such report or complaint, then the employee should report the retaliation to his or her supervisor, the director of Human Resources or the organization's complaint hotline as soon as possible. The report should provide a thorough account of the incident(s) and should include names, dates of specific events, the names of any witnesses, and the location or name of any document in support of the alleged retaliation.

A thorough investigation will be conducted. Adverse actions in retaliation for an employee's report or complaint may result in discipline, up to and including termination, of the person or persons performing such actions.

Distribution of Whistleblower Policy

A copy of this policy will be distributed annually to all board members, employees and volunteers who provide substantial services to the organization. In addition, the policy and complaint hotline telephone number shall be posted visibly in a manner consistent with employee notifications in locations frequented by employees. A description of the Whistleblower Policy and Procedures is contained on our website at [*insert URL*].

Compliance With the Government Entity's Whistleblower Policy

All employees will be required to annually sign a form attesting to, among other things, adherence to the organization's Whistleblower Policy. A periodic audit will be conducted to ensure adherence to and effectiveness of this policy.

Instructions for using this tool: Before using this tool, the entity or audit committee should review any applicable federal, state, or local laws and regulations, as well as the appropriate rules promulgated by other relevant regulatory bodies, if any.

Sample Tracking Report						
Date Submitted	Tracking Number	Description of Complaint	Submitted By*	Current Status**	Actions Taken	
					Date	Comments

* Submitted By Codes: Employee (E); Vendor (V); Governing Body Member (B); Grantee (G); Other (O)

** Current Status Codes: R—Resolved; UI—Under Investigation; D—Dismissed; W—Withdrawn; P—Pending/No Action

Chapter 11

Issues Report From Management

Overview: The sample report in this chapter is to be used by management when considering significant issues, estimates, and judgments that may have a material effect on the government entity's financial statements, among other concerns. Management should be encouraged to use this tool as a means to document any significant issues, judgments, and estimates for discussion with the audit committee. Each matter should be prepared as a separate issues report. Statements should be clear and concise. Some issues may carry over to subsequent meetings, in which case, any updated information should be included in bold.

In many cases, management will communicate with the audit committee regarding the government entity's accounting policies, practices and estimates; and the independent auditor participates in the discussion and confirms that management has adequately communicated the required matters.

Defining Significant Issues, Critical Accounting Estimates, Significant Unusual Transactions, and Judgments

As a first step to any discussion of this nature, it is important for the audit committee to define its threshold for significant issues, critical accounting estimates, significant unusual transactions, and judgments.[1] A significant issue, critical accounting estimate, significant unusual transaction, or judgment is one that

1. creates controversy among members of the management team, or between management and the internal or independent auditor, or where there is a lack of authoritative guidance or consensus in practice;
2. has or will have a material effect on the financial statements, such as a critical accounting estimate or significant unusual transaction;
3. is or will be a matter of public interest or exposure;
4. must be reported in an upcoming filing with an external body, and management is unclear or undecided on its presentation (this may include the annual report;[2] federal, state, or local filings; and any bond filings);
5. results from the application of 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 government entity. 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;

[1] The audit committee's threshold is separate from management or the independent auditor's materiality threshold for uncorrected misstatements although these thresholds should be taken into account (for example, when reviewing the management representation and legal representation letters) when the audit committee defines its own.

[2] For state and local government entities, this is the Comprehensive Annual Financial Report or CAFR. For federal entities, this is an Agency Financial Report (AFR) or Performance and Accountability Report (PAR).

6. applies to the initial selection or changes to significant accounting policies or application of such policies in the current period;
7. relates to the application of a standard in a way that is not consistent with general practice;
8. relates to key controls over financial information that are being designed, redesigned, have failed, or otherwise are being addressed by the entity;
9. is used for consultation with other accountants;
10. corrects or accepts uncorrected misstatements.

The audit committee needs to be proactive and consistent in its inquiries regarding significant issues, critical accounting estimates, significant unusual transactions, 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 these matters should contain the following elements for a proper basis of discussion by the audit committee:

1. *Definition of Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.* In this section of the issues report, management should define and summarize the issue as concisely and clearly as possible.
2. *Management's Position.* This section should address management's position on the issue. If there is disagreement among members of management, those disagreements should be identified as explicitly as possible, with brief explanations of why each member of the management team has taken his or her respective position.
3. *Relevant Literature.* Any professional literature or regulatory requirements addressing this issue should be cited. If no professional literature is available, it would be appropriate to define industry practice. If this is a developing area, and there is neither accepted industry practice nor other sources to support and refute these positions, this fact should be reported. If there was a choice on the accounting treatment, it should be disclosed here, along with a discussion of how the choices of treatment were compared and the basis on which the final choice was made.
4. *Risks.* Management should identify and evaluate various risks (opportunities and threats) associated with this proposal.
5. *Regulatory Disclosure* (if applicable). Management must inform the audit committee about how it intends to address this issue in required filings with regulatory bodies as required by law (for example, insurance commissions, banking authorities, or others).
6. *Auditor's Position.* Has management consulted with the independent auditor on this issue? Does he or she agree with management's position? Has he or she addressed the audit issues that might be associated with it? If so, use this section of the issues report to discuss the independent auditor's position. If not, use this section to state explicitly that the auditor has not been consulted.

7. *Other Information Relating to This Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment*. Management should use this section of the issues report to highlight other related and relevant information that is not already included in the sections above.

Sample Issues Report From Management

1. *Define the Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.* In the government entity's 2013 financial statements, a $500,000 contribution from a donor was reported in temporarily restricted net assets. No amounts were shown as released from restrictions during 2013. During 2014, the client determined that it should have released $200,000 from restrictions in 2013. Does a restatement for a change in classification of net assets require a restatement of the 2013 financial statements?
2. *Management's Position.* Management is willing to restate the 2013 financial statements if required by GAAP.
3. *Relevant Literature.* Governmental Accounting Standards Board (GASB) Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements (December 2010)*.
4. *Risks.* Users of the 2013 financial statements relied on financial statements that understated unrestricted net assets and overstated temporarily restricted net assets.
5. *Regulatory Disclosure.* This issue is generally not applicable.
6. *Auditor's Position.* According to GASB Statement No. 62, "A correction of an error in previously issued financial statements should be accounted for and reported as a prior-period adjustment and excluded from the change in net assets section of the flows statement for the current period." (Paragraph 60) "When comparative statements are presented, corresponding adjustments should be made of the amounts reported in the flows statement and the statement of net assets for all of the periods reported therein to reflect the retroactive application of the prior-period adjustments." (Paragraph 61) "When prior-period adjustments are recorded, the resulting effects on the change in net assets of prior periods should be disclosed in the notes to the financial statements in the period in which the adjustments are made. … When financial statements for more than one period are presented, the disclosure should include the effects for each of the periods included in the statements." (Paragraph 62)
7. *Other Information Relating to This Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.* The auditor determined the $200,000 was a material amount and concluded a restatement and disclosure were appropriate for the correction.

Issues Report From Management

1. *Define the Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.*

2. *Management's Position.*

3. *Relevant Literature.*

4. *Risks.*

5. *Regulatory Disclosure.*

6. *Auditor's Position.*

7. *Other Information Relating to This Significant Issue, Critical Accounting Estimate, Significant Unusual Transaction, or Judgment.*

Chapter 12

Guidelines and Questions for Conducting an Audit Committee Executive Session

Overview: It is generally accepted practice that audit committees should hold executive sessions with senior management, the CFO or equivalent of the financial management team, the Chief Audit Executive (CAE) or equivalent of the internal audit team,[1] and the partner, inspector general, independent government auditor, or equivalent independent auditor. The "Additional Questions to Consider" tool at the end of this chapter is designed to provide guidance as to the amplitude of the questions that should be asked. It is intended to assist the audit committee in asking the right *first* questions, with the understanding that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up question(s). The tool also contains 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 as well as the management teams' decision-making processes and interactions.

What Is an Executive Session?

An executive session is a best practice employed by audit committees for many reasons. Here, we are advocating that the executive session be used to meet with key members of the executive management and financial management teams on a one-on-one basis. Typically within most government entities, there is a focus on transparency. As such, it is important that the individual facilitating audit committee meeting consults legal counsel to understand applicable laws that govern these types of meetings (e.g., open meeting laws, freedom of information, etc.).

Executive sessions should occur at every audit committee meeting, though not everyone needs to be in an executive session at every meeting. For example, it is appropriate for the CAE and the independent auditor to have an executive session at every meeting, but the CFO might be in executive session with the audit committee only at the meeting before year-end results are released.

During an executive session meeting, minutes are usually not recorded, and when meeting with specific members of the financial management 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 staff in a safe environment. Executive sessions should be routine at every audit committee meeting, rather than an exception. In an open session, the audit committee should avoid asking whether an individual has anything to discuss in an executive session; that question alone could place the individual in an awkward position with others in the government entity and may

[1] The audit function, including internal audit, may also be performed by an Office of Inspector General (OIG) or similar entity in accordance with the statute that created the audit organization.

deter the purpose of the executive sessions. Questions for an executive session are designed to promote "safety" within an executive session and are based on areas that the discussants may not feel free to answer honestly in an open environment. In addition, there may be other information that the audit committee wants to know.

Asking open-ended questions in this kind of environment could be a major source of information for the audit committee. This tool includes examples of the types and depth 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 all-inclusive.*** Audit committee members must have the expertise not only to understand the answers to the questions, but also to use these answers to develop appropriate follow-up questions. It will not be unusual to ask similar questions of key executives, the independent auditor, or the CAE, as a comparison of their respective responses is 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 you do not understand!*

Audit committee members should also consider the history of the government entity, the industry in which it operates, the current economic and political climate, and other factors when asking questions during the open audit committee meeting and in an executive session. Finally, the audit committee should remind management that its members are accessible even outside the meeting, and that he or she should feel free to contact the audit committee members at other times if the need arises.

It is important to note that not every organization 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. The audit committee should explore how a function or role is accomplished, and compose questions appropriately. Also, the audit committee should consider and take into account other roles in the government entity. It may be that other people within a government entity should be asked to meet with the audit committee in an executive session.

Additional Questions to Consider: Tool for Audit Committee Members

Purpose of this tool: As a part of fulfilling your responsibilities as an audit committee member, this tool is intended to help you consider the types of questions you should be asking management during audit committee meetings or executive sessions. Your audit committee should be made up of members who have the expertise to evaluate the answers and the insight to identify the appropriate follow-up question. Also, the performance evaluations section has additional evaluation questions concerning the performance of the internal audit function, independent auditor role, and audit committee.

Note: There are four categories of questions (Fraud/Ethics, Internal Environment, Independent Auditor, Financial Statements) and varied positions of whom you might ask the same question (Government Entity Head, CFO, CAE, general counsel, CIO, and independent auditor role).

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions										
		Position								
Question	**Concept**	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	**Comments**
1. Do you believe the financial statements present the government entity's financial position fairly?	Financial Statements	X	X	X		X		X	
2. Has the government entity solicited or received advice from or given advice to any outside party on how to structure any transaction to produce a desired financial statement effect? If so, please provide details.	Financial Statements	X	X	X	X	X		X	
3. Do you believe the disclosures are adequate and that the average user of the financial statements will understand them?	Financial Statements	X	X	X		X			
4. Are you satisfied that an appropriate audit was performed by the independent auditor?	Independent Auditor	X	X	X		X	X		
5. Are you aware of any situations in which the government entity's accounting practices were manipulated?	Fraud/Ethics	X	X	X	X	X			

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
6. Are you aware of any current or past fraud occurrence or any kind of fraud in the government entity? Do you know of any situations in which fraud could occur?	Fraud/Ethics	X	X	X	X	X	X	X	
7. Have you encountered any situations in which the government entity complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	Fraud/Ethics	X	X	X	X	X	X	X	
8. Do you feel comfortable raising issues without fear of retribution?	Fraud/Ethics	X	X	X	X	X	X	X	
9. Are you aware of any disagreements between the government entity's management team and the independent auditor?	Independent Auditor	X	X	X	X	X	X	X	
10. Are you aware of any disagreements between the government entity's management team and the internal auditor?	Internal Environment	X	X	X	X	X	X	X	

(continued)

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
11. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, professional practice, or the mores of business?	Fraud/Ethics	X	X	X	X	X	X	X	
12. Are there any questions we have not asked that we should have asked? If so, what are those questions?	Misc.	X	X	X	X	X	X	X	
13. Overall, is management cooperating with the internal auditor? Does management have a positive attitude in responding to findings and recommendations, or is it insecure and defensive of findings?	Internal Environment	X	X	X	X	X	X	X	
14. 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?	Internal Environment	X	X	X	X	X	X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
15. Discuss areas in which there is an accounting treatment that could be construed as aggressive.	Financial Statements	X	X	X		X		X	
16. Do you have the freedom to conduct audits as necessary throughout the government entity?	Internal Environment			X				X	
17. Were you restricted or denied access to requested information?	Internal Environment			X	X			X	
18. 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 satisfy any issues raised to your satisfaction?	Fraud/Ethics			X				X	
19. Are you aware of any disagreements between the governmental entity's management and the independent auditor?	Independent Auditor		X	X		X		X	

(continued)

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
20. Are there any issues since our last meeting that you wish to discuss with the audit committee?	Misc.	X	X	X	X	X	X	X	
21. Do you believe the financial statements and related disclosures convey the government entity's financial situation adequately to the governing body and the public?	Financial Statements		X	X	X	X		X	
22. Now that you have the opportunity, is there anything you want to tell the audit committee? Is there anything else that we need to know?	General	X	X	X	X	X	X		
23. Are you satisfied with the presentation of information about the government entity in its financial statements?	Financial Statements	X	X	X	X			X	
24. Are you aware of any issues that could cause embarrassment to the government entity?	Internal Environment	X	X	X	X	X	X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
25. Is there any activity in the government entity with which you are uncomfortable, consider unusual, or that you believe warrants further investigation?	Internal Environment	X	X	X	X	X	X	X	
26. For independent auditors from CPA firms, explain the process the independent auditor uses to assure that all of your engagement personnel are independent and objective with respect to our audit. Particularly, with respect to non-audit 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 independent audit organization or any member of the engagement team? Note: this question is not applicable to offices of inspector general or other government auditors.	Independent Auditor							X	

(continued)

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions

Question	Concept	Position: Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
27. Have management, legal counsel, or others made you aware of anything that could be considered a violation of laws, regulations, GAAP, professional practice, or the ethics of business?	Independent Auditor	X	X	X	X			X	
28. Are there any areas of the financial statements, including the notes, which you believe could be more explicit or transparent, or provide more clarity to help a user understand the financial statements?	Independent Auditor		X	X	X			X	
29. Have you expressed any concerns or offered comments to management with respect to how our presentation, including the notes or Management's Discussion and Analysis could be improved?	Independent Auditor							X	
30. Which accounting policies or significant business transactions do you think a stakeholder will have trouble understanding based on our disclosure? What additional information should we provide?	Independent Auditor							X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
31. Based on your auditing procedures, do you have any concerns that management may be attempting to manage cash flows, either properly or improperly? Have you noticed any biases as a result of your audit tests with respect to estimates?	Independent Auditor							X	
32. In which areas have you and management disagreed?	Independent Auditor		X					X	
33. Discuss your impressions of the performance of the CAE in terms of the completeness, accuracy, and faithfulness of the financial reporting process.	Independent Auditor							X	
34. Has the audit organization been engaged to provide any services besides the independent audit of which the audit committee is not already aware?	Independent Auditor		X					X	
35. How can management improve in terms of setting an appropriate tone at the top?	Independent Auditor							X	

(continued)

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions

Question	Concept	Position: Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
36. Describe the ideas you have discussed with management for improving internal control over financial reporting.	Independent Auditor		X					X	
37. Describe any situation in which you believe management has attempted to circumvent the spirit of GAAP, though it has complied with GAAP.	Independent Auditor		X					X	
38. Is there anything going on in the government entity with which you are uncomfortable, that you consider unusual, or that warrants further investigation?	Independent Auditor	X	X	X	X	X	X	X	
39. Describe your working relationship with the Government Entity Head.	Internal Environment		X	X	X		X		
40. If you were the partner, federal inspector general, other independent government auditor, or equivalent, what would you do differently?	Internal Environment	X	X	X	X	X	X		

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
41. How do you interface with the internal audit, and do you believe it is successful?	Internal Environment	X	X		X		X		
42. Has the independent auditor been engaged for any services other than the annual audit of the financial statements for which the audit committee is not already aware?	Independent Auditor	X	X	X	X	X	X		
43. What issues arose from any internal control documentation and validation efforts?	Internal Environment	X	X	X			X		
44. What aspects of the business put the most strain on the government entity's liquidity? On the government entity's capital position?	Financial Statements		X			X			
45. Which systems are the most difficult to use?	Internal Environment	X	X	X	X	X	X		
46. Are there any new systems or functionality that you would like to purchase but have delayed due to cost considerations?	Internal Environment	X	X	X	X	X	X		

(continued)

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
47. What procedures or oversight are applied to manual journal entries that are proposed during the closing process?	Financial Statements		X			X			
48. Do the accounting and finance departments of the government entity have adequate personnel, both in numbers and quality, to meet all their obligations?	Internal Environment		X			X			
49. What are the most difficult challenges facing the finance organization today?	Internal Environment		X			X			
50. Which departments might benefit the most from additional personnel?	Internal Environment	X	X	X	X	X	X		
51. What were the personnel turnover rates in the accounting and finance teams for the last year?	Internal Environment		X			X			
52. Which of the government entity's areas of operations had the biggest unplanned loss this past year? The biggest gain? What, if any, changes do you believe need to be made in these areas?	Financial Statements	X	X	X	X	X		X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	**Concept**	**Government Entity Head**	**CFO**	**CAE**	**General Counsel**	**Controller**	**CIO**	**Independent Auditor Role**	**Comments**
53. Describe your working relationship with the heads of the respective business units.	Internal Environment	X	X	X	X	X	X	X	
54. What are the biggest risks facing the government entity in the next year? What steps do you think the entity should take to address those risks?	Internal Environment	X	X	X	X	X	X	X	
55. What are the biggest risks facing the government entity over the long term? What measures do you believe the entity should take to address those risks?	Internal Environment	X	X	X	X	X	X	X	
56. In light of the fact that you certified to your review of the financial statements that the financial statements do not contain any untrue statement of material fact or omit material facts, that they present fairly the results of operations, and that you take responsibility for the design of the internal control	Financial Statements	X	X			X			

(continued)

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions

Question	Concept	Position: Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
56. (continued) system, and have evaluated the effectiveness of the internal control system, what were your areas of concern? Are you satisfied that those areas have been resolved?									
57. What procedures are applied to the review of manual journal entries made during the closing process, and to other entries that could be termed as a management override of the internal control over financial reporting?	Financial Statements		X			X		X	
58. If you were the Government Entity Head, how would you do things differently in the internal audit department?	Internal Environment			X				X	
59. Do you believe you have adequate resources available to you to fulfill the charge of the department? If not, what additional resources are needed?	Internal Environment			X					

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
60. Did you encounter any disagreements or difficulties between the internal audit function and the independent auditor in connection with the recently completed audit of the government entity's financial statements? How will you approach the financial statement audit differently next year?	Internal Environment			X				X	
61. What critical risks are being monitored by the internal audit function on a periodic or regular basis? How do you address the continuous auditing of these critical risks, and are automation and integrated system reporting assisting you in this effort?	Internal Environment			X					
62. Are you aware of any disagreements between the internal audit function and management?	Internal Environment	X	X	X	X	X	X	X	
63. What issues arose from any control documentation and validation efforts?	Financial Statements	X	X	X	X	X	X	X	

(continued)

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
64. Are the information technology systems upon which you rely integrated, or is manual intervention required to integrate your systems?	Internal Environment		X			X	X	X	
65. What is your assessment of your performance?	Internal Environment	X	X	X	X	X	X	X	
66. What is your assessment of the CAE's performance?	Internal Environment	X	X		X	X	X	X	
67. How could the financial statements and related disclosures be improved?	Financial Statements	X	X	X	X	X		X	
68. Are you satisfied with the integrity of the information running through the systems in the government entity? How could technology improve the integrity of the information?	Internal Environment	X	X	X	X	X	X	X	
69. From what exposure does the government entity's firewall protect the entity's sensitive data?	Internal Environment	X		X	X		X	X	

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions									
		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
70. If you had an unlimited budget, how would you spend funds to improve the government entity's internal controls including information architecture?	Internal Environment	X	X	X	X	X	X	X	
71. What do you consider your critical risk areas?	Internal Environment	X	X	X	X	X	X		
72. Describe your relationship with the Government Entity Head, CFO, and other key people in the accounting and finance teams.	Internal Environment	X	X	X	X	X	X	X	
73. Are manual journal entries identified and approved? Are they somehow brought to the attention of the CAE or other officers who did not participate in creating the journal entries?	Financial Statements		X	X		X		X	
74. Is documentation updated every time there is a change to the internal controls process?	Internal Environment		X	X		X	X		
75. What role, if any, did your firm (OIG or similar government auditor) have in management's documentation and assessment of the government entity's internal control structure?	Independent Auditor							X	

(continued)

Sample Questions to Ask During Audit Committee Meetings or Executive Sessions

		Position							
Question	Concept	Government Entity Head	CFO	CAE	General Counsel	Controller	CIO	Independent Auditor Role	Comments
76. What audit procedures are applied to manual journal entries that are proposed during the closing process, or to other journal entries that could be termed as management overrides of the internal control system around financial reporting?	Independent Auditor							X	
77. Was any audit work not performed due to any limitations placed on you by management, such as any areas scoped out by management, or any restriction on fees that limited the scope of your work?	Independent Auditor			X				X	
78. Was the audit fee (if applicable) that you charged the government entity sufficient for the work that you performed?	Independent Auditor							X	
79. If you had had an unlimited audit fee, what additional work would you have performed?	Independent Auditor	X	X	X	X	X	X	X	

Chapter 13

Independent Auditor Communications with Audit Committee

Overview: The audit committee's responsibility to oversee the government entity's financial reporting and disclosures is increasingly challenging as the requirements and complexity of accounting standards continue to grow. This chapter is designed to help the audit committee fulfill its responsibilities with respect to oversight of the entity's accounting and financial reporting, as well as oversight of the independent auditor (CPA firm or independent government audit organization), by addressing key required communications between independent auditors and audit committees. Clear communication among the audit committee, management, and the independent auditor (auditor) are essential to the effective discharge of these responsibilities. The required communications are based on AICPA auditing standards and generally accepted government auditing standards (GAGAS), and are intended to enhance the relevance, timeliness, and quality of communications between the auditor and the audit committee, and to foster constructive dialogue and enhanced understanding about significant audit and financial statement matters. While the communications addressed in this chapter are described as those between the audit committee and the independent auditor, part or all of the communication could be with the chair of the audit committee, the governing body, or others in the government entity who meet the description of "those charged with governance."

Background

The Sarbanes Oxley Act of 2002 (the Act) contained a number of reforms intended to improve the integrity of accounting and financial disclosure. Although the Act applies to public companies, it led to changes in auditing standards for required communications between the auditor and the audit committee (or those charged with corporate governance) related to all financial statement audits regardless of industry. When those charged with governance are also involved in managing the entity, as is often the case with smaller entities, the auditor must consider whether communication with management, and especially management with financial reporting responsibilities, adequately informs those charged with governance. Therefore, the audit committee must ensure they have reached an understanding with the auditor about the appropriate levels of communication under those circumstances. Items noted herein as PCAOB or SEC requirements may be considered best practices although not required for government entities.

Objectives of Communications

The following sections summarize matters that may be communicated related to the audit of the government entity's financial statements and are not meant to describe all topics that the auditor is communicating to the audit committee, only the minimum required communication. Broadly speaking, the required communications[1] cover the following four objectives and other significant communications for the auditor's communications with the audit committee:

1 AU-C section 260, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*).

1. Communicate the auditor's responsibilities and establish terms of the firm's audit engagement
2. Inquire of the audit committee about matters relevant to the audit
3. Communicate audit strategy, scope, timing, and approach, including accounting policies, practices and estimates
4. Provide timely observations that are significant to the financial reporting process, including the independent auditor's evaluation of the quality of the entity's financial reporting

Timing of Communications

Audit committee communications should be made in a timely manner and prior to the issuance of the independent auditor's report. The appropriate timing of a particular communication to the audit committee depends on factors such as the significance of the matters to be communicated and corrective or follow-up action needed. Many, however, consider it a "best practice" to also have the audit committee meet with the auditors during the audit planning process. Communications may be made to only the audit committee chair if doing so helps with timeliness; however, all such matters should be communicated to the audit committee prior to the issuance of the auditor's report. Although this section focuses primarily on communications by the auditor, communications among management, the auditor, and the audit committee are important in assisting the committee fulfill its responsibility to oversee the financial statement process and other matters of governance interest. Communications by the auditor do not relieve management of this responsibility.

1. Terms of the Independent Auditor's Audit Engagement

Terms of the audit and engagement letter. The independent audit organization must establish an understanding of the terms of the engagement with the audit committee, and, in an engagement letter must include the objectives of the audit, the responsibilities of the auditor, and the responsibilities of management. It is important for the audit committee to understand the purpose of the audit and its limitations, and the auditor's engagement terms should clearly describe the auditor's responsibilities under general accepted auditing standards or generally accepted government auditing standards. It is important to inform the audit committee that the external audit is not a substitute for a robust internal audit department or function, and does not relieve management of their duty to design and maintain adequate internal control. Consideration should be given to having the audit committee chair sign the engagement letter after committee approval.

Discussions with management in connection with appointment or retention. The auditors must discuss with the audit committee any significant issues that the audit firm discussed with management in connection with the independent auditor's appointment or retention, including any significant discussions regarding the application of accounting principles and auditing standards.

Independence. Generally accepted auditing standards require independence for all audits. Although the auditor's report affirms the auditor's independence, the auditor should communicate to the audit committee circumstances such as financial interests, business or family relationships, or nonaudit services provided that, in the auditor's judgment, may be thought to bear on independence and that the auditor considered in reaching the conclusion that independence has not been impaired. Many government entities require audit committee approval prior to engagement of the independent auditor for any additional audit fees or for non-audit related services to ensure the committee is fully aware of any additional fees or services provided by any sector of the independent auditors (for example, information technology consulting).

2. Inquiries About Matters Relevant to the Audit

The independent auditor must ask the audit committee whether it is aware of matters relevant to the audit. including, but not limited to, violations or possible violations of laws or regulations or risks of material misstatement, including inquiries related to fraud risk. Although not required, an independent auditor may choose to seek a representation letter from the audit committee addressing such matters.

The auditor may also discuss with the audit committee his or her view about roles and responsibilities between those charged with governance and management, how those charged with governance oversee the effectiveness of internal control and the detection or possibility of fraud, significant communications with regulators, or other matters deemed relevant to the audit of the financial statements.

PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (AICPA, *PCAOB Standards and Related Rules*), requires the audit firm to make specific inquiries of the audit committee, management, internal audit, and others within the entity regarding their views of fraud risks within the entity. The specific required inquiries of the audit committee include the committee's views about fraud risks in the entity; whether the audit committee has knowledge of fraud, alleged fraud, or suspected fraud affecting the entity; whether the audit committee is aware of tips or complaints regarding the entity's financial reporting (including those received through the internal whistleblower program, if such a program exists), and if so, the audit committee's responses to such tips and complaints; and how the audit committee exercises oversight of the entity's assessment of fraud risks and the establishment of controls to address fraud risks.

3. Audit Strategy, Timing, and Approach

Communicating the Audit Strategy and Timing. As part of communicating overall audit strategy, the auditor must specifically communicate the timing of the audit, discuss significant risks identified during risk assessment procedures, and, if applicable, discuss the following:

- The nature and extent of specialized skills or knowledge required to perform procedures or evaluate results related to significant risks
- The approach for internal control relevant to the audit including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting
- If applicable, the extent to which the independent external auditor will rely on the government entity's internal auditors or other parties in connection with the audit

- The names and responsibilities of others not employed by the independent auditor who performs audit procedures
- The basis for the auditor's determination that it can serve as the principal auditor, if significant parts of the audit are performed by other auditors
- The concept of materiality in planning and executing the audit
- Confirmation of the appropriate person or people in the entity's governance structure with whom to communicate

Critical Accounting Policies and Practices. The auditor must inform the audit committee of all critical accounting policies and how they are applied in the entity. Critical accounting policies are those that are both most important to the portrayal of the entity's financial condition and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain. The audit committee should expect the following communications:

- All critical accounting policies, including those that applied for the first time during the year, changes in accounting policies, or accounting practices that are not specifically addressed in the accounting literature, for example, those that may be unique to a specific industry
- The reason certain policies and practices are considered critical
- How those accounting policies are applied in the entity
- Policies and practices the entity used to account for significant unusual transactions
- The effect on the financial statements or disclosures of critical accounting policies in controversial or emerging areas for which there is lack of authoritative guidance or consensus, or diversity in practice, such as revenue recognition, multi-year pledges, reserves, planned giving gifts, and alternative investments
- Whether these critical policies are included in the financial statements

Critical Accounting Estimates. Critical 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.

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

a. The process used by management to develop critical accounting estimates

b. Management's significant assumptions in developing critical accounting estimates that have a high degree of subjectivity

c. For any significant changes to (*a*) or (*b*), a description of management's reasons for the changes and the effects of the changes on the financial statements

d. The basis for the auditor's conclusion about the reasonableness of those estimates

In many cases, management will communicate with the audit committee regarding the entity's accounting policies, practices, and estimates. The independent auditor participates in the discussion and confirms that management has communicated the required matters adequately.

4. Evaluation of the Quality of the Government Entity's Financial Reporting

The auditor must communicate judgments about the quality, not only factual information and conclusions regarding the acceptability of the government entity's accounting policies and practices. The communication should be tailored to the entity's specific circumstances and include evaluation of the following:

- **Significant Accounting Policies and Practices**: Auditor's conclusions about the qualitative aspects, including the auditor's assessment of management's disclosures. Communication must include any situation in which the auditor identified bias in management's judgments about the amounts or disclosures, and evaluation of differences between estimates supported by audit evidence and estimates included in the financial statements.
- **Critical Accounting Estimates**: The basis for auditor's conclusions regarding estimates, judgments and uncertainties underlying financial statements and conclusions.
- **Significant Unusual Transactions**: The auditor's understanding of the business rationale for significant unusual transactions.
- **Financial Statement Presentation**: Evaluation of whether presentation of financial statements and disclosures are in conformity with the applicable financial reporting framework (in other words, FASAB or GASB).
- **New Accounting Pronouncements**: If applicable, any concern regarding significant effects on future financial reporting related to management's anticipated application of accounting pronouncements that have been issued but are not yet effective.
- **Alternative Accounting Treatments**: Permissible alternative accounting treatments related to material items, ramifications thereof, and the treatment preferred by the auditor.

5. Other Significant Communications

In addition to communications about the quality of financial reporting noted in Section 4, the auditor must communicate, when relevant, the following regarding the audit process and results.

Responsibility for Other Information. 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 may accompany the entity's financial statements is not necessarily included in the scope of the auditing procedures. The auditor should communicate his or her responsibility for such information, and the results of any related procedures performed.

Matters for Which the Auditor Consulted. The auditor should communicate any difficult or contentious matters for which the auditor consulted outside the engagement team, which may include the independent auditor organization's national office, industry specialists, or an external party.

Matters for Which Management Consulted. Sometimes, management of the entity may consult with other independent accountants about significant accounting or auditing matters. If the auditor is aware that such consultation has occurred, the auditor should discuss with the audit committee his or her views about the significant matters that were the subject of the consultation.

Material Written Communications. The auditor should notify the audit committee of other material communications with management, such as the management letter, schedule of unadjusted differences, and written representations the auditor is requesting from management.

Uncorrected and Corrected Misstatements. The auditor should inform the audit committee about all corrected and uncorrected misstatements arising from the audit that could, in the auditor's judgment, have a significant effect on the entity's financial reporting process. The audit engagement team tracks proposed adjustments during the audit, except for those that are clearly trivial, for discussion with management. Management evaluates those proposed adjustments and determines whether or not to record the adjustments.

The auditor's communications should

- inform the audit committee about adjustments arising from the audit that could have a significant effect, either individually or in the aggregate, on the entity's financial reporting process;
- address whether or not the proposed adjustments were recorded, and the implications of any misstatements on the entity's financial reporting process;
- address whether the adjustments to accounts and disclosures may not have been detected except through the auditing procedures performed (meaning that the entity's own internal control system did not detect the need for the adjustment); and
- provide the schedule of uncorrected misstatements related to both accounts and disclosures, and support for the determination that the uncorrected adjustments were immaterial, including qualitative factors.

Departure from the Auditor's Standard Report. The following matters related to modifications of the auditor's standard report should be communicated:

- The reasons for the modification and the wording of the report, if the auditor expects to modify the opinion in the auditor's report
- The reason for and the wording of the explanatory language if the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report

Disagreements With Management. Disagreements may arise between the 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 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.

The auditors should communicate any disagreements with management, whether or not satisfactorily resolved, about matters that could be significant, individually or in the aggregate, to the government entity's financial statements or the auditor's report.

Difficulties Encountered in Performing the Audit. The auditor should inform the audit committee about any significant difficulties encountered in working with management and staff during the audit. Examples include, but are not limited to, an unreasonably brief time to complete the audit, delays or unavailability of needed personnel or information, or unexpected extensive effort required by the auditor to obtain sufficient audit evidence. These difficulties could represent a scope limitation that may result in a modified auditor's opinion, or the auditor's withdrawal from the engagement.

Going Concern. The auditor must communicate those conditions and events the independent auditor has identified that, when considered in the aggregate, lead the auditor to believe that there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, along with the basis for the conclusion. The auditor must also communicate the effects on the financial statements and on the auditor's report.

Other Matters. Any other matters arising from the audit that are significant to the oversight of the entity's financial reporting process should be communicated, including any complaints or concerns regarding accounting or auditing matters that have been conveyed to the audit firm.

Interim Reviews. The audit committee should expect communications from the auditor related to interim reviews to include

- an engagement letter communicating the terms of the engagement to review interim financial information.
- material weaknesses or significant deficiencies, if any, of which the auditor becomes aware.
- other significant matters impacting the interim financial information.
- a schedule of uncorrected misstatements, if any.

Illegal Acts

The 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? Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), defines it as "violations of laws or government regulations attributable to the entity, or acts by management or employees on behalf of the entity. Illegal acts do not include personal misconduct by the entity's personnel unrelated to their business activities."

When performing a GAGAS financial audit, the auditor should extend the AICPA requirements pertaining to the auditor's responsibilities for laws and regulations to also apply to compliance with provisions of contracts or grant agreements. Also, if the auditor becomes aware of abuse that could be material to the financial statements, auditors should apply audit procedures specifically directed to ascertain the potential effect on the financial statements. Auditors should discuss with the audit committee any insight into potential areas or transactions that could be considered regarding violations of contracts or grant agreements or abuse. The audit committee may also want to initiate a discussion about potential areas of abuse with the auditor during the engagement letter process. See paragraphs 4.07-4.09 of the *Government Auditing Standards* (the "Yellow Book") for more information about the additional obligations of auditors regarding the investigation of abuse.

Internal Control Matters

See also chapter 8, "Internal Control: Guidelines and Tool for the Audit Committee," in this toolkit, which defines key terms used in the assessment of internal controls.

The auditor may communicate in writing to management and the audit committee all significant deficiencies and material weaknesses observed relating to the government entity's internal control in 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 entity's ability to initiate, record, process, and report financial data consistent with the management's assertions in the financial statements.

The auditor must also communicate to management, in writing or orally, control deficiencies that are not significant. These may be communicated with other observations that may be of potential operational or administrative benefit, including recommendations for improving internal control. This is typically provided in the form of a management letter, or may be combined with required communications noted in the previous paragraph.

Management may be required by a regulator or grantor to prepare a written response to the auditor's communication regarding significant deficiencies or material weaknesses identified during the audit. These responses may include a description of corrective action to be taken, plans to implement new controls, or a statement indicating that management believes the cost of correcting the deficiency would exceed the benefits to be derived from doing so.

Fraud

See also chapter 9, "Fraud and the Responsibilities of the Audit Committee: An Overview," in this toolkit.

AU-C section 240, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), requires 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 independent auditor should reach an understanding with the audit committee regarding nature and scope when an inconsequential fraud committed 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 independent auditor. It is a best practice for the auditor to disclose any perceived fraud, illegal acts, violation of provisions of contracts or grant agreements, and potential abuse to the audit committee, regardless of materiality, to ensure management's commitment to a sound internal control environment.

Chapter 14

Responding to the Identification of a Material Weakness—A Checklist for the Audit Committee

Overview: The guidance in this chapter is designed to familiarize the audit committee of a government entity that has received a report on its internal control over financial reporting from its independent auditor that identifies a material weakness. The first half of the chapter summarizes the internal control evaluation requirements; the second half includes steps the audit committee should take if faced with this situation. See also chapter 8, "Internal Control: Guidelines and Tool for the Audit Committee," in this toolkit for a more comprehensive discussion of the audit committee's oversight role with respect to internal control.

Background

A key area for audit committee oversight is to review and provide input on the government entity's internal control framework. To obtain reasonable assurance with respect to the organization's internal control framework, the audit committee

- reviews and provides advice on the organization's system of internal control.
- receives reports on all matters of significance resulting from work performed by those who provide financial and internal control assurance to the governing body or the head of the government entity.

Internal Control Evaluation Requirements

In addition to AICPA requirements, reporting on financial statement audits performed in accordance with Generally Accepted Government Auditing Standards (GAGAS) also includes reports on internal control over financial reporting. These reports should include a description of the scope of the auditors' testing of internal control over financial reporting, any significant deficiencies and material weaknesses identified; and whether the tests performed provided sufficient, appropriate evidence to support opinions on the effectiveness of internal control.

The auditor should be required to obtain an understanding of internal control relevant to the audit when identifying and assessing the risks of material misstatement. In making those risk assessments, the auditor considers internal control in order to design audit procedures that are appropriate in the circumstances. The auditor may identify deficiencies in internal control not only during this risk assessment process but also at any other stage of the audit.

When auditors identify such findings, they should plan and perform procedures to develop the elements of the findings that are relevant and necessary to achieve the audit objectives. The auditor may have an additional engagement to report on the effectiveness of an entity's internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal*

Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements (AICPA, *Professional Standards*). This section does not address an AT section 501 engagement.

To understand control deficiencies best, it is important for audit committee members to understand certain key terms. Review the section "Internal Control Over Financial Reporting" in chapter 8, "Internal Control: Guidelines and Tool for the Audit Committee," in this toolkit for definitions and explanations of the terms *deficiency, significant deficiency,* and *material weakness*.

Responding to the Identification of a Material Weakness

When a GAGAS financial audit is performed, if the auditors' report discloses deficiencies in internal control, auditors obtain and report the views of responsible officials of the audited entity concerning the findings, conclusions, and recommendations, as well as any planned corrective actions. The audit committee should be engaged in the review and approval of that response and any subsequent corrective action plan. The checklist in this section provides guidance and questions which the audit committee can ask as part of its review.

Additional Resources

Government entities are not subject to SEC requirements. CPA firms or government auditors performing audits of government entities are not subject to PCAOB rules. Government audit committees may want to refer to public company requirements as a resource. The following are various forms of guidance applicable to public companies that may be beneficial to audit committees and management:

- PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*
- PCAOB Auditing Standard No. 4, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*
- GAO's *Standards for Internal Control in the Federal Government* at www.gao.gov/assets/670/665712.pdf
- OMB Circular A-123, *Management's Responsibilities for Internal Control*, at www.whitehouse.gov/omb/circulars_a123_rev/

Steps the Audit Committee Can Consider If Faced With an Adverse Report on Internal Control

Instructions for using this tool: In a government entity facing a negative report on internal control, those charged with governance should take steps to ensure that (1) any material weakness(es) in internal control are swiftly corrected, and (2) key stakeholders are assured that corrective action has been taken.

Note: This tool has been prepared purposefully for broad application. No single tool of a practical length could be developed to address all different situations that could cause a negative report on an organization's internal controls over financial reporting. When faced with a negative report, those charged with governance should use this tool in the context of the deficiencies noted. As with all tools of this type, users must apply their own insight and judgment to the situation to maximize benefits.

It is important for those charged with governance to understand the material weakness(es) giving rise to the negative report. They should meet with the management team, internal auditors, and the independent external auditors (CPA firms or independent government auditors), and understand the issue from each perspective to make fully informed recommendations and decisions. The following are sample questions to help guide the audit committee through this process.

Sample Questions	Comments
Management Team	
1. Interview members of the management team, including the chief financial officer (CFO), controller, and other management, as necessary, closer to the situation, about the weakness(es). You should consider conducting these interviews in an executive session.	
• Who identified the weakness, and in what context, such as the annual financial statement audit, routine internal audit or management review was it identified?	
a. Management	
b. Internal audit	
c. Independent auditors	
d. Another third party	
• What are the nature and root cause of the control failure?	
• How long has the weakness existed?	

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Sample Questions	Comments
Management Team	
• What are the financial statement implications of the control failure? Are there regulatory or compliance implications? Will this weakness become public information? Are there reputational implications? Could the control failure have been the result of fraud?	
• If the root cause is systemic, such as turnover, were other controls affected? Are there other controls in the area that may mitigate for the control that failed?	
• What is management's plan and timing to correct the material weakness?	
2. Explore with the management team how much was known about the weakness(es) when the Government Entity Head and CFO prepared the financial statements and made certifications regarding those financial statements (if applicable).	
• Consider any implications to these financial statements in light of the material weaknesses noted.	
3. In subsequent years, ask the management team for an update on the status of the current year weakness.	
Those Charged with Governance	
1. Discuss the material weakness with those charged with governance.	
• Are you comfortable with management's assertions about the material weakness and the corrective action plan? Determine whether internal audit, management, or a third party conducted any recent testing in the area and understand the results of their testing.	

Sample Questions	Comments
Those Charged with Governance	
• Do you have concerns that fraud or an illegal act was involved in the material weakness?	
• Has management been responsive to findings and recommendations in the past? Has management been cooperative and open during the review of the material weakness?	
Independent Auditor	
1. In executive session, discuss the findings, implications, and recommendations with the independent external auditor and internal auditors.	
• Determine whether the independent external auditor's (or internal auditor's, if applicable) result is consistent with the result of management's assessment of internal controls.	
2. Collect information from the independent external auditor based on his or her knowledge of internal controls and experiences with other clients:	
• Has the weakness been discussed with the entity in the past? Does management have the proper tone at the top regarding internal controls?	
• Is this weakness a result of a unique situation at the entity?	
• Is this weakness a result of a unique situation in the related industry or government sector?	
3. After meeting with the management team, those charged with governance and the independent external auditor (or internal auditor, if applicable), address whether the weakness(es) could have resulted from an illegal act.	

(continued)

Sample Questions	Comments
Independent Auditor	
• Consider the need to conduct a formal investigation in the area to determine if the weakness(es) resulted from an illegal act.	
• Consider the need to engage a forensic accountant or auditor to review the situation if any fraud or illegal activity is suspected.	
• If an illegal act is suspected, work expeditiously to determine if such an act occurred. If confirmed, notify those charged with governance or other relevant parties.	
4. Consult experts from outside the entity about the weakness(es) and the steps necessary to be taken to correct it or them.	
5. Work with management to develop a plan to correct the weakness(es):	
• Identify metrics that can be reported to internal and external parties on the progress being made in correcting the weakness(es).	
6. Provided the entity has corrected its internal control weakness successfully, consider whether to engage the independent external auditor to issue a separate report on the elimination of the weakness in internal control over financial reporting.	
7. In subsequent years, ask the independent external auditor for an update on the status of the current year weakness.	
Additional Considerations	
1. Review with management its plan to respond to audit findings, conclusions and recommendations.	
2. Review with management its plan to reassure key stakeholders about the findings, conclusions and corrective action plans.	

Sample Questions	Comments
Additional Considerations	
3. Review with management its strategy with reporters who might be interested in the government entity's plans to correct the weakness(es) noted (if applicable).	
4. Inquire of management if they have considered other potential implications of the findings identified. For example, consider whether the findings identified could have an impact on:	
• Compliance with debt covenants	
• Grant requirements	
• Other parties	

PART III: Performance Evaluation

Chapter 15

Evaluating the Internal Audit Function: Questions to Consider

Overview: The audit committee, including the chief audit executive (CAE), has the responsibility to oversee and evaluate the internal audit function. This includes ensuring the internal audit function is independent and objective in order to perform its work effectively across the government entity to provide the audit committee with an assessment on the state of the government entity's risk, control, governance, and monitoring activities. In discharging this responsibility, the audit committee should answer a series of questions about the quality and performance of the internal audit function, and should obtain input from others in the government entity including management and independent auditor.

Note: The Institute of Internal Auditors (IIA) establishes standards for the internal audit profession and provides certifications in internal auditing. The International Standards for the Professional Practice of Internal Auditing (standards) provide guidance for the conduct of internal auditing at both the organizational and individual auditor levels. Internal audit functions that commit to adhering to these standards are required to establish a Quality Assurance and Improvement program that includes both ongoing and periodic internal quality assessment reviews (QARs) and undergo an external QAR a minimum of once every five years. If required or elect to conduct audits in accordance with Government Auditing Standards, the external peer review is required at least once every three years.

Instructions for using this tool: The sample questions included in this tool are only a starting point for evaluating the performance and effectiveness of the internal audit function. Audit committee members should ask follow-up questions as appropriate and required.

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
1. Has the internal audit charter been evaluated at least annually and presented to senior management and the audit committee for approval?	☐	☐	☐	
2. Has the CAE assessed whether the internal audit activity's purpose, authority, responsibility, as defined by the internal audit charter, is adequate to enable the activity to meet its objectives?	☐	☐	☐	
3. *a.* Does the internal audit function maintain a quality assurance and improvement program?	☐	☐	☐	

(continued)

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
b. Has the internal audit function conducted the external QAR (either a full external assessment or a self-assessment with an independent external validation) required by IIA standards in the last five years or every three years if conducting the audits in accordance with GAGAS?	☐	☐	☐	
c. Did the CAE discuss the form and frequency of external assessment; and the qualifications and independence of the external assessor or assessment team, including any potential conflict of interest with the audit committee?	☐	☐	☐	
d. Has the CAE at least annually discussed the results of the quality assurance and improvement program with the audit committee?	☐	☐	☐	
e. Has the CAE disclosed any nonconformance with the standards?	☐	☐	☐	
4. Is the CAE reporting relationship appropriate to provide adequate independence to enable the internal audit activity to meet its responsibility? Government entity independence is effectively achieved when the CAE reports functionally to the audit committee and administratively to the Government Entity Head.	☐	☐	☐	
5. Does the government entity's executive leadership support and value the work performed by the internal audit function?	☐	☐	☐	
6. If the internal audit function is outsourced:				
a. Are the areas outsourced appropriately?	☐	☐	☐	
b. Is sufficient monitoring in place to assure the quality of the outsourced function?	☐	☐	☐	

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
7. Is the internal audit function independent and are the internal auditors objective when performing their work?	☐	☐	☐	
8. Is the internal audit function's size, budget, and structure adequate to meet its established objectives?	☐	☐	☐	
9. Has the internal audit function discussed all scope limitations and access issues?	☐	☐	☐	
10. Do the internal auditors feel comfortable raising issues that could reflect negatively on management? Are matters that warrant audit committee attention brought forth on a timely basis?	☐	☐	☐	
11. Are the technical knowledge, including information technology knowledge, and experience levels of the internal audit function staff sufficient to ensure that duties are performed appropriately?	☐	☐	☐	
12. Is the internal audit function's work planned appropriately to address the risks of the government entity and focused on the right areas/topics of high risk, judgment, and sensitivity?	☐	☐	☐	
13. Has the internal audit function solicited the input of senior management and the audit committee in its planning?	☐	☐	☐	
14. Does the internal audit function's work encompass a good balance between operational and financial areas?	☐	☐	☐	
15. Does the internal audit function appear to be using its time and resources effectively and efficiently in performing the annual internal audit plan?	☐	☐	☐	

(continued)

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
16. Relating to the annual independent audit, was the internal audit function involved?	☐	☐	☐	
a. If so, was the internal auditor function involvement effective?	☐	☐	☐	
b. If so, were activities adequately coordinated with the external auditor?	☐	☐	☐	
17. Are reports accurate, objective, clear, concise, constructive, complete, and timely; and supported by sufficient, reliable, relevant, and useful information?	☐	☐	☐	
18. Did the internal audit function provide constructive observations, implications, and recommendations in areas needing improvement?	☐	☐	☐	
19. Does management respond in an appropriate and timely fashion to significant recommendations and comments made by the internal audit function?	☐	☐	☐	
20. Did the internal audit function address any feedback satisfactorily from the audit committee or senior management?	☐	☐	☐	
21. Does the internal audit function stay abreast of relevant updates such as green book/COSO framework, yellow book/GAAP, and other relevant governmental regulations?	☐	☐	☐	
22. Does the internal audit function have adequate on-boarding and training programs to incorporate new staff members quickly?	☐	☐	☐	
23. Does the internal audit function have continuing education programs and leadership training to grow and develop staff?	☐	☐	☐	
24. Please share any additional thoughts that could further improve the internal audit function's effectiveness and efficiency.	☐	☐	☐	

Evaluation of Internal Audit Team	Yes	No	N/A	Comments
Other Comments, Further Questions				

Chapter 16

Evaluating the Independent Auditor: Questions to Consider

Overview: As a best practice, the audit committee has the responsibility to hire, compensate, evaluate, and terminate the independent auditor (auditor). In discharging this responsibility, the audit committee should answer a series of questions about the quality and performance of the auditor, and should obtain input from others in the government entity, including management and internal audit.

For some government entities, the independent auditor may be from another government entity. If this is the case, while the audit committee and government entity management would not have the authority to hire and terminate the independent auditor, most of these questions would still be applicable in being able to provide feedback around the performance and effectiveness of the independent auditor.

Instructions for using this tool: The sample questions included in this tool are only a starting point for evaluating the performance and effectiveness of the auditor. Audit committee members should ask follow-up questions as appropriate and required.

Questions for Audit Committee Members

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
Quality of Resources and Services				
1. Does the audit team have the knowledge and skills necessary to meet the government entity's audit requirements, including specialized skills and knowledge of the specific government sector or enterprise? (Consider abilities of the partner(s), manager(s), director(s), and fieldwork leaders, and level of access to specialized expertise).	☐	☐	☐	
2. Does the auditor identify and discuss the appropriate risks considered in the planning of the audit, including tone at the top, fraud, governance matters, and risk of management override of controls?	☐	☐	☐	

(continued)

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
Quality of Resources and Services				
3. Are you satisfied with the auditor's planning, execution, and communication related to the audit, including the scope, nature, extent/sampling, and timing?	☐	☐	☐	
4. Does the audit team leverage the work performed by internal audit, management, or government auditors (e.g. GAO/OIG) for the audit or reporting of internal control over financial reporting and compliance when determining the work needed for the audit of the financial statements?	☐	☐	☐	
5. Do the auditor's written reports to the committee cover all appropriate issues adequately, giving consideration to requirements such as GAAP (that is, FASAB or GAAS) and GAGAS (if applicable) as well as elements required by the auditor contained in the committee charter?	☐	☐	☐	
6. If applicable, are the audit fees reasonable and sufficient in light of the quality of services provided, size and complexity of the government entity, and the risks facing the government?	☐	☐	☐	
7. Has the auditor presented the committee with the audit organization's latest AICPA peer review report (or any other required peer review report such as the PCAOB inspection report)? If findings are noted with the report(s), has the auditor communicated the resolution? See chapter 5 for additional questions to ask when reviewing the report.	☐	☐	☐	
8. Has the committee requested that the auditor describe the audit organization's annual internal quality assurance process that is performed in between the required AICPA peer review (or any other required peer review)?	☐	☐	☐	

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
Quality of Communications				
9. Does the auditor communicate issues openly, and in a complete and understandable way?	☐	☐	☐	
10. Does it appear that the auditor is free from undue influence by management, and that the auditor is comfortable raising issues that would reflect negatively on management?	☐	☐	☐	
11. Does the auditor take advantage of an executive session appropriately, if permitted by law, by discussing any sensitive issues professionally, candidly, and in a timely manner?	☐	☐	☐	
12. Does the auditor communicate, or ensure that management communicates, relevant developments in accounting principles and auditing standards that could affect the government entity?	☐	☐	☐	
13. Does the auditor volunteer constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the government entity's internal controls over financial reporting?	☐	☐	☐	
Independence and Objectivity				
14. Considering all audit-related and nonaudit services performed by the auditor, are you satisfied that the auditor remains independent and objective both in fact and appearance?	☐	☐	☐	
15. Are you satisfied that the auditor reports all matters openly to the committee that might be thought to bear on the audit organization's independence?	☐	☐	☐	

(continued)

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
Independence and Objectivity				
16. Based on the open and informative nature of the auditor's answers to questions posed by the committee, do you feel confident that the auditor maintains appropriate objectivity and professional skepticism?	☐	☐	☐	
Final Evaluation				
17. Based on your assessment, would you rehire the auditor to conduct future audits? If yes, what changes would you make, if any? If no, why not?	☐	☐	☐	

Questions for Management and/or Internal Audit

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
In addition to the questions above, following are questions the audit committee may ask of government entity's personnel such as the CAE, Government Entity Head, CFO, controller, or general counsel, to assist in evaluating the performance of the auditor.				
1. Does the auditor work with internal audit to ensure the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources?	☐	☐	☐	
2. *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 performance of the engagement leadership assigned, including the partner(s), manager(s), director(s), and fieldwork leaders?	☐	☐	☐	
3. Was the work with the auditor conducted in the spirit of professionalism and mutual respect?	☐	☐	☐	
4. *a.* Are you aware of any other information that might impair the independence of the independent auditor?	☐	☐	☐	
b. Are you aware of any individuals on the audit team who might not be independent with respect to the government entity for whatever reason?	☐	☐	☐	

Evaluation of the Independent Auditor	Yes	No	N/A	Comments
5. *a.* If the choice were yours, would you hire the independent auditor to conduct future audits?	☐	☐	☐	
b. If yes, what changes would you make, if any? If no, why not?	☐	☐	☐	
Further Questions or Other Comments				

Chapter 17

Conducting an Audit Committee Self-Evaluation: Questions to Consider

Overview: The audit committee should conduct an annual self-evaluation to determine its performance and effectiveness. Audit committee members should answer a series of questions independently to complete their self-evaluations. The entire audit committee should discuss the answers and plan for further action as appropriate prior to starting the next audit committee year.

Instructions for using this tool: The sample questions included in this tool are only a starting point to evaluating the performance and effectiveness of the audit committee. These questions should be completed anonymously by each audit committee member prior to the audit committee meeting, and the entire committee should discuss the responses.

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
1. Does the committee have a charter that covers all standard best practices? For a listing of standard best practices for an audit committee charter, see chapter 2, "Audit Committee Charter Matrix," in this toolkit.	☐	☐	☐	
2. Has the charter been reviewed annually?	☐	☐	☐	
3. Is the audit committee charter used to guide the committee's efforts and agenda?	☐	☐	☐	
4. Have all elements of the committee's responsibilities, as delineated in the audit committee charter, been covered throughout the fiscal year?	☐	☐	☐	
5. Are the members educated appropriately on the government entity, its organizational structures, governance and internal control environment, and current hot topics, as well as the government entity's risk profile?	☐	☐	☐	

(continued)

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
6. Is there a member that is truly independent of the government entity, such as an appointed public member?	☐	☐	☐	
7. Is there a sufficient mix of necessary skill sets and knowledge among the committee members, including acumen around financial reporting, risk assessments, internal controls, and systems?	☐	☐	☐	
8. Do the committee members actively promote and advance the ethical values of the government entity? For example, do they speak regularly to the importance of ethical behavior and compliance with such guidelines? Do they insist or demonstrate the commitment to holding employees accountable for ethical lapses?	☐	☐	☐	
9. Do the committee members participate in some form of continuing education to stay abreast of changes in the relevant financial accounting and reporting, regulatory, and ethics areas?	☐	☐	☐	
10. Are the committee's meeting packages complete?	☐	☐	☐	
11. Are the meeting packages given to committee members with enough lead time to allow for sufficient review?	☐	☐	☐	
12. Do the meeting packages include the right information to allow meaningful discussion?	☐	☐	☐	
13. Are the committee meetings well organized, efficient, effective, and of the appropriate length?	☐	☐	☐	
14. Do the committee meetings occur often enough to allow discussion of issues that are relevant to and consistent with the committee's responsibilities?	☐	☐	☐	

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
15. Do the minutes and reports to the full governing body reflect the significant activities, actions, and recommendations of the committee?	☐	☐	☐	
16. Does the committee have open access to management, internal audit, and independent auditors?	☐	☐	☐	
17. Do committee members have open, honest, and effective communication with management, the internal auditors, and the independent auditors?	☐	☐	☐	
18. Is the committee able to challenge management, the internal auditors, and the independent auditors with its own view on issues as appropriate?	☐	☐	☐	
19. Are differences of opinion on issues resolved to the satisfaction of the entire committee?	☐	☐	☐	
20. Is the committee aware of the difference between giving advice, making requests, and making decisions that appropriately are management's responsibility?	☐	☐	☐	
21. Does the committee successfully respect these differences?	☐	☐	☐	
22. Does the committee have a clear definition of the services the independent auditors are allowed to perform in order to maintain independence?	☐	☐	☐	
23. Does the committee approve all allowed services of the independent auditors in advance?	☐	☐	☐	
24. Does the committee review the independent auditors' reports:				
a. At least annually?	☐	☐	☐	
b. To ensure the auditors maintain their independence?	☐	☐	☐	

(continued)

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
25. Is the committee aware of the last time the independent audit firm or lead partner was rotated and is the committee considering a future rotation?	☐	☐	☐	
26. If applicable, does the committee provide input regarding the hiring and evaluation of the Chief Audit Executive (CAE)?	☐	☐	☐	
27. If applicable, does the committee assess the adequacy of the budget and staffing level of the internal audit function on an at least annual basis?	☐	☐	☐	
28. Does the committee directly ask the CAE whether management is fully cooperating and supporting the performance of audit activities?	☐	☐	☐	
29. Do individual members of the committee initiate private discussions with the CAE regarding the adequacy of the internal audit function budget and the cooperation of management?	☐	☐	☐	
30. Does the committee provide feedback to the CAE?	☐	☐	☐	
31. Does the committee notify the governing body of its assessment regarding the adequacy of the budget and staffing to ensure the quality and objectivity of the internal audit team?	☐	☐	☐	
32. Does the committee receive the appropriate level of information to evaluate the soundness of the government entity's internal control environment?	☐	☐	☐	
33. May the committee engage outside experts as appropriate?	☐	☐	☐	
34. Does the committee conduct executive sessions in a manner that offers a safe haven to the individual?	☐	☐	☐	

Audit Committee Self-Evaluation	Yes	No	N/A	Comments
35. During executive sessions, does the committee ask tough and necessary questions, evaluate the answers, and pursue issues that might arise to a satisfactory resolution?	☐	☐	☐	
36. Do the committee members challenge the chair as appropriate?	☐	☐	☐	
37. Does the committee receive constructive feedback from management, internal and independent auditors, and peer groups?	☐	☐	☐	
38. Do the committee members feel that the government entity's overall governance and internal controls, including financial reporting processes, are stronger as a result of the committee members' participation and actions on the audit committee?	☐	☐	☐	
Further Questions and Other Comments				

PART IV: Other Tools

Chapter 18

Enterprise Risk Management: A Primer on the COSO Framework

Overview: Enterprise risk management 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 government entity. Many government entities, governing bodies, and audit committees view risk management from this strategic perspective, and consider risk management oversight to be a critical element of governance.

This chapter is intended to give governing bodies an overview of enterprise risk management, its opportunities and limitations, the relationship between enterprise risk management and internal control, and the roles and responsibilities for risk management in the government entity. Enterprise risk management is a management responsibility, subject to oversight of the governing body. It does not involve external audit attestation.

Audit committee role: It should be noted that there is no regulatory mandate for implementation of enterprise risk management. However, if and when implemented, this committee should assume oversight of the process.

Enterprise Risk Management 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 of the Treadway Commission published a document called *Enterprise Risk Management—Integrated Framework*,[2] (ERM framework), which defined enterprise risk management as

> ... 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 toward achieving an entity's objectives, set forth in four categories:

1. Strategic: high-level goals, aligned with and supporting its mission

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

[2] The COSO publication *Enterprise Risk Management—Integrated Framework* (Product Code Number 990015), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of this publication are used to support the continuing work of COSO.

2. Operations: effective and efficient use of its resources
3. Reporting: reliability of reporting
4. Compliance: compliance with applicable laws and regulations

The COSO Enterprise Risk Management Framework consists of the following eight interrelated components:

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. Enterprise risk management ensures that management has in place a process to set objectives, that the chosen objectives support and align with the entity's mission, and that they 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 carried out effectively.
7. *Information and Communication:* Relevant information is identified, captured, and communicated in a form and time frame that enable 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.

Enterprise risk management is not a serial process, but a multi-directional iterative process, with the eight components impacting each other. Likewise the eight components will not function identically in every government entity. Application in small and medium-sized government entities is likely to be less formal and less structured.

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

Relationship Between COSO Enterprise Risk Management—Integrated Framework and Internal Control—Integrated Framework and Standards for Internal Control in the Federal Government (Green Book)

In the 20 years since COSO released its *Internal Control—Integrated Framework* (the original framework), government operating environments have changed dramatically, becoming increasingly complex and technologically driven. At the same time, stakeholders are more engaged, seeking greater transparency and accountability for the integrity of systems of internal control that support government decisions and governance of the entity.

In 2013, COSO published the updated *Internal Control—Integrated Framework* (framework). COSO believes the framework will enable organizations to effectively and efficiently develop and maintain systems of internal control that can enhance the likelihood of achieving the entity's objectives and adapt to changes in the business and operating environments.

In 2014, in conjunction with the requirements of *The Federal Managers' Financial Integrity Act* (FMFIA), the Comptroller General of the United States issued the Standards for Internal Control in the Federal Government (known as the Green Book). The Green Book addresses not only the five components of internal control, but also adopts the concept of principles, related to the five components of internal control, as introduced by the 2013 COSO framework. The Green Book is not only a federal requirement; it is also considered a best practice for state and local governments.

The 2004 ERM framework and the two aforementioned internal control frameworks are intended to be complementary. Yet, while these frameworks are distinct and provide a different focus, they do overlap. The ERM framework encompasses internal control, with several portions of the text of the original COSO *Internal Control—Integrated Framework* reproduced. Consequently, the ERM framework remains viable and suitable for designing, implementing, conducting, and assessing enterprise risk management.

Both of the aforementioned Internal Control frameworks remain in place as tools for evaluating internal control by itself and are also encompassed within enterprise risk management. The relationship between internal control and enterprise risk management is possibly best captured by the phrase "you can have effective internal control without effective enterprise risk management, but you cannot have effective enterprise risk management without effective internal control."

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

These key areas are included in the ERM framework to expand on the internal control framework:

- *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 non-financial 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.
- *Risk appetite and risk tolerance:* Risk appetite, set by management, with oversight by the governing body, is a broad-based conceptualization of the amount of risk that a government entity is willing to take to achieve its objectives. Often expressed as the desired or acceptable balance among growth, risk and return, or as stakeholder value-added measures, a government 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 performance relative to the achievement of objectives. 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.
- *Portfolio view of risk:* 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 business units, or by focusing on risk for the entity as a whole using capital, operating earnings 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.

  There are four risk response categories:

  1. *Acceptance:* No action is taken to affect risk likelihood or impact.
  2. *Avoidance:* Exiting the activities giving rise to risk; may involve exiting a program or funding stream, declining expansion of programs with losses, or discontinuing a program or department.
  3. *Reduction:* Action is taken to reduce risk likelihood, impact, or both; typically involves many everyday business decisions.
  4. *Sharing:* Reducing risk likelihood or impact by transferring or otherwise sharing a portion of the risk; common techniques include purchasing insurance products, forming joint ventures, engaging in hedging transactions, or outsourcing an activity.

Other Key Terms in Enterprise Risk Management

There are several additional terms that you will hear when discussing enterprise risk management. They are described in the rest of this section.

Inherent and residual risk: Management needs to consider both inherent and residual risk. Inherent risk is the risk to the achievement of a government entity's objectives in the absence of any actions management might take to alter either the risk's likelihood or impact. Residual risk is the risk to the achievement of objectives that remains after management's responses have been developed and implemented. Risk analysis is applied first to inherent risk. Once risk responses have been developed, as discussed below, management then considers residual risk. Assessing inherent risk in addition to residual risk can assist the entity in understanding the extent of risk responses needed.

Event identification techniques: A government 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 past trends, such as loss histories, as well as to the future. Some are industry specific; most are derived from a common approach. They vary widely in levels of sophistication, and most entities use a combination of techniques.

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

Risk analysis techniques: As part of risk analysis, the government entity analyzes the significance of risks to the achievement of objectives and sub-objectives. Entities may address significance further by using the following criteria:

- *Likelihood and impact of risk occurring:* "Likelihood" and "impact" are commonly used terms, although some entities use instead "probability," "severity," "seriousness," or "consequence." Likelihood represents the possibility that a given event will occur, while impact represents its effect. Sometimes the words take on more specific meaning, with likelihood indicating the possibility that a given risk will occur in qualitative terms such as high, medium, and low. The word probability indicates a quantitative measure such as a percentage, frequency of occurrence, or other numerical metric.
- *Velocity or speed to impact upon occurrence of the risk:* Risk velocity refers to the pace with which the government entity is expected to experience the impact of the risk. For instance a state-owned hospital may be concerned about the potential for a slowdown in the collection of a disproportionate share of hospital receivables when dealing with the changes stemming from the Affordable Care Act. Failing to manage the risks may result in significant erosion in the entity's ability to operate. In this instance, changes in funding

require the need to timely change operations and understand the impact on the need for financing of future operations due to changing cash flow streams.

- *Persistence or duration of time that an occurrence of the risk could affect the entity:* Certain risks are temporary in nature and others are more lasting. For example, the risk of a labor strike that briefly disrupts the ability to provide services has a shorter duration than the risk of a persistent shift in consumer demands for less costly alternatives to healthcare. Additionally, those risks with a potentially high impact that have a low likelihood should be considered, avoiding the notion that such risks "couldn't happen here," as even low likelihood risks can occur. The importance of understanding risks assessed as having a low likelihood is greater when the potential impact of the risk might persist over a longer period of time. For instance, the long-term impact on the entity from not providing services for a few days may be viewed much differently than the long-term impact of not being able to compete with lower cost models.

Portfolio View of Residual Risk Example

The following example summarizes ERM concepts:

> A government entity providing services to individuals with developmental disabilities held a management team retreat to brainstorm its key risks: changes to programs, changes to the reimbursement system, compliance with rules and regulations for the provision of services, and an increase in the living wage as mandated by the federal government without an increase in funding.
>
> Management assessed the risks and developed risk responses to bring these key risks to within established limits. These responses included establishing a team of inside and outside experts to fully understand the managed care reimbursement and service system, continuous monitoring of compliance with rules and regulations through a quality assurance system, compliance reporting directly to a governing body, and increasing efforts to manage unfunded costs outside of the entity's control.

Roles and Responsibilities

Everyone in the organization has some role to play in enterprise risk management.

Governing Body Authority for key decisions involving strategic direction, broad-based resource allocation and setting high-level objectives is reserved for the governing body. 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 governing body and its committees.

The role of the governing body in providing oversight of enterprise risk management in an organization includes these five responsibilities:

1. Influencing and concurring with the government entity's risk philosophy and risk appetite
2. Determining that overall strategy and strategic decisions are in alignment with the government entity's risk appetite and philosophy

3. Ascertaining the extent to which management has established effective enterprise risk management in the government entity
4. Reviewing the government 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: The role of internal audit in a government entity is largely defined by *Generally Accepted Government Auditing Standards*. The role of internal audit in enterprise risk management could be considered twofold. In addition to identifying and evaluating risk exposures, internal audit activities should include 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 following:

- Enterprise risk management processes, both design and function
- Effectiveness and efficiency of risk responses and related control activities
- Completeness and accuracy of enterprise risk management reporting

The responsibility for evaluating the effectiveness of the government entity's risk management function requires the internal audit function to maintain its independence and objectivity with respect to this function. Accordingly, a best practice from a corporate governance perspective would suggest that reporting responsibility for the risk function be a management responsibility that is separate from internal audit. That said, because of internal audit's position in the government entity and its knowledge of risk assessment, the internal audit team often is responsible for facilitating the ERM process. In the role of facilitator, internal audit can aid in maintaining its independence by communicating its role regularly to stakeholders, including the audit committee. The audit committee should monitor this structure to ensure that roles and responsibilities are understood, and internal audit is maintaining its independence. We do note that if an organization does not have an internal audit function, ERM can still be implemented as it is a very important function within the organization.

Limitations of Enterprise Risk Management

Effective enterprise risk management will provide reasonable assurance about the achievement of an entity's objectives to management and the governing body. 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 limiting factors that decrease the effectiveness of management-level decisions. 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 enterprise risk management, and an understanding of the responsibilities of the governing body and the audit committee with respect to risk management within an organization.

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

Much of enterprise risk management encompasses governing body and management responsibilities that previously may have been carried out intuitively or in a manner less comprehensive and systematic than is contemplated by an enterprise approach.

All organizations, from small governments to large, face myriad risks and opportunities in a rapidly changing world. Whether small or large, 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: A Tool for Strategic Oversight

The next chapter in this toolkit, chapter 19, "Enterprise Risk Management: A Tool for Strategic Oversight," contains a tool with questions modeled on the COSO framework, *Enterprise Risk Management—Integrated Framework*.

Chapter 19

Enterprise Risk Management: A Tool for Strategic Oversight

Overview: The tool in this chapter is created around the eight interrelated components of the *Committee of Sponsoring Organizations* of the *Treadway Commission* (COSO) Enterprise Risk Management (ERM) Framework.[1] Refer to chapter 18, "Enterprise Risk Management: A Primer on the COSO Framework," in this toolkit, 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 governing body and management have reasonable assurance that they understand the extent to which the government entity's strategic and operations objectives are being achieved and that the government entity's reporting is reliable and 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 answer to verify that the components of enterprise risk management are present and functioning properly.

These questions should be discussed in an open forum with executive management and program directors, as well as members of the financial management, risk management, and internal audit teams to ensure that the enterprise risk management function is operating as management represents. Performance audits performed by federal inspectors general, state auditors, local government auditors, and internal auditors contribute to understanding some of the risks associated with the particular government entity.

Evaluation of the risk management process is not a one-time event, but is, rather, a continuous activity for the audit committee, which should always look for potential deficiencies, and should probe the responsible parties continually regarding risks and opportunities.

[1] The questions in this tool are adapted from *COSO Enterprise Risk Management—Integrated Framework* (Product Code Number 990015), published September 2004 by the Committee of Sponsoring Organizations. It may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of this publication are used to support the continuing work of COSO.

COSO Framework	Yes	No	Not sure	Comments
Internal Environment				
1. Is the assignment of risk oversight mandated clearly? Ultimately, the governing body is responsible for overseeing risk management, but oversight of the risk management process is often delegated to an oversight committee such as the audit committee.	☐	☐	☐	
2. Is the government entity's philosophy for managing risk articulated in a comprehensive code of conduct or in other policies that address acceptable business practices and expected behavior?	☐	☐	☐	
3. Is the risk appetite for the government entity articulated formally in qualitative or quantitative terms?	☐	☐	☐	
4. Is the risk appetite consistent with the stated risk management philosophy and aligned with business strategy? Is it included in the strategic plan?	☐	☐	☐	
5. Are the audit committee's responsibilities for strategic oversight of risk assessment and risk management defined in its charter or by-laws?	☐	☐	☐	
Objective Setting				
1. Has the governing body established high-level objectives that are consistent with the strategic direction and risk appetite for the government entity?	☐	☐	☐	
2. Has management identified critical success factors, relevant performance measures, milestones, and risk tolerances for the achievement of the government entity's strategic objectives?	☐	☐	☐	

COSO Framework	Yes	No	Not sure	Comments
Objective Setting				
3. Has management identified breakpoints or risk tolerances that will trigger broad discussion of the potential need for intervention or modification of strategy?	☐	☐	☐	
4. Has management established operations, reporting, and compliance objectives that are aligned with the overall strategic objectives?	☐	☐	☐	
5. Is a relevant and timely progress reporting mechanism in place to monitor implementation of the strategy?	☐	☐	☐	
Event Identification				
1. Has management employed a systematic approach in the identification of potential events that will affect the government entity?	☐	☐	☐	
2. Is the categorization of events across the government entity, vertically through operating units, by type (including internal, external, and strategic) or by objective appropriate to the entity?	☐	☐	☐	
3. Has management included high impact, low likelihood events in its portfolio of events for assessment?	☐	☐	☐	
Risk Assessment				
1. Has management conducted a systematic assessment of the likelihood, impact, velocity, and persistence of all events with the potential for significant impact on the government entity? The risk events should be assessed individually and not be aggregated into categories for assessment and reporting.	☐	☐	☐	
2. Has management considered sufficiently the interdependency of potentially related events in its event identification and risk assessment process?	☐	☐	☐	

(continued)

COSO Framework	Yes	No	Not sure	Comments
Risk Response				
1. Has management adopted an appropriate and cost-effective array of risk responses, such as mitigation strategies, at the activity level of the government entity to reduce inherent risks to levels in line with established risk tolerances?	☐	☐	☐	
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 government entity?	☐	☐	☐	
Control Activities				
1. Has management implemented adequate control activities throughout the government entity to assure that its risk responses are carried out properly and in a timely manner?	☐	☐	☐	
Information and Communication				
1. Do the government entity's management information systems capture and provide reliable, timely, and relevant information sufficient to support effective enterprise risk management?	☐	☐	☐	
2. Have adequate communication vehicles been implemented to assure that relevant risk-related information is communicated by front-line employees upward in the government entity and across programs or processes?	☐	☐	☐	
3. Is the portfolio of risks identified in the ERM process included in the strategic planning process?	☐	☐	☐	

COSO Framework	Yes	No	Not sure	Comments
Monitoring				
1. Are sufficient ongoing monitoring activities built into the government entity'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 internal audit work, if applicable?	☐	☐	☐	
3. Have all deficiencies in risk management processes identified by internal audit, or as a result of ongoing monitoring activities, been communicated to the appropriate levels of management, the governing body, or both?	☐	☐	☐	
4. Do the governing body's agendas promote integration of risk issues with other agenda items such as strategy, organization, and finance?	☐	☐	☐	
5. Have all deficiencies and recommendations for improvement in risk management processes been addressed? Have appropriate corrective actions been taken?	☐	☐	☐	
6. When new policies, programs, and other activities are implemented to enhance the government entity but also subject it to inherent risk, are results monitored to determine whether those new activities create more risk than anticipated?	☐	☐	☐	

Chapter 20

Single Audits or OMB A-133 Audits—Audits of Federal Funds

Overview: The Office of Management and Budget (OMB) has issued final guidance, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards (Uniform Grant Guidance [UGG]), that establishes uniform cost principles and audit requirements for federal awards to nonfederal entities and administrative requirements for all federal grants and cooperative agreements. The Uniform Grant Guidance will be effective for nonfederal entities for all federal awards or funding increments provided after December 26, 2014. The standards in the new Audit Requirements of the guidance will be effective for audits of fiscal years beginning on or after December 26, 2014.

OMB Circular No. A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (superseded as Subpart F in 2 CFR §200.500.520, UGG in 2014) was issued pursuant to the Single Audit Act of 1984 and the Single Audit Act Amendments of 1996. Subpart F establishes the standards in order to obtain consistency and uniformity among federal agencies for the audit of states, local governments, and not-for-profit entities expending federal awards.

This chapter is intended to aid state and local governments, other government entities, and their audit committees 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 management and audit committee should answer the questions contained in this chapter to verify that the policies and procedures for complying with Federal rules and regulations are present and functioning properly.

The Single Audit Act as amended requires that nonfederal entities (defined as state and local governments and not-for-profit entities) that expend $750,000 ($500,000 for years ending prior to 12/26/2014) or more during the entity's fiscal year in federal awards have a single or program-specific audit in accordance with the provisions of the Single Audit Act. 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) and the federal program's laws, regulations, or grant agreements do not require the auditee to have a financial statement audit.

Requirements and Responsibilities

Audit committees of government entities that are either recipients or sub-recipients of federal awards are required to ensure that the entity maintains a system of internal control over all federal programs in order to demonstrate compliance with pertinent laws and regulations. A recipient means a non-federal entity that expends federal awards received directly from a federal awarding agency to carry out a federal program. A sub-recipient is an entity that receives a federal award indirectly through a state or local government or a not-for-profit entity. Some of the questions audit committees should understand are as follows:

- Has management identified all federal awards by Catalog of Federal Domestic Assistance (CFDA) number, including clusters of programs, federal program title, federal awarding agency, and any pass-through entities if applicable on a timely basis? Also has management identified the rules and regulations and compliance requirements related to each federal award?
- Does the government entity have a system of internal control over compliance with rules and regulations related to all federal programs and is the system functioning properly?
- Does the system of internal control over compliance provide for timely and effective communication of rules and regulations to program and accounting staff?
- Does the system of internal control over compliance provide for timely monitoring of its effectiveness and compliance with the applicable rules and regulations?
- Does management monitor compliance and take timely action for correcting weaknesses in the design of system of internal control or its implementation?
- Are the audits mandated under the UGG performed and copies provided to the Federal Audit Clearinghouse as required in a timely manner?
- If audit findings and questioned costs are identified, is there a process to address the findings? Does the process involve specific responses and, when necessary, taking corrective action that will resolve current or previous findings, or both?
- Was the reporting package prepared in conjunction with the independent auditor submitted electronically with the data collection form, and electronically signed by both the auditee and the auditor within the required timeline? Note that the recipient entity is legally responsible for the accuracy and timely submission of these forms even if the auditor prepares the forms.
- Has the government entity appropriately monitored any sub-recipients and has the entity obtained a copy of the sub-recipient entity Single Audit audit report? If there were any findings, were they addressed?

Oversight of Independent Auditors and Audited Financial Statements

The audit committee should understand the responsibilities of the auditors of recipients of federal awards and their reporting responsibilities to the not-for-profit entity. These are as follows.

Auditors of recipients of federal awards are required to:

- Plan and conduct the financial statement audit in accordance with generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS).
- Plan and conduct the audit of compliance for each major federal program in accordance with GAAS, GAGAS, and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (UGG after December 26, 2014).

- Determine if the organization-wide and program-specific financial statements are presented fairly in accordance with generally accepted accounting principles (GAAP).
- Determine if Schedule of Expenditures of Federal Awards (SEFA) is presented in accordance with OMB Circular A-133 (UGG after December 26, 2014) and audited in relation to the entity's financial statements as a whole.
- Determine that the independent auditor performed audit procedures that demonstrate an understanding of the recipient's internal controls and sufficient testing in order to support a "low assessed risk" for major programs.
- Determine that the recipient has complied with laws, regulations, and grant agreements in all material respect through adequate audit procedures.
- Follow-up on the status of previous audit findings.

Awarding agencies have the following responsibilities in the audit process:

- Identifying the federal awards made by informing each recipient of the CFDA title and number, the award name and number, the award year, and whether the award is for R&D. When some of this information is not available, the federal agency should provide information necessary to clearly describe the federal award.
- Advising recipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements.
- 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, unless exceptions have been granted by OMB.
- Ensure that recipients follow up on audit findings and develop and implement a corrective action plan if necessary.

Reporting

The auditor's reports over the Single Audit may be either combined with the financial statements or issued in a separate report. The auditor's reports will state that the audit was conducted in accordance with GAAS, GAGAS, and the OMB UGG for Federal Awards and include the following:

- An opinion (or disclaimer of opinion) about whether the financial statements are fairly presented in accordance with U.S. generally accepted accounting principles.
- An in-relation to opinion (or disclaimer of opinion) about whether the supplementary schedule of expenditures of federal awards is fairly presented in relation to the financial statements taken as a whole.
- Report on internal controls over financial reporting and on compliance and other matters based on an audit of the financial statements.

- Report on compliance and internal control over compliance applicable to each major Federal program required by the UGG Schedule of findings and questioned costs, including:
  — A summary of auditors' results

  — Findings related to the financial statements that are required to be reported in accordance with GAGAS

  — Findings and questioned costs for federal awards

  — Corrective action plan related to the current year's findings, if applicable

  — List of major programs using the required risk-based methodology

  — Determination concerning federal programs regarding whether the recipient of the federal award is a "high risk" or "low risk" auditee

Conclusion

The specific requirements and responsibilities of federal agencies and nonfederal recipients are detailed in OMB Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards.[1] Federal agencies are required to apply the provisions of the UGG to all nonfederal entities that receive and expend federal awards either directly from federal awarding agencies or as sub-recipients who receive federal awards from a pass-through entity. The UGG also contains administrative requirements, cost principles and other important information. Additional information is available from the United States Chief Financial Officers Council website, www.cfo.gov/cofar.

1 See www.gpo.gov/fdsys/pkg/FR-2013-12-26/pdf/2013-30465.pdf

Chapter 21

Unique Transactions and Financial Relationships

Overview: Some transactions and financial relationships put a government entity at increased financial risk. Generally accepted accounting principles provide guidance about how a government entity should account for and report these transactions and relationships as a means to fully inform the entity'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 the entity's financial statements. This tool is intended to assist audit committee members in gaining an understanding of these unique transactions and relationships so they may assess the appropriateness of management's accounting treatment for them and whether it meets the objectives of financial reporting.

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

1. Related party considerations (significant contributions or services provided by or contracts with the governing body).
2. Relationships with legally separate entities.
3. Joint ventures.
4. Tax-exempt financing.
5. Investments in derivative financial instruments.
6. Securities lending transactions.

The following sections provide background about these types of transactions and relationships.

Related Party Considerations (Significant Contributions or Services Provided by or Contracts with Directors)

The audit committee should determine the existence of significant related party relationships and transactions with such parties. Transactions with the governing body of the government entity's governing board may have to be disclosed.

The government entity should have an increased sensitivity when it enters into business relationships with the governing body. It also should have appropriate controls (1) for addressing potential conflicts of interest that could arise in related-party transactions and (2) for ensuring that such transactions are disclosed to and approved by the audit committee.

Additionally, a government entity should determine if any family members or key employees or officers are employed by the government entity. These relationships should be fully disclosed on an annual basis to the governing body and reported as necessary in either financial or cost reports, as applicable.

Relationship With Legally Separate Entities

Separate entities are created by government entities for a variety of reasons.

Financial reporting standards require an entity to determine when a separate organization should be included as part of the entity's financial reporting organization through consolidation. Although detailed and complex analyses ultimately determine which legally separate entities should be consolidated, organizations are generally included if they are controlled by the entity.

Joint Ventures

A *joint venture* is a legal entity that results from a contractual arrangement to pool resources and share the costs, risks, and rewards of an activity with other organizations. In a joint venture, each of the participants retains an ongoing financial interest, an ongoing financial responsibility, or both.

Joint ventures typically are accounted for using the equity method of accounting. Under the equity method, the entity recognizes its respective share of the joint venture's income or loss and any changes in the value of the joint venture.

Tax Exempt Financing

Many government entities enjoy the benefit of borrowing through the use of tax-exempt bonds. In the typical tax-exempt bond transaction, a government agency issues bonds carrying interest rates below those of taxable bonds. Upon issuance, the bonds are purchased by an underwriter and sold to institutional investors, the general public, or both. Some tax-exempt bonds are issued with credit enhancements, giving the investors in such bonds assurance regarding their credit worthiness. Government entities use credit enhancements to lower the overall cost of borrowing. Bond insurance and letters of credit from highly rated financial institutions are two such enhancements. In such cases, the provider of the credit enhancement usually requires certain fees, financial covenants, collateral, or any combination of such, from the government entity in return for providing the enhancement.

To ensure success, the typical tax-exempt bond transaction involves the services of many experts. For example, the government entity should employ the services of a competent borrower's counsel having an excellent track record in transactions similar to the proposed deal. The government entity will also need a highly experienced underwriter to help structure the deal, guide the process, and eventually sell the bonds. Often, a government entity borrower will engage a financial consultant to assist in developing pro-forma financial statements. If a credit enhancement is part of the plan, the government entity will select an appropriate provider and negotiate the best possible credit deal. In addition, the issuer and the credit enhancement provider will be represented by legal counsel.

Bond issuance costs generally should not exceed 2 percent of the total face amount issued. Additionally, the repayment term for tax-exempt bonds usually cannot exceed the average estimated economic life of the project costs funded by such bonds and proceeds from the tax-exempt financing generally cannot be used to fund costs for which specific resources have been dedicated, such as restricted contributions received from institutional and individual donors.

Many regulatory issues are operative in issuing tax exempt bonds. The audit committee of a government entity tax-exempt bond issuer should obtain assurance from management, competent advisors, or both that all applicable laws and regulations have been observed. Specific consideration should be given to the following:

- State laws governing the issuance and the use of tax-exempt bond proceeds—Although tax-exempt borrowing is allowed by federal law (under certain circumstances), each state must enact enabling legislation to designate conduit issuers and regulate the use of tax-exempt bond proceeds. For example, some states may restrict the use of tax-exempt bond proceeds to housing programs.
- IRS regulations concerning the following:
  - — Use of proceeds—IRS regulations include specific qualified uses for tax-exempt bond proceeds. Generally, proceeds must be used primarily for capital projects, with certain exceptions. No more than 2 percent of proceeds may be used to finance issuance costs.
  - — Qualifying borrowers and issuers—Issuance of tax-exempt bonds and use of the proceeds therefrom are restricted to certain types of entities. The IRS is the watchdog agency to ensure that the substantial benefits provided by tax-exempt borrowing accrue only to the intended beneficiaries.
  - — Arbitrage rebate—These regulations are complex, usually requiring the assistance of special experts to ensure compliance. IRS arbitrage rebate regulations ensure that a government entity borrowers use bond proceeds in a timely manner in compliance with tax regulations.

    If a government entity issuer earns a profit from investment of tax-exempt bond proceeds in taxable securities and fails to timely use this profit (arbitrage) to pay project costs, IRS arbitrage rebate regulations require the government entity to return (or rebate) the excess investment earnings to the U.S. Treasury or face severe penalties.
- SEC regulations concerning public debt offerings—Regulations include compliance requirements regarding initial offering statements, the types and quality of information provided to the public and the veracity of statements made concerning the bonds. Additionally, under SEC Rule 15c2-12, issuers of fixed-rate tax-exempt debt are required to make prescribed secondary market disclosures until the bonds are retired.

In short, due to the complexity of tax-exempt bond transactions, it is imperative that an audit committee monitor the entity's compliance with laws and regulations, both for the initial offering and on an ongoing basis after the debt has been issued. The audit committee should review the details of a proposed tax-exempt bond transaction well before the anticipated issuance date.

Derivatives

An entity's investment policies may allow investments in financial instruments that are not routine or actively traded in the market. Routine or actively traded financial instruments, such as repurchase agreements, government agency debt securities, and money market funds, have some degree of risk. However, derivatives, which are financial instruments or contracts that have unique characteristics underlying their ultimate investment yield, typically have much greater risk.

When a government entity holds derivatives, these financial instruments are included in the amount of investments reported in the entity's financial statements, at the instrument's market value, referred to as its fair value. In many cases the derivative may not be actively traded in the market, or its fair value may be based on complicated, unknown events. For this reason, the notes to the financial statements should include the following: (1) the entity's objectives for holding or issuing derivatives, (2) the context needed to understand those objectives, and (3) its strategies for achieving those objectives. In addition to many other details, the disclosure should provide information about the entity's policies related to the various types of derivative instruments and a description of the items or transactions for which risks are hedged.

Securities Lending Transactions

Sometimes, government entities have large amounts of long-term investments in their portfolios. If an entity 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 it purchased for delivery to a buyer. In these transactions, the entity 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 an entity lends its securities, it reports these securities as "pledged assets." In fact, the value of the cash or the securities received as collateral must be reported as assets in the financial statements. Of course, because the collateral must be returned in the future, the entity also reports a liability for these transactions in the financial statements. In addition, the notes to the financial statements should disclose the following:

- The policy for requiring collateral or other security
- The carrying amount and classification of assets not reported separately in the statement of financial position
- The fair value of collateral and the amount sold or re-pledged as of the statement date in situations in which the transferor has received collateral that it is permitted to sell or re-pledge

Audit Committee Questions for 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 entity. Audit committee members should answer the following questions in discussion with management and consultation with the external auditor or other experts as needed.

	Interviewer Notes
Significant Contracts With Directors	
1. Has the government entity entered into any contracts or agreements with anyone charged with governance for providing goods or services to the entity? If so, please review the details of the arrangement.	
2. For any such agreements, review how the agreement was disclosed to and approved by the governing body.	
3. Was the agreement reviewed in connection with the government entity's conflict of interest policy, if one exists?	
Legally Separate Entities	
1. Has the government entity created, authorized, or become aware of any legally separate organizations that have financial relationships with the government entity? If so, provide details of the arrangement.	
Joint Ventures	
1. Has the government entity entered into any agreement with another organization to share resources, costs, and risks for providing goods and services or other purposes? If so, describe the details of the arrangement.	
2. For any such agreements, please describe how the government entity accounts for its participation and how the effects of such participation are displayed or disclosed in the entity's financial statements.	

(continued)

	Interviewer Notes
Tax-Exempt Bond Offerings	
1. Review the proposed tax-exempt bond transaction deal points, including use of funds, bond structure, interest rate mode, credit enhancement, covenants, collateral, repayment terms, and source of repayment funds, for example.	
2. Review the process for selection and qualifications of expert advisers engaged to assist with the tax-exempt bond transaction including the following:	
• Borrower's counsel	
• Financial consultant underwriter	
• Bond counsel	
• Credit enhancement provider	
• Arbitrage rebate compliance consultant	
• Bond trustee	
3. Review the procedures management will implement to ensure compliance with state and federal laws and IRS and SEC regulations governing tax-exempt bond transactions. Specifically, how will management protect the government entity from the risk of noncompliance default?	
4. Review management's proposed accounting treatment of issuance costs and review the tax-exempt bond footnote disclosure in the financial statements.	
5. Review the initial offering statement. Discuss compliance with SEC regulations including Rule 15c2-12 disclosures, if applicable.	
6. Review IRS Form 8038, "Information Return for Tax Exempt Private Activity Bond Issues." Discuss ongoing compliance with IRS regulations concerning arbitrage rebate rules, if applicable.	
7. Review all debt covenants resulting from the tax-exempt bond transaction and procedures to ensure compliance on an ongoing basis. Review the material debt covenants footnote disclosure in the financial statements.	

	Interviewer Notes
Derivatives	
1. Review the government entity's policies for investing in derivative financial instruments. Are there any restrictions regarding the type, maturity length, or percentage of total portfolio?	
2. Review how management has valued its derivatives for financial statement presentation. Discuss the types of risks these investments have and how management has decided to manage those risks.	
Securities Lending	
1. Review the government entity's policies for entering into securities lending agreements.	
2. Review how securities lending transactions have been accounted for and whether they have been included in the government entity'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.	
Other Questions and Notes:	

Chapter 22

Analytical Procedures for Not-for-Profit Entities

Overview: The ratios presented in this chapter are a guide for organizations to use, and one should understand what they mean for each specific government entity. No two government entities are the same; therefore using a ratio or benchmark that may be significant for one government entity may not have the same significance for a different entity. Users should avoid the tendency to view standalone ratios as either "good" or "bad" based on whether they are high or low or comparing multiple government entities that conduct different activities, have different demographics, or are in different points in their lifespan. With that in mind, the metrics and indicators in this chapter are most helpful if used consistently and compared from period to period within the same entity.

The key financial ratios below are calculated for four major financial statements' categories: (1) government-wide (governmental activities only), (2) governmental funds, (3) General Fund, and (4) business-type activities.

(1) Government-Wide Governmental Activities

Government-wide financial statements report information on all of the non-fiduciary activity of the government and its component units. The study focuses on governmental activities that are normally supported by taxes and intergovernmental revenues. The government-wide financial statements use the economic measurement flow and accrual basis of accounting. The measurement and timing of recognition is similar to that of a business entity.

Government-wide General Ratios

Change in net position as a percent of net position

Formula:

$$\frac{\text{Increase (decrease) in governmental activities net position}}{\text{Governmental activities net position, beginning of year}}$$

Interpretation: The ratio measures the change in the government entity's financial condition for the year. A positive ratio indicates that the financial condition has improved; a negative ratio indicates a deteriorating financial condition.

Revenue coverage ratio

Formula:

$$\frac{\text{Governmental activities current year revenue*}}{\text{Governmental activities current year expense}}$$

* Current revenue includes both program and general revenue but excludes gains, losses, contributions, special and extraordinary gains or losses and transfers.

Interpretation: The ratio measures inter-period equity—whether current year revenue covers the cost, including depreciation, of providing current year services. A ratio greater than 1.00 indicates positive inter-period equity; current year taxpayers are providing adequately for current year services. When the ratio falls below 1.00, either prior year revenues were used to fund a portion of current year services or future citizens are being burdened with some of the cost for providing services consumed currently. A higher value for the ratio is usually considered favorable. However, an extremely high ratio may indicate that the government entity is not providing services commensurate with the current revenues being generated from its tax base.

Unrestricted net position as a percent of current year revenue

Formula:

$$\frac{\text{Governmental activities unrestricted net position}}{\text{Governmental activities current year revenue*}}$$

*Current revenue includes both program and general revenue but excludes gains, losses, contributions, special and extraordinary gains or losses and transfers.

Interpretation: The ratio measures the ability of the government entity to operate if its normal revenue stream is temporarily interrupted or significantly impaired. The ratio is the measure of the cushion that the government entity has for bad years. Municipalities may set a target minimum value for this ratio. A higher ratio is usually considered favorable. However, an extremely high ratio may indicate that the government entity is not providing appropriate current services for its constituents based on its recurring revenue stream.

Accumulated depreciation as a percent of depreciable capital assets

Formula:

$$\frac{\text{Governmental activities accumulated depreciation, end of year}}{\text{Governmental activities depreciable capital assets, end of year}}$$

Interpretation: The ratio is a measure of the relative age of depreciable capital assets compared to the assets' economic lives. Lower ratios are considered to be more favorable; the government entity will not face significant replacement cost in the near future.

Government-wide Liquidity Ratio

Liquidity ratio

Formula:

$$\frac{\text{Governmental activities liquid assets*}}{\text{Governmental activities current liabilities}}$$

*Cash and short-term investments, excluding any restricted assets

Interpretation: The ratio measures the government entity's ability to meet current obligations from existing cash and short-term investment balances. A higher ratio is considered favorable indicating that the government entity will be able to pay current liabilities as they become due.

Government-wide Debt Ratios

Debt to assets leverage ratio

Formula:

$$\frac{\text{Governmental activities total debt*}}{\text{Governmental activities total assets}}$$

* Total long-term liabilities excluding operating liabilities such as accrued compensated absences, claims and judgments payable, and pension obligations. Short-term operating debt is also not included.

Interpretation: The ratio is a measure of the degree to which the government entity's total assets have been funded with debt. A lower ratio is considered favorable indicating that the government does not have significant creditor claims against its assets and has less risk of default on debt.

Total debt per capita

Formula:

$$\frac{\text{Governmental activities total debt*}}{\text{Population}}$$

*Total long-term liabilities excluding operating liabilities such as accrued compensated absences, claims and judgments payable, and pension obligations.

Interpretation: The ratio is a measure of the debt burden to citizens. A lower ratio is considered favorable indicating that the citizens are less heavily burdened. The government entity has the ability to issue future debt at a lower cost.

Government-wide Revenue Ratios

Tax revenue per capita

Formula:

$$\frac{\text{Governmental activities tax revenue}}{\text{Population}}$$

Interpretation: The ratio is a measure of the tax burden to citizens. A lower ratio is considered favorable indicating that current citizens are paying lower taxes. Therefore the government entity has greater ability to increase taxes to meet future needs.

Total grants, contributions and other intergovernmental revenue as a percent of total revenue

Formula:

$$\frac{\text{Governmental activities total operating grants and contributions+} \atop \text{total capital grants and contributions + other intergovernmental revenue}}{\text{Governmental activities total revenue*}}$$

*Current revenue includes both program and general revenue but excludes gains, losses, contributions, special and extraordinary gains or losses and transfers.

Interpretation: The ratio measures the government entity's reliance on grants, contributions and other intergovernmental revenue. A lower ratio is considered favorable indicating that the government entity is less reliant on external sources that are beyond its control.

Government-wide Expense Ratios

Expense ratios measure the current-period cost of providing services to citizens or current-period financing cost. Functional expense categories include depreciation measuring the cost of using capital assets to provide current year services. Low ratios are depicted as favorable. However, the amount of expense incurred is not necessarily commensurate with the quality, efficiency or effectiveness of the service provided.

Total expense per capita

Formula:

$$\frac{\text{Government-wide total expense}}{\text{Population}}$$

Interpretation: The ratio is a measure of the expense necessary, on average, to provide services to a given citizen. A lower ratio is considered favorable indicating that a government entity is providing services to citizens at a comparatively lower cost. However, when comparing the results of this ratio between two different municipalities, one must consider whether the two municipalities provide comparable levels of police, fire, waste management, parks and recreation, and similar services. In addition, the amount of expense incurred is not necessarily commensurate with the quality, efficiency or effectiveness of the services provided.

Total general government (administration) expense per capita

Formula:

$$\frac{\text{Government-wide general government (administration) expense}}{\text{Population}}$$

Interpretation: See previous interpretation of total expense per capita.

Total public safety expense per capita

Formula:

$$\frac{\text{Government-wide public safety expense}}{\text{Population}}$$

Interpretation: See previous interpretation of total expense per capita.

Total interest expense per capita

Formula:

$$\frac{\text{Government-wide interest expense}}{\text{Population}}$$

Interpretation: The ratio is a measure of the interest expense incurred per citizen. A lower ratio is considered favorable, indicating that a government entity has minimized its debt obligations, and reduced the strain that debt service payments can place on current municipal resources.

(2) Governmental Funds

Governmental funds are used to account for the basic activities of the government entity that are not supported by user charges or characterized by the government entity acting in a fiduciary capacity. Governmental funds account for operations, acquisition of capital assets related to basic operations, and the debt service requirements for related debt. Primary resources are taxes, intergovernmental revenues and, for capital asset acquisition, long-term debt proceeds. Governmental funds report using the current financial resource measurement flow and the modified accrual basis of accounting. Expenditures are often controlled by annual budgets.

Total debt service expenditures as a percent of total revenues

Formula:

$$\frac{\text{Governmental fund debt service expenditures}}{\text{Governmental fund total revenues}}$$

Interpretation: This ratio measures the amount of current revenue that is devoted to meeting the year's debt service requirements. Significant debt service requirements potentially lower the amount that can be used for providing current services. A low ratio is considered favorable.

Capital outlay expenditures as a percent of total expenditures

Formula:

$$\frac{\text{Governmental fund capital outlay expenditures}}{\text{Governmental fund total expenditures}}$$

Interpretation: The ratio measures whether the government entity is adequately providing for capital asset additions and improvements. A high ratio is considered favorable indicating that the government entity is providing adequately for its capital asset needs.

(3) General Fund

The General Fund is the primary operating fund of a government entity. It accounts for the revenues that are not restricted for specific purposes and activities. Most of the basic operations of the government entity are accounted for in the General Fund. The General Fund, a governmental fund, reports using the current financial resource measurement focus and the modified accrual basis of accounting.

Unrestricted fund balance as a percent of total revenues

Formula:

$$\frac{\text{General Fund unrestricted fund balance*}}{\text{General Fund revenues}}$$

*Includes both assigned and unassigned fund balance.

Interpretation: The ratio measures the ability of the General Fund to continue operations if its revenue is temporarily interrupted or declines. This is a measure of the General Fund operating cushion. Municipalities may set a target for this ratio. A higher ratio is usually considered favorable. However, an extremely high ratio may indicate that the government entity is not providing the level of services commensurate with its revenue stream.

Intergovernmental revenue as a percent of total revenue

Formula:

$$\frac{\text{Governmental fund intergovernmental revenue}}{\text{Governmental fund total revenue}}$$

Interpretation: The ratio measures the General Fund's reliance on revenues from external sources to finance current operations. A low ratio is considered favorable indicating that the General Fund is not overly reliant on revenue sources that are beyond its control.

Transfers in as a percent of total revenues and transfers in

Formula:

$$\frac{\text{General Fund transfer in}}{\text{General Fund total revenues and transfers in}}$$

Interpretation: The ratio measures the reliance of the General Fund on transfers from other funds. To the extent the transfers are from enterprise funds, the users of enterprise services may be subsidizing General Fund operations. A low ratio is considered favorable indicating that the General Fund is not dependent on transfers.

(4) Business-Type Activities

Business-type activities within a government entity are operations that financed and operated in a manner similar to a private business entity. This can include airports, public utilities, hospitals, and colleges. The revenues collected are intended to operate and provide the function or services that the customer expects. The ratios used may vary based on the entity's industry.

Debt Service Coverage

Formula:

$$\frac{\text{Operating Income + Depreciation + Interest Income}}{\text{Debt Service Payments (Principal + Interest)}}$$

Interpretation: The ratio measures the ability of the entity to meet current debt service requirements. Municipalities may set a target for this ratio. A higher ratio is considered favorable. Ratio can be used to project future debt capacity.

Days Cash on Hand (Measure of Working Capital)

Formula:

$$\frac{\text{Cash + Cash Equivalents}}{\text{(Operating Expenses – Depreciation)/365}}$$

Interpretation: The ratio measures the working capital levels, in relation to the governmental entity's operating expenses. A higher ratio may signal greater financial flexibility. A target is often set for this ratio. This target should be set based on historical cash flow and current entity risks.

Chapter 23

Resources for Audit Committees

Overview: There is a wealth of resources available online to assist audit committee members in discharging their responsibilities. This chapter provides a list of organizations and websites that contain resources for audit committee members to investigate.

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

American Institute of Certified Public Accountants
www.aicpa.org

The American Institute of Certified Public Accountants (AICPA) is the national professional association for all certified public accountants. This includes CPAs working as independent auditors, accountants, or consultants in public practice, business and industry (including CFOs, controllers, and internal auditors), government, not-for-profit entities, and the academic community.

The AICPA has developed this Audit Committee Toolkit to aid audit committee members in performing their functions. In addition, the AICPA produces publications on accounting and auditing, financial reporting, tax, technology, and many other relevant topics. Some additional online resources useful to audit committees include the following:

- Audit Committee Effectiveness Center and Matching System at www.aicpa.org/audcommctr
- Fraud Resource Center at www.aicpa.org/interestareas/forensicandvaluation/resources/fraudpreventiondetectionresponse/pages/fraud-prevention-detection-response.aspx
- Internal Control Interest Area at www.aicpa.org/InterestAreas/BusinessIndustryAndGovernment/Resources/CorporateGovernanceRiskManagementInternalControl/Pages/COSO_Integrated_Framework_Project.aspx
- AICPA Governmental Audit Quality Center information at www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx
- Forensic and Valuation Services at www.aicpa.org/InterestAreas/ForensicAndValuation/Pages/ForensicValuationHome.aspx

In addition, the AICPA provides numerous conferences and CPE sessions dedicated to the government sector, the largest of which is the governmental conference held in August of each year.

Association of Audit Committee Members
www.aacmi.org

The Association of Audit Committee Members is a not-for-profit association of audit committee members dedicated to strengthening the audit committee by developing national best practices, including a robust whistleblower system. They are devoted exclusively to improving audit committee oversight.

Association of Certified Fraud Examiners
www.acfe.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. It offers guidance on fraud prevention, detection, and investigation, as well as internal controls. The ACFE publishes the *Report to the Nations on Occupational Fraud and Abuse* body of research aimed at deepening knowledge and understanding of the tremendous financial impact of occupational fraud and abuse on businesses and organizations.

Association of Governing Boards of Colleges and Universities
www.agb.org

The Association of Governing Boards of Universities and Colleges is a national organization providing university and college presidents, board chairs, and individual trustees of both public and private institutions with the resources they need to enhance their effectiveness.

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.

Association of International Certified Professional Accountants
www.cgma.org

The Association of International Certified Professional Accountants established the Chartered Global Management Accountant (CGMA) designation in January 2012. The CGMA's mission is to promote the science of management accounting on the global stage. The designation champions management accountants and the value they add to organizations. Relevant tools and resources supporting board and audit committee responsibilities are included within the vast library on their website.

Association of Local Government Auditors
algaonline.org

ALGA is a professional organization committed to supporting and improving local government auditing through advocacy, collaboration, education, and training, while upholding and promoting 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.

Business Roundtable
www.businessroundtable.org

The Business Roundtable (BRT) is an association of chief executive officers of leading U.S. corporations. The BRT is committed to advocating public policies that foster vigorous economic growth, a dynamic global economy, and a well-trained and productive U.S. workforce essential for future competitiveness. The BRT's Corporate Governance Committee focuses on issues related to corporate governance and responsibilities, including accounting standards.

Center for Audit Quality
www.thecaq.org

The Center for Audit Quality (CAQ) is an autonomous, nonpartisan, nonprofit group based in Washington, D.C. It is governed by a board that comprises leaders from public company auditing firms, the AICPA, and three members from outside the public company auditing profession. The CAQ is dedicated to enhancing investor confidence and public trust in the global capital markets. The "Audit Committee Annual Evaluation of the External Auditor" resource is designed to allow audit committees to evaluate the auditor's performance objectively.

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, in May 2013, *Internal Control—Integrated Framework and the Enterprise Risk Management—Integrated Framework*.

Conference Board
www.conference-board.com

The Conference Board is a global, independent membership organization that creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. The Conference Board conducts research, convene conferences, make forecasts, assess trends, publish information and analysis, and bring executives together to learn from one another. The Conference Board's Commission on Public Trust and Private Enterprise has proposed reforms to strengthen corporate compensation practices and help restore trust in America's corporations and capital markets.

Corporate Board Member
www.boardmember.com

Corporate Board Member magazine's website, Boardmember.com, serves as a central resource for officers and directors of publicly traded corporations, large private companies, and Global 1000 firms. Their resource center offers the full texts of *Corporate Board Member* magazine articles, as well as additional articles, tools, Webcasts, and interviews. Topics include corporate governance, strategic board trends and issues, executive and director compensation, audit committees, risk management, international and technology trends, investor relations, board education, and other critical topics facing today's directors and officers of publicly traded companies. The Corporate Board Member extends its governance leadership through an online resource center, conferences, roundtables, and timely research.

Ethics & Compliance Officers Association
www.theecoa.org

The Ethics & Compliance Officers Association (ECOA) is the professional association exclusively for individuals responsible for their organizations' 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 Resources Center
www.ethics.org

The Ethics Resources Center (ERC) is a nonprofit, nonpartisan research organization, dedicated to independent research that advances high ethical standards and practices in public and private institutions, including a focus on ethics and compliance aspects of the federal government. Their mission is to promote ethical leadership worldwide by providing leading-edge expertise and services through research, education, and partnerships on current and emerging issues. The ERC's resources on business and organizational ethics are especially useful.

Financial Accounting Standards Advisory Board
www.fasab.org

The FASAB serves the public interest by improving federal financial reporting through issuing federal financial accounting standards and providing guidance after considering the needs of external and internal users of federal financial information.

Financial Executives International
www.financialexecutives.org

Financial Executives International (FEI) is a professional association for senior level financial executives, including chief financial officers, vice-presidents of finance, controllers, treasurers, and tax executives. The FEI provides peer networking opportunities, emerging issues alerts, personal and professional development, and advocacy services.

GMI Ratings
www3.gmiratings.com

GMI Ratings was formed in 2010 through the merger of three independent companies: The Corporate Library, GovernanceMetrics International, and Audit Integrity. Drawing on the shared vision and intellectual capital of its predecessor firms, GMI Ratings emerged as a clear leader in the understanding of risks affecting the performance of public companies worldwide. Today, GMI Ratings provides institutional investors, insurers, and corporate decision-makers the most extensive coverage of environmental, social, governance, and accounting-related risks.

Government Finance Officers Association
www.gfoa.org

The Government Finance Officers Association (GFOA), represents public finance officials throughout the United States and Canada. The association's nearly 18,000 members are federal, state/provincial, and local finance officials deeply involved in planning, financing, and implementing of thousands of governmental operations in each of their jurisdictions. The GFOA's mission is to enhance and promote the professional management of governmental financial resources by identifying, developing, and advancing fiscal strategies, policies, and practices for the public benefit.

Governmental Accounting Standards Board
www.gasb.org

The Governmental Accounting Standards Board (GASB) is the independent organization that establishes and improves standards of accounting and financial reporting for U.S. state and local governments. Established in 1984 by agreement of the Financial Accounting Foundation (FAF) and 10 national associations of state and local government officials, the GASB is recognized by governments, the accounting industry, and the capital markets as the official source of generally accepted accounting principles (GAAP) for state and local governments.

Harvard Business School's Corporate Governance
www.exed.hbs.edu

Harvard Business School's Corporate Governance website is a comprehensive overview of research, educational programs, and other activities at Harvard Business School aimed at providing new frameworks for thought and practice in the interrelated areas of corporate governance, leadership, and values. It includes links to the ongoing workshop series, background papers, research programs, executive education programs, viewpoints on key issues published in the national press, faculty comments in the media, and an online forum for exchanging views on emerging issues.

Institute of Internal Auditors
www.theiia.org

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

IT Governance Institute
www.itgi.org

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

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

The National Association of College and University Business Officers (NACUBO) represents chief administrative and financial officers through a collaboration of knowledge and professional development, advocacy, and community. Its vision is to define excellence in higher education business and financial management.

National Association of Corporate Directors
www.nacdonline.org

Founded in 1977, the National Association of Corporate Directors (NACD) is the premier educational, publishing, and consulting organization in board leadership, and the only membership association for boards, directors, director-candidates, and board advisers. The NACD promotes and advances exemplary board leadership through high professional board standards; creates forums for peer interaction; enhances director effectiveness; asserts the policy interests of directors; conducts research; and educates boards and directors concerning traditional and cutting-edge 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.

Office of Management and Budget
www.whitehouse.gov/omb

The Office of Management and Budget (OMB) publishes the circulars that include federal regulations related to audits of government entities and not-for-profit entities that receive and expend federal funds.

The Society of Corporate Secretaries & Governance Professionals
www.ascs.org

Originally founded as the American Society of Corporate Secretaries (ASCS), the Society of Corporate Secretaries & Governance Professionals (the society) acts as a positive force for enlightened corporate governance. The Society's key mission is to promote excellence in corporate governance. The Society's members address issues of public disclosure under the securities laws and matters affecting corporate governance, including the structure and meetings of boards of directors and their committees, as well as the proxy process and the annual meeting of shareholders and shareholder relations, particularly with large institutional owners.

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 entities when required by law, regulation, agreement, contract, or policy.

Chapter 24

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
CAS	Cost Accounting Standards
CEO	Chief Executive Officer
CFDA	Catalog of Federal Domestic Assistance
CFO	Chief Financial Officer
CFR	Code of Federal Regulations
CIO	Chief Information Officer
COFAR	Council on Financial Assistance Reform
COSO	Committee of Sponsoring Organizations of the Treadway Commission
D&B	Dun and Bradstreet
DUNS	Data Universal Numbering System
ERM	Enterprise Risk Management
FAC	Federal Audit Clearinghouse
FAIN	Federal Award Identification Number
FAR	Federal Acquisition Regulation
FASAB	Federal Accounting Standards Advisory Board
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAGAS	Generally Accepted Government Auditing Standards (also known as the Yellow Book)
GAO	U.S. Government Accountability Office
GAQC	AICPA's 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
IDES	FAC's Internet Data Entry System
IIA	Institute of Internal Auditors
IPPF	*International Professional Practices Framework* (also known as the Red Book)

IRC	Internal Revenue Code
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
SSAE	AICPA's Statement on Standards for Attestation Engagements
TPA	Third-party Administrator
UG	Uniform Guidance (2 CFR Chapters I and Chapter II: Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards)