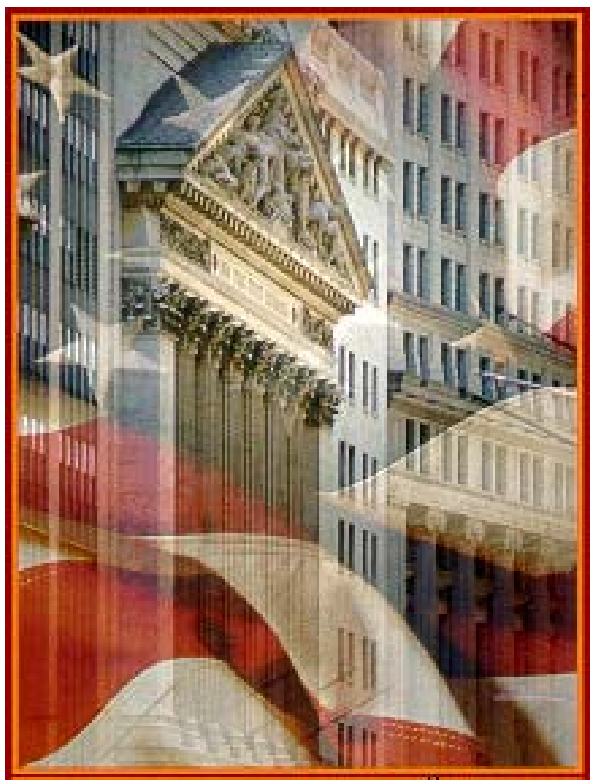
AUDIT COMMITTEE GUIDE
FOR
PUBLIC SECTOR ENTITIES

State and Local Governments
&
Nonprofit Organizations



National Office of Audit and Accounting

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McGladrey & Pullen, LLP is one of the largest CPA firms in the country whose primary focus is to provide audit and assurance services to mid-sized companies. Additionally, we have a large public sector practice. McGladrey & Pullen professionals use a unique combination of industry expertise and computer-based tools to deliver efficient and cost effective services and value added recommendations to help our clients.

Audit Committee Guide for Public Sector Entities

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Introduction

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

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

The Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (BRC) issued in February 1999 delivered ten recommendations to strengthen the role of the audit committee. The Securities and Exchange Commission (SEC), Nasdaq, and the exchanges adopted new rules for audit committees. While most governments and not-for-profits do not report to the SEC, we believe that the SEC's rules and regulations make sense in the public sector.

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

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Historical Perspective

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

Regulatory Perspective

With the increasing reliance on state and federal funding by many local governments and not-for-profits, regulators look to the entity's governing board as being ultimately responsible for the control of these resources and compliance with program requirements and objectives.

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

The Purpose of this Guide

McGladrey & Pullen, LLP is publishing *Audit Committee Guide for Public Sector Entities* to assist the Governing Boards of public sector entities to effectively and efficiently meet their financial fiduciary responsibilities. While audit committees of public sector entities and companies alike have always had a significant role in corporate governance, the extent of these responsibilities were raised to new levels in late 1999 and early 2000. In 1999, the Blue Ribbon Committee Report on Improving the Effectiveness of Corporate Audit Committees was released, which led to significant changes in the public company audit committee rules of the SEC, the Auditing Standards Board and NASDAQ, NYSE and AMEX. Of particular interest is the SEC's adoption of rules requiring improved public disclosures about the functioning of a registrant's audit committee.

We believe the increased responsibilities of public company audit committees will have a significant affect on the audit committees of nonpublic companies as well as public sector entities. As a result, the Governing Boards of public sector entities must become much more attentive to the appropriate functioning of their audit committees.

This booklet addresses the responsibilities of audit committees and finance committees acting in the capacity of an audit committee. The use of "Committee" in this booklet is intended to refer to both types of committees. Additionally, the use of "organization" or "entity" in this booklet is intended to refer to any state or local government entity, agency, or political subdivision, as well as not-for-profit organizations.

Hopefully, this booklet will provide some best practices ideas in helping you establish an audit committee. We also hope this booklet will help your Committee to be more effective. Obviously, you will need to select among the various best practices discussed below to develop a process that is relevant to your organization.

Responsibilities of the Committee

The October 1987 Report of the National Commission on Fraudulent Financial Reporting (known as the Treadway Commission) recommended the following responsibilities for an audit committee of a public company:

> "The audit committee of the Board of Directors plays a role critical to the integrity of the company's financial reporting. The Commission recommends that all public companies be required to have audit committees composed entirely of independent directors. To be effective, audit committees should exercise vigilant and informed oversight of the financial reporting process, including the company's internal controls. The Board of Directors should set forth the committee's duties and responsibilities in a written charter. Among other things, the audit committee should review management's evaluation of the independence of the public accountant and management's plans for engaging the company's independent public accountant to perform management advisory services."

Obviously, the Treadway Commission report placed significant responsibilities at the feet of the audit committee of public companies. We believe that this statement is a reasonable foundation for the design and implementation of an effective Committee of a public sector entity.

The primary role of the Committee is to provide assurance to the Governing Board that the organization has the appropriate culture and the personnel, policies, systems and controls in place to safeguard entity assets and to accurately report financial information to internal and external users. The preparation of the financial statements and related communications are the responsibility of the entity's management and the Governing Board. The independent auditor's role is to report on the fairness of the presentation of the entity's financial statements, to identify potential internal control problems and instances of material noncompliance, and to provide advice and counsel to management and the Committee. Typically, it is best if the auditor views the Committee as their primary employer so the Committee is confident the auditor is communicating openly about issues and concerns. The auditor may be less candid if there is a strong relationship and loyalty to management. However, in many public sector entities, the auditor will have a significant relationship with management and the audit committee will need to work with the auditor to develop more than just a reporting relationship with the Committee.

The specific activities of the Committee will vary from entity to entity, depending on the size, complexity, industry of the organization and needs of the Governing Board. The primary responsibilities of a Committee usually include oversight of the following:

Open communication between the Committee, financial and program management and the auditor.

Internal accounting controls to safeguard assets, ensure compliance and avoid fraud.

Budgetary and finance.

Quality and timely financial and compliance reporting.

Selecting the auditor.

The annual audit process.

Reporting to the Governing Board.

We strongly suggest that the Committee establish a charter that sets forth its principle responsibilities and activities. We have included two examples in the Appendix.

Recommended Skills for Committee Members

We believe that the Committee should be comprised of experienced members that are independent of the management of the company. An independent attitude is necessary for Committee members to be most effective and to serve the best interests of the Governing Board and constituents.

In 1997 the Government Finance Officers Association (GFOA) approved the release of an accounting, auditing and financial reporting recommended practice for the establishment of an audit committee. Although the GFOA's recommendations are addressed to government finance officers, they are just as applicable to other public sector entities. Following are the GFOA's recommendations regarding the establishment of audit committees.

1. Every government should establish an audit committee or its equivalent. Reliable audits are essential to the credibility of financial reporting by state and local governments. The audit committee is a practical tool that a government can use to enhance the independence of the external auditor, and hence the reliability of the financial statement audit.

2. The audit committee should be formally established by charter, enabling resolution, or other appropriate legal means.

3. The members of the audit committee collectively should possess the expertise and experience in accounting, auditing, and financial reporting needed to understand and resolve issues raised by the independent audit of the financial statements.

4. A majority of the members of the audit committee should be selected from outside management. At the same time, the audit committee should include at least one representative each from the executive and legislative branches of the government.

5. An audit committee should be sufficiently large to ensure that its members possess all of the skills needed to realize the committee's objectives. At the same time, the audit committee should be small enough to operate efficiently. Therefore, as a general rule, an audit committee should be composed of no less than five and no more than seven members.

6. The primary responsibility of the audit committee should be to oversee the independent audit of the government's financial statements, from the selection of the independent auditor to the resolution of audit findings.

7. The audit committee should have access to the reports of any internal auditors, as well as access to any annual internal audit work plans.

8. The audit committee should present annually to the governing board and management a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public.

Some minor modifications to the above may be necessary for application to a not-for-profit entity. However, the intent is to have a formally established group of five to seven individuals with diverse backgrounds, who report to the governing board and who collectively possess the expertise to oversee the entity's external audit(s).

The Committee should be comprised of individuals with a combination of the talents listed below, the most relevant being an appropriate level of financial literacy. Obviously, it may not be practical for every Committee member to have all of these characteristics.

Expertise in financial accounting and reporting, indicated by:

- Professional certification in accounting, such as a CPA or a CMA.
- Past experience in finance or accounting at a significantly high level of responsibility, or
- Other comparable experience or background which results in an appropriate level of financial sophistication, such as a COO or CEO.

Ability and willingness to ask probing questions about operating and compliance risks and financial matters.

Independence in attitude.

Industry experience.

Willingness to actively participate in the Committee process.

It may be beneficial to develop a Committee training manual to educate new members about the organization and its financial and compliance matters. This manual may also be a good resource for Committee members. It may also be beneficial to engage an outside expert to periodically assess the Committee's activities and to assist in improving the process followed.

Developing Effective Committees

Open Communications

The Committee should take a leadership role in establishing open and straightforward communications between the Committee and both management and the auditor. The Committee relies heavily on open and timely communications so that it may address issues in a thorough and expeditious manner. Both management and the auditor need to believe they have the ear of the Committee and that their concerns will be listened to and addressed on a timely and thorough basis.

We suggest the following ideas to stimulate open discussions:

Establish clear expectations of the type of proactive communications expected by the Committee, including issues, significant new developments and ideas.

The Committee chairperson should periodically schedule separate meetings with management and the auditor to discuss issues, new developments and ideas.

Consider the need for quarterly joint meetings or conference calls with management and the auditor. These meetings can be brief and designed to keep everyone informed of progress and new issues.

Required face-to-face meetings with management and the auditor both before year-end and after the auditor completes fieldwork and in some cases during the audit process. The content of these meetings are discussed under The Annual Audit Process section of this booklet.

Internal Accounting Controls

It is imperative that the Committee determine annually that the organization has an effective and efficient system of internal accounting and administrative controls in place to safeguard assets, ensure compliance, and to prevent and detect fraudulent activities. The following procedures are best practice ideas to help the Committee determine that strong internal accounting controls are in place:

Determine that there is an appropriate "tone at the top" of the organization which indicates the importance of sound operating ethics and business practices. This can be determined by reviewing the organization's code of conduct and management's internal and external communications, by assessing the quality of financial, compliance and other communications the Committee has received from management, by observing management attitudes and by interviewing financial and program management and the external auditor.

Determine that the organization's financial and program personnel have an adequate level of competency and experience and the depth of resources to perform their function effectively and efficiently. The competency, experience and integrity of the CFO/controller/administrator is a significant factor in determining the quality of controls in the organization. This assessment may include one or more of the following steps:

- Make an assessment of the complexity of the organization and the financial competency, experience and attitude of the CEO/superintendent/administrator/etc. This will help determine the level of sophistication and backbone that is needed in the top financial management position in the organization.
- Obtain the job description and biography of the CFO/controller/administrator/etc. to make an assessment of whether a gap exists between their skills compared to the skill level you believe is required.
- Consider calling references to determine whether an adequate level of experience exists in the CFO/controller/administrator/etc.
- Discuss the competency of the CFO/controller/administrator/etc. with the external auditor to obtain their views of the strengths and weaknesses of the individual.
- Obtain and read the job evaluations and the current personal development plan of the CFO/controller/administrator/etc. The Committee should provide input to the annual personal development and training program for the CFO/controller/administrator/etc.

Obtain an understanding of the key operating and administrative risks facing the organization that deserve special attention in the organization's assessment of internal accounting and administrative controls and in its insurance practices. This understanding can be obtained by interviewing key management, the auditor, legal counsel and/or the insurance agent and by understanding the nature of the organization's operations and programs. It may be useful to have the CFO/controller/administrator/etc. and the insurance agent provide an assessment of the organization's business risks and the related insurance coverage in place to protect the organization.

Obtain an understanding of the organization's key performance indicators and the processes used to measure actual results against these indicators. These indicators may provide an early warning that internal control problems are occurring.

Obtain an understanding of the organization's cash management and investment policies to ensure that cash is managed effectively and that excess cash is appropriately invested in securities that are authorized and match the risk/return objectives of the organization. The Committee should insist that the organization establish an investment policy for excess cash balances.

Obtain an understanding of all related party transactions to determine whether they are free of conflicts and transacted on a basis similar to that obtainable from an independent third party.

Determine that the organization has a thorough accounting policy and procedure manual. The accounting manual accomplishes the following objectives:

- Establishes a proper tone and emphasis for following procedures.
- Establishes accounting policies to be followed on complex areas or where accounting principles offer choices.
- Establishes the timing and substance of specific procedures to be followed in the company's system of internal accounting control. Without this specificity, finance department personnel must follow previous work or are left to determine their own procedures. These specific procedures also provide a basis for the supervisory personnel to periodically perform reviews to ensure that the internal control system is properly functioning.
- The manual provides a tool for new hires to more quickly understand the organization's culture and the procedures to be followed.

Determine that the entity has a thorough and complete understanding of laws, regulations and agreements that could have a material effect on the entity's financial statements and major federal and state funded programs. Depending on the nature of the organization's funding and number and complexity of statutory, regulatory and contractual compliance requirements, it may be necessary to develop and maintain a thorough administrative policy and procedure manual in addition to or to supplement the accounting manual.

Annually require the CFO/controller/administrator/etc. to provide the Committee with an assessment of the strengths and weaknesses of the organization's system of internal controls and recommendations for improvements. The recommendations should cover the following:

- Significant changes made to the control system during the year and the reasons for such changes.

- Significant personnel changes made during the year that affect the internal control system, whether these changes have created any new exposures and how the CFO/controller/administrator/etc. is addressing these issues.
- Significant new programs or activities or processes implemented, the related operating exposures created and the new controls in place to help control risks.
- Adjustments to correct new or increased exposures to safeguarding assets or fraudulent activities. The objective is to understand the control risks in the organization so that the Committee can make an informed decision as to whether an acceptable level of risk containment is being achieved.
- Adjustments to improve the efficiency of the system of internal accounting and administrative control. These systems need to be both effective and efficient, since an organization has limited resources to allocate to its activities.

Obtain a communication (either verbal or written) from the auditor addressing the organization's system of internal accounting and administrative controls. Most audit firms will provide a letter addressing any known significant reportable conditions. Reportable conditions are defined by the auditing literature as matters "coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements." With respect to compliance, reportable conditions are "matters coming to the auditor's attention relating to significant deficiencies in the design and operation of the internal control over compliance that in the auditor's judgment, could adversely affect the entity's ability to administer a program in accordance with application requirements of laws, regulations, contracts and agreements." The Committee should discuss with the auditor the significance of any reportable conditions or material weaknesses, the risk of exposure to the organization and the auditor's thoughts on how to cost-effectively remedy the exposure.

If the organization outsources its data processing services to a third party, obtain an annual report from the provider's auditor regarding the functioning of the system. These reports are known as service organization reports or SAS 70 reports.

If the organization outsources any of its accounting functions to a third party, consider obtaining the following information from that provider:

- An assessment of the strengths and weaknesses of the organization's internal control system.
- An understanding of the provider's contract with the organization, the provider's control system and insurance coverage for any significant problems caused by a failure of provider personnel to identify and correct any control problems. The extent of this effort may be affected by the financial and political problems to organization management and the Board that could be created by a failure of the provider to exercise due care.

Budgets and Financing

Budgeting is an important element of the financial planning, control and evaluation processes for almost all governmental entities and most nonprofit organizations. Most states have enacted legislation that requires political subdivisions, and in some cases nonprofit organizations (especially those dependent of state funding), to adopt a budget for at least their general operating fund and various programs. The budgetary practices of public sector entities vary greatly, and the Committee as well as its external auditor should be knowledgeable about any laws, regulations, or administrative policies governing the budgetary requirements of the entity and its related organizational units.

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

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

Obtain an understanding of planned efficiencies and other cost cuts. It is important that the process include a periodic reevaluation of activities so that low value and inefficient activities can be addressed or eliminated on a timely basis.

Obtain a reconciliation of the major changes between last year's actual (or forecasted) results and the new year's budgeted results.

Obtain an understanding of the capital budget items. Including considering any alternatives to construction or purchase.

Obtain an understanding of management's process to monitor actual vs. budgeted results and how corrective action is identified and implemented.

Obtain an understanding of any regulatory or contractual requirements concerning the preparation, submission, monitoring and compliance with the annual budget.

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

Does the organization have a short- and long-term cash flow forecast that demonstrates the adequacy of the organization's debt financing currently in place? The forecast should typically include both an expected case and a worst case so that adequate cushion exists in the organization's financing capacity.

Does the organization have an understanding of its current cost of debt?

Does the organization have a strategic plan and a related three to five year forecast that identifies the financing needs of the organization? Has the organization identified likely alternative sources for its additional financing needs and the steps that will be needed to secure this financing?

Financial Reporting

Another key objective of the Committee is to ensure that the entity is providing quality and timely financial information to internal and external users. Obviously, the entity's financial statements are the most significant component of these disclosures. However, there may be other important components of the entity's financial communications, including written reports to the Board, debt holders and government agencies. The following thoughts are presented to help the Committee assess the quality and timeliness of financial information provided by the entity:

Obtain an understanding of the financial reports that the entity issues internally and externally. This inventory can be obtained from the CFO/controller/administrator/etc. and will help the Committee understand the full scope of the entity's financial communications. Usually, there are no surprises in understanding this inventory, but sometimes there are unusual items on the list for which the Committee may have some indirect responsibility.

Obtain an understanding of the timing that relevant financial reports are delivered to internal management and external users. Obviously, the timing of financial information is a key element to the relevancy of such information. The slow delivery of reports is a clear indicator that there are problems with the accounting and control system and/or the competency or depth of resources of the finance department.

Discuss the following items with the auditor. As noted below, the Committee should request that the auditor put this information, as well as other information, in writing annually in accordance with auditing standards.

- Obtain an understanding of the accounting principles used by the entity. In particular, obtain an understanding of any new accounting policies selected by management during the year and the auditor's conclusions regarding the appropriateness of the selection. Also, obtain an understanding of whether the auditor has any concerns that such policies are not in conformity with generally accepted accounting principles or any other method normally followed by the entity.
- Obtain an understanding of the significant accounting judgments and estimates that management must make in the preparation of its financial statements (i.e., bad debt, insurance claims or reserves). Also, obtain an understanding of the entity's methodology in determining these estimates and whether the auditor believes management's estimates are reasonable and on the conservative or aggressive end of the acceptable range of the estimate.
- Obtain an understanding of the number and magnitude of the journal entries that the entity was required to make in order for the financial statements to be prepared in accordance with generally accepted accounting principles. In particular, obtain an understanding of the magnitude of the adjustments that the entity did not make as identified by the auditor. If significant concerns are identified, it would be beneficial to obtain an explanation from management why such adjustments were not recorded. Keep in mind that an explanation citing "not material" cuts both ways. We recommend that immaterial adjustments be recorded for known errors so the entity has a track record of accounting for transactions correctly. In particular, watch for intentional departures from generally accepted accounting principles that are not material. These immaterial departures set a poor precedent and may ultimately become material.

Compliance Audit Reporting

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

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

Selecting the Auditor

The responsibility for the selection of the audit firm varies in public sector entities. In some cases, the audit firm selection process is handled entirely by management; while in other cases, the Committee manages the selection process. In any event, we recommend that the Committee be actively involved in establishing the selection criteria, interviewing the finalists and in making the final decision.

The following factors should be considered in selecting an auditor:

> The relevant experience and expertise of the audit firm and the local office that will be responsible for the engagement, including:
>
> - The importance of the client size and industry to the firm and the local office.
> - The technical and industry resources the audit firm has to assist the engagement team or that are available for direct access by the organization.
> - The availability of other relevant technical expertise locally and nationally.
> - The resources the organization will need as it grows and/or matures.

The quality of the firm's audit practice. Obtain a copy of the firm's latest peer review report and related letter of comments, and consider calling references provided by the audit firm. Obviously, reference checking requires a thorough effort since the referrals will be supporters of the firm. In particular, ask the referral about staff turnover, responsiveness on issues, proactivity in providing ideas and advice and meeting engagement deadlines. Also, ask what they like most and least about the firm and the partners. Consider funding sources or oversight agencies as an additional source of information about the audit firm.

Obtain an understanding of the firm's involvement with standard setting bodies and participation in trade organizations (e.g. GFOA, ASBO, NACUBO).

The partners to be assigned to the engagement. Obtain an understanding of:

- Management's assessment of the personal chemistry with the proposed engagement partners.
- Relevant and current industry experience of the audit partners on similar clients and participation/membership in trade organizations.
- Level of involvement the partners will have with the engagement.

Determine that there are no potential conflicts with the audit firm, including:

- Are there any known or potential independence issues, including family relationships?
- Are there any known or potential conflicts of interest?

Obtain an understanding of the auditor's views on the unique and difficult aspects of the engagement to help determine that they have made a thorough assessment of the organization's financial and compliance audit requirements and difficulties.

Obtain an understanding from management of the level of interest and enthusiasm that the audit firm candidate has expressed in the selection process. Often, this is a good indicator of the importance of your business to that firm.

The Annual Audit Process

We recommend the following minimum process to be followed by the Committee with respect to the annual audit of the entity's financial statements.

Ensure that the auditor, financial management and the Committee have maintained an open channel of dialog to discuss issues and concerns during the year including corrective action taken with respect to prior audit findings.

Confirm the independence of the auditor annually. Audit firms must now provide SEC clients with an annual report indicating any potential independence issues that may exist. It may be beneficial for the Committee to obtain a similar written communication.

Investigate any matter brought to the Committee's attention within the scope of its duties, with the power to retain outside counsel for this purpose if, in its judgment, that assistance is appropriate.

The Committee should meet with management and the auditor well in advance of year-end to discuss the following issues:

- Follow up on any significant prior year items that management or the audit firm was to address during the course of the year, such as compliance findings, internal control and management letter comments from the auditor.
- Understand any new professional standards that will affect the current year's audit and concur with management's proposed handling of such matters. The auditor should provide the Committee with summaries or copies of the relevant professional standards to help the Committee members understand the changes and the related effects on the financial statements.
- Understand and concur with the proposed scope of the audit, including changes in the entity's operations and programs or significant new issues affecting the entity's financial statements in the current year and the auditor's thoughts on materiality with respect to the financial statements to be reported on. It is recommended that the Committee understand the audit approach on significant items in the financial statements, including the entity's responsibility to provide access to information and other assistance and compliance requirements, as well as material judgments and estimates to be made by management. This meeting provides the Committee with an opportunity to direct the activities of the auditor to additionally address any specific areas of concern. It may be necessary to excuse management from a portion of the meeting to discuss these matters privately.
- Agree with the proposed timing of the engagement and deliverables, including the delivery of the audited financial statements, compliance and/or regulatory reports, any reports to the Committee relating to reportable conditions, required communications and other business advice.
- Understand the auditor's proposed staffing.
- Understand and concur with the auditor's arrangement letter, including the proposed fees. It may be beneficial to excuse the auditor from a portion of the meeting to discuss management's views on the fee estimate, proposed arrangement letter or any other matters.
- Address any regulatory or oversight issues.
- Understand the extent of services provided by the audit firm to the entity, including any tax and consulting services.

The Committee should request the CFO/superintendent/administrator/etc. to periodically communicate the progress of the audit and whether any significant issues have been identified and the status of the resolution of such matters.

The Committee should meet with management and the auditor after the completion of fieldwork, but before the issuance of the final reports and letters, to discuss the results of the audit and the draft financial reports and related letters. The following matters should be discussed:

- Obtain an assessment from the auditor of reportable control conditions or material weaknesses in internal controls.
- Obtain an understanding from management of major variances in the financial statements from last year and from budget, if relevant. This will help the Committee understand what is happening to the entity's financial condition, results of operations and cash flows.
- Obtain an understanding of changes in the significant accounting estimates in the entity's financial statements, the relative conservatism of such estimates and the affect of changes in these estimates on the entity's financial statements.
- Obtain an understanding of the significant audit adjustments made and any significant passed adjustments at year-end.
- Discuss the auditor's observations and suggestions regarding the entity's compliance with laws, regulations and agreements, internal controls and other business suggestions.
- The Committee excuse management for a portion of the meeting to discuss the following items with the auditor:
  - Any concerns regarding compliance with the entity's code of conduct.
  - Any significant concerns in the accounting policies or the application of accounting principles. In particular, obtain the auditor's views of the appropriateness, not just the acceptability, of the entity's accounting principles and the clarity of the financial disclosure practices.
  - Any concerns regarding management's estimates and judgments.
  - Any concerns about audit adjustments made or passed.
  - Any concerns about specific compliance findings.
  - Any concerns about related party transactions or conflicts of interest.
  - Any significant disagreements with management during the audit process.
  - Any difficulties in completing the audit, including the ability to obtain satisfactory audit evidence and the level of cooperation and preparedness of the entity.
  - Any concerns about the quality of financial disclosures.
  - Any special items the Committee asked the auditor to address during the planning meeting.
  - The anticipated fees for the engagement relative to the amount agreed to in the arrangement letter.
  - The competency of the CFO/controller/administrator/etc. and other finance department personnel. In particular, obtain any suggestions the auditor may have to enhance the skills and experience of the individuals.

      - Any other matters the auditor would like to discuss with the Committee.
  - The Committee excuse the auditor for a portion of the meeting to discuss the following with management:
      - Did the auditor provide the staffing agreed to in the planning meeting?
      - Did the auditor perform the engagement professionally, effectively and efficiently?
      - Does management disagree with any of the comments made by the auditor, including instances of noncompliance and the quality of internal controls, estimates, accounting policies and disclosures?
      - Does management have any comments about the business advice comments provided to management?
      - Are there any issues that suggest that the audit firm needs to improve their service or that suggest the audit firm should be replaced?
      - Are there any fee issues or concerns that have been or should be addressed with the auditor?
      - Any other matters management would like to discuss with the Committee.

Reporting to the Governing Board

The Committee chairperson should work with the Governing Board to determine what should be reported, when it should be reported and who should make such a presentation. Obviously, the Committee is responsible for presenting the final audit reports and related letters and, where appropriate, the proposed budget. Typically, the Committee would request that these items be presented by management and the auditor.

The Committee may also request management and/or the auditor to discuss the following issues with the Board:

Summary of changes in the financial statement items from last year and/or budget and the major reasons for those changes.

Summary of the results of the key performance indicators, the reasons for any material changes and, where appropriate, the corrective action being taken by management.

Significant business risks of the entity and how management controls such risks.

Significant internal control exposures and how management intends to reduce or eliminate those exposures.

Significant compliance findings and related corrective action plans.

The entity's short- and long-term financing plan and how any shortfalls are being addressed by management.

Additional Available Resources

The following bibliography is provided as an additional reference to assist the Committee members in understanding and improving their roles:

American Bar Association - Corporate Director's Guidebook, Second Edition.

American Bar Association - Guidebook for Directors of Nonprofit Corporations.

Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. This book includes a long list of additional reference sources.

Statement on Auditing Standards No. 61, *Communications with Audit Committees,* as amended.

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

National Commission on Fraudulent Financial Reporting, Report (October 1987).

McGladrey & Pullen, LLP would be pleased to discuss the ideas presented in this guide. We believe that an active and effective Audit Committee will provide a substantial return on investment to the organization and its constituents.

Appendix

Simple Public Sector Audit Committee Charter

General

Provide an open avenue of communication between the Governing Board and both management and the independent auditor(s). Annually discuss the desired level of communications with management and the independent auditor(s).

Annually assess the independence and financial literacy of Committee members.

Meet two to four times per year or more frequently as circumstances require. The Committee may ask members of management, the independent auditor(s), or others to attend meetings and provide pertinent information as necessary.

Confirm and assure the independence of the independent auditor(s).

Review the scope and timing of the audit management and the independent auditor(s) to assure completeness of coverage and the effective and efficient use of audit resources.

Inquire of management and the independent auditor(s) about significant risks or exposures and assess the steps management has taken to minimize such risk.

Consider and review with management and the independent auditor(s):

- The adequacy of internal controls including computerized information system controls and security.
- Related findings and recommendations of the independent auditor(s) together with management's responses.

Consider and review with management and the independent auditor(s):

- Significant findings during the year, including the status of the audit recommendations from the prior year.
- Any difficulties encountered in the course of audit work including any restrictions on the scope of activities or access to required information.
- Any changes required in the planned scope of the audit plan.

Meet periodically with management and the independent auditor(s) in separate executive sessions to discuss any matters that the Committee or these groups believe should be discussed privately.

Report periodically to the Governing Board on significant results of the foregoing activities.

Instruct the independent auditor(s) that the Governing Board is the auditor's client.

Reporting

Advise management and the independent auditor(s) they are expected to provide a timely analysis of significant current financial and compliance reporting issues and practices.

Provide that management discuss with the Committee their qualitative judgments about the appropriateness, not just the acceptability, of accounting principles and financial disclosure practices used or proposed to be adopted. Particularly, discuss the degree of aggressiveness or conservatism of accounting principles and underlying estimates.

Inquire as to the auditor's independent qualitative judgments about the appropriateness, not just the acceptability, of the accounting principles and the clarity of the financial disclosure practices used or proposed to be adopted.

Inquire as to the auditor's views about whether management's choices of accounting principles are conservative, moderate, or aggressive from the perspective of income, asset, and liability recognition, and whether those principles are common practices or are minority practices.

Determine, as regards to new transactions or events, the auditor's reasoning for the appropriateness of the accounting principles and disclosure practices adopted by management.

Assure that the auditor's reasoning is described in determining the appropriateness of changes in accounting principles and disclosure practices.

Inquire as to the auditor's views about how the organization's choices of accounting principles and disclosure practices may affect financial statement users.

Activities

Recommend the selection of the independent auditor(s) for approval by the Governing Board, approve the arrangements and related fees of the independent auditor(s). Review and approve the dismissal of the independent auditor(s).

Consider, in consultation with the independent auditor(s), the audit scope and plan of the audit engagement.

Review with management and the independent auditor(s) the results of annual audits and related comments including:

- The independent auditor's audit of the organization's annual financial statements, accompanying footnotes and its report thereon.
- Any significant changes required in the independent auditor's audit plans.
- Any difficulties or disputes with management encountered during the course of the audit.
- Compliance audit findings.

- Other matters related to the conduct of the audit which are to be communicated to the Committee under generally accepted auditing standards.

Review annually with the independent auditor(s) the results of the monitoring of compliance with the entity's code of conduct.

Assure that the auditor's reasoning is described in accepting or questioning significant estimates by management.

Review and update the Committee's Charter annually.

Review and concur in the appointment, replacement, reassignment, or dismissal of the CFO/controller/administrator/etc.

Review and approve requests for any management consulting engagement to be performed by the independent auditor(s) and be advised of any other study undertaken at the request of management that is beyond the scope of the audit engagement letter.

Review periodically with general counsel legal and regulatory matters that may have a material impact on the entity's financial statements, compliance policies and programs.

Conduct or authorize investigations into any matters within the Committee's scope of responsibilities. The Committee shall be empowered to retain independent counsel and other professionals to assist in the conduct of any investigation.

Detailed Public Sector Audit Committee Charter

Purpose

The primary function of the Audit Committee is to assist the Governing Board in fulfilling its financial and compliance oversight responsibilities. The Audit Committee should review the entity's financial reports and other financial information; the entity's systems of internal controls and ethics policies that management and the Board have established; and the entity's auditing, accounting, financial and compliance reporting process. Consistent with this function, the Audit Committee should foster adherence to, and should encourage continuous improvement of the entity's policies, procedures and practices. The Audit Committee's primary duties and responsibilities are to:

Serve as an independent and objective party to monitor the entity's financial and compliance reporting process and internal control system.

Review and appraise the audit efforts of the entity's independent auditor.

Provide an open avenue of communication among the independent auditor, financial and senior management, and the Governing Board.

Membership

The Audit Committee shall be comprised of three or more directors as determined by the Board, each of whom shall be independent directors, and free from any relationship that, in the opinion of the Board, would interfere with the exercise of his or her independent judgment as a member of the Audit Committee. All members of the Audit Committee shall have a working familiarity with basic finance and accounting practices, as well as the compliance environment in which the entity operates, and at least one member of the Audit Committee shall have accounting or related financial management expertise. Audit Committee members may desire to enhance their familiarity with finance, accounting, laws and regulations by participating in educational programs.

The members of the Audit Committee shall be elected by the Board at the annual meeting or until their successors are elected and qualified. The Board shall appoint the Chairperson of the Audit Committee.

Meetings

The Audit Committee shall meet at least two to four times annually, or more frequently as circumstances dictate. As part of its job to foster open communication, the Audit Committee should meet at least annually with management and the independent auditor in separate executive sessions to discuss any matters that the Audit Committee or each of these groups believe should be discussed privately. In addition, the Audit Committee or at least its Chair should meet with the independent auditor and management quarterly.

Responsibilities and Duties

The Audit Committee should:

Review

Annually review and update this Charter.

Review the entity's annual financial statements and any compliance or other reporting or financial information submitted to any governmental body, or the public, including any certification, report, opinion, or review rendered by the independent auditor.

Independent Auditor

Recommend to the Governing Board the selection of the independent auditor, considering independent and effectiveness and approve the fees paid to the independent auditor. On an annual basis, the Audit Committee should review and discuss with the auditor all significant relationships the auditor has with the entity to determine the auditors' independence.

Review the performance of the independent auditor and approve any proposed discharge of the independent auditor by management.

Periodically consult with the independent auditor out of the presence of management about internal controls, compliance, and the fullness and accuracy of the entity's financial statements.

Financial and Compliance Reporting Process

In consultation with the independent auditor, review the integrity of the entity's financial and compliance reporting processes.

Consider the independent auditors' judgments about the quality and appropriateness of the entity's accounting principles as applied in its financial reporting.

Consider and approve, if appropriate, major changes to the entity's auditing and accounting principles and practices as suggested by the independent auditor, management, or the internal auditing department.

Establish regular and separate systems of reporting to the Audit Committee by management and the independent auditor regarding any significant judgments made in management's preparation of the financial statements and the view of each as to appropriateness of such judgments.

Following completion of the annual audit, review separately with management and the independent auditor any significant difficulties encountered during the course of the audit, including any restrictions on the scope of work or access to required information.

Review any significant disagreement among management and the independent auditor in connection with the preparation of the financial statements and/or related to compliance reporting.

Review with the independent auditor and management the extent to which compliance, corrective actions and changes or improvements in financial or accounting practices, as approved by the Audit Committee, have been implemented.

Ethical and Legal Compliance

Establish, review and update periodically a Code of Ethical Conduct and ensure that management has established a system to enforce this Code.

Review management's monitoring of compliance with the entity's Code of Ethical Conduct, and ensure that management has the proper review system in place to ensure that financial statements, compliance, other reports and financial and compliance information, disseminated to governmental organizations and the public, satisfy legal and/or regulatory requirements.

Review, with the organization's counsel, any legal matter that could have a significant impact on the organization's financial or its material compliance with laws, regulations and agreements statements.

Perform any other activities consistent with this Charter, the entity's by-laws, resolutions or ordinances, and governing law, as the Audit Committee or the Board deems necessary or appropriate.