Creating Effective Public Sector Audit Committees

Jack Armitage
University of Nebraska, Omaha

Even though not required by law, many governments have created audit committees. Compared to the private sector there is limited guidance available for the effective creation and use of public sector audit committees. Any entity implementing an audit committee should first prepare an audit committee charter to document the authority, mission, and responsibilities of the audit committee. The charter is probably the most important foundation for achieving an effective audit committee. The purpose of this paper is to provide recommendations based on best practices for public sector audit committees with primary attention focused on the public sector audit committee charter.

INTRODUCTION

The origin of the use of audit committees is unclear, but the earliest evidence of audit committees in the USA private sector occurred in the late 1930s when the New York Stock Exchange (NYSE) advised corporations that their external auditors should be chosen by a select group of the corporation's directors who were not corporate officers. These committees, though, had very little power, were less than effective, and existed in name only (Williams, 1980). The first official recommendations for the use of audit committees in the USA came in 1940, when the Securities and Exchange Commission (SEC) issued Accounting Series Release No. 19 (SEC Accounting Guide, 1989, p. 4523). In the years following, few companies formed audit committees and the SEC recommendation received little support for years, until 1967 when the American Institute of CPAs recommended that all publicly owned corporations appoint audit committees (AICPA Executive Committee, 1967).

During the 1970s, the role of private sector audit committees received much attention because of demands for greater corporate accountability and governance. The need for audit committees became clear during this time period. Audit committees provided external auditors a channel of communication with boards of directors, which aided auditors when dealing with management over accounting standards, and audit committees helped meet society's desire for increased audit quality. During this period, the SEC and the U.S. Congress strongly recommended the use of audit committees, and in 1978, the NYSE established a requirement that all listed companies create and maintain an audit committee.

The private sector financial scandals of the early 21st century in the USA (Enron, World Com, Tyco, Health South, etc.) resulted in the passage of the Sarbanes-Oxley Act of 2002 (SOX) which placed significant new responsibilities on boards of directors of corporations. This legislation also required audit committees to assume new and expanded responsibilities. These responsibilities include overseeing all aspects of the entity's audit, including hiring, compensating, monitoring, and evaluating the external auditor, as well as monitoring and evaluating the internal audit function.

Even though there is very little national legislation or regulatory requirements for public sector audit committees, many governments have created audit committees. Compared to the private sector there is limited guidance available for the effective creation and use of public sector audit committees. The purpose of this paper is to review the available guidance and best practices in Australia, New Zealand, UK, and USA for public sector audit committees with primary attention focused on designing the public sector audit committee charter. A well designed audit committee charter is the most important foundation for achieving an effective audit committee.

SOURCES OF GUIDANCE

The available guidance for public sector audit committees is more limited than for businesses. Although there is no all encompassing legislation or regulation in the USA that requires audit committees in the public sector, several prominent USA professional organizations recommend or encourage that audit committees be created for government entities (AGA, 2008). These include the Governmental Finance Officers Association (GFOA, 2008), the National Association of College and University Business Officials, the Institute of Internal Auditors (IIA, 2009), the Governmental Accountability Office, and the Office of Management and Budget. In Australia, the FMA and CAC Acts both require Australian Government public sector entities to establish an audit committee and the Australian National Audit Office provides guidance (ANAO, 2005). In the UK, public sector audit committee guidance is available through the Audit Committee Handbook (UK Treasury, 2007). Although audit committees are a relatively recent development in New Zealand, the New Zealand Institute of Internal Auditors and KPMG published a survey of current practice characteristics in public sector audit committees in New Zealand (IIA New Zealand, 2005). Also, some of the Big 4 audit firms have published guidance for public sector entities that wish to form an audit committee.

Much of the guidance is similar and all of the organizations publishing guidance recommend governmental entities use an audit committee. However, there are some differences that will be examined in the paper.

AUDIT COMMITTEE CHARTER

Any entity implementing an audit committee should first prepare an audit committee charter to document the authority, mission, and responsibilities of the audit committee. The charter is probably the most important foundation for achieving an effective audit committee. In the public sector, the audit committee is often codified in legislation adopted by a legislative body or approved by a resolution adopted by an elected governing board (AGA, 2008). The charter should be reviewed once a year, and where necessary, updated and revised (IIA New Zealand, 2005).

The charter should be written in a way that makes it a living document and will help manage the agenda of the committee. The charter should be approved annually and the audit committee should provide to the full governing board an annual report addressing all of the responsibilities of the audit committee as contained in the charter.

The following will be addressed as they relate to an audit committee charter: mission, committee membership, characteristics and skills of members, relations with external auditors, relations with internal auditors, meetings and notifications, decision making and voting process, compensation, reporting requirements, and review of the charter.

Mission

The primary question that must be answered by the charter's mission is "Why do we need an audit committee?" An audit committee charter should address the appropriate scope of the committee's activities and make clear that these activities are advisory in nature. Most public sector audit committees have one or more of the following three objectives; (1) some level of responsibility for the external audit,

(2) some level of responsibility for the internal audit function, and (3) some level of responsibility for ensuring the entity has auditable financial statements (AGA 2008).

Sometimes an audit committee is created as a response to a precipitating event such as a financial, internal or external audit, or fraud crisis. In this case it is important that the mission of the audit committee be created with a sufficient scope of audit committee responsibilities to provide all the potential benefits of an audit committee, rather than just focusing on the event leading to the crisis.

Public sector audit committees do not fit the mold of most for profit audit committees or the USA SOX model of audit committee. Instead, the public sector entity must create an audit committee that meets its specific needs for providing independent review and oversight of the entity's financial reporting process, internal controls, and the internal and external audit functions. Of the audit committee charters reviewed by the AGA (2008), the mean number of responsibilities included in an audit committee charter was 17. The Australian Model Audit Committee Charter - FMA Entity (ANAO, 2005) includes 31 responsibilities for the audit committee.

Committee Membership

Public sector audit committee members usually have a much broader range of backgrounds than is found in the private sector. As well, the independence of the members of the audit committee is less important in the public sector. In the private sector all audit committee members are members of the company's board of directors, but in governments this is usually not the case. If the audit committee consists only of governing board members of the entity it is more likely the members will lack financial backgrounds, and this is especially the case if all governing board members are elected politicians. Often the audit committee includes members that are not governing board members and that have no connection to the public entity at all. The UK Treasury Handbook (2007) indicates that the audit committee chair should be an independent non-executive member of the governing board, while the ANAO (2005) recommends that at least one member of the audit committee is independent.

The GFOA (2008) advocates that all audit committee members are members of the entity's governing board who are independent of the financial management activity of the entity. KPMG (2003) recommends that the committee be made up of outsiders that are independent of the entity as well as the federal government, and that are respected members of the community. Deloitte and Touche (2005) suggests that the committee can include both independent outsiders and members of the governing board. The guidance provided by the USA Department of Defense (DoD, 2007) Inspector General allows for independent outsiders, representatives of other DoD entities, employees of other federal agencies, or members of management of the entity. The AICPA (2008) indicates that audit committee membership may include governing board members that are independent outsiders.

There is wide variation in the size of public sector audit committees. Examples can be found with committees having as few as three members to some in excess of 20 members. ANAO (2005) indicates the size of the committee should be at least three members but not more than five. The UK Treasury (2007) guidance and the GFOA (2008) only indicate a minimum size of three members. The AGA (2008) found the most common size to be four to six members while the New Zealand IIA (2005) survey found the audit committee size in New Zealand to range from 6 - 8 members. The desired skills of members represented on the committee and the committee's mission should drive the decision on the size of the committee.

Another factor affecting the size of an audit committee can be open meeting laws. To be effective, the audit committee needs the ability to meet with the external and internal auditors in private if necessary. This ability may be provided in the statutes governing the entity, but if not, this issue should be considered in determining the size and composition of the audit committee. For example, if the audit committee is made up of only governing board members, it may be possible that the audit committee does not have the ability to meet in private with the internal or external auditors, which is necessary for an audit committee to be effective.

It is important for audit committees to have continuity of membership to ensure institutional memory. It is most common to have three year terms for the members and allow for members to serve more than a single term (AGA 2008, ANAO 2005). To help ensure continuity, staggered terms should be used. Although ensuring institutional memory can be an important factor for the effectiveness of an audit committee, sometimes new blood is needed to bring new perspectives and new skills to the board.

Characteristics and Skills of Members

The audit committee members collectively must possess the knowledge in accounting, financial reporting, and auditing to carry out the committee's responsibilities in an effective manner. All members should possess a basic understanding of governmental financial reporting and auditing and the committee must have at least one member that is a financial expert. Also it is beneficial to the audit committee to have at least one member possessing recent and relevant financial experience (UK Treasury 2007). If it is not possible to have financial experts on the committee, the committee must possess the ability and budgetary resources to access an external expert. To be a financial expert, a person must have: (1) an understanding of generally accepted accounting principles and financial statements, (2) experience in preparing or auditing financial statements of comparable entities, (3) experience in applying such principles in connection with the accounting for estimates, accruals, and reserves, (4) experience with internal accounting controls, and (5) an understanding of audit committee functions (SOX, Section 407).

The financial expert can insure that the technical questions are asked and translate the accounting jargon for the other committee members. The auditing expert is important to ensure that both the external and internal audits are being conducted within the professional standards and be able to question the audit processes and procedures. Other committee members may be appointed based on their expertise in the type of governmental entity, IT, or other needs specified by the mission of the audit committee. More specificity of qualifications will usually provide for a stronger audit committee.

Audit committees that restrict membership to only elected or appointed governing board members often have difficulty obtaining all the necessary expertise on the committee. In this case the committee has no choice but to engage outside experts to provide the necessary financial and auditing knowledge. Another potential risk for an audit committee made up of only elected governing board members is that it is more likely the committee will tend to be political.

Relations with External Auditors

The relations with the external auditor for a governmental audit committee vary much more than for audit committees in the private sector. Private sector audit committees usually have full responsibility with regard to relations with the external auditor. Although some public sector audit committees do little more than "receive" the audit report from the external auditors, others have full responsibility over the external auditors. When public sector audit committees have responsibility for relations with the external auditors, the AGA (2008) considers best practice to require the committee to participate directly in preparation of the RFP, in interviews with selected firms, and in selection of the external auditor.

If the audit committee is responsible for the external audit, the committee must meet with the external auditor at least three times (an AGA best practice) and provide close monitoring of the audit process. The following activities are typically carried out:

- conduct at least one executive session with the external auditors
- preapprove any nonaudit services requested by the board from the external auditors, paying special attention to any independence issues
- review significant audit finding
- review critical accounting policies and practices used by the organization
- review serious difficulties or disputes with management encountered during the audit
- review internal control related matters communicated by the external auditors

The audit committee should also inquire of external auditors, chief audit executive (CAE), and the internal auditors about significant risks facing the organization. This objective can be accomplished by documenting the material risks the organization faces, and updating and reviewing them on a periodic basis. In addition, the audit committee should review with the external auditors the scope and plan of the internal auditors to address coordination of audit efforts to ensure completeness of coverage, elimination of duplicated efforts, and effective use of audit recourses.

It is important for the audit committee to have the ability to meet with the external or internal auditors in a private meeting. A closed door meeting allows the audit committee to raise issues, ask questions, and seek feedback without the management of the entity present. In New Zealand, the IIA survey found that 72 percent of audit committees hold closed meetings with external or internal auditors (IIA New Zealand 2005).

Relations with Internal Auditors

The work of the internal audit department is likely to be the single most significant resource used by the audit committee to effectively discharge its responsibilities (UK Treasury 2007). To maximize the value of this resource it is important that open communications be established and maintained with the CAE.

Public sector audit committees' responsibilities over the internal audit function differ widely between public sector organizations. Some audit committees are involved with personnel matters for the internal audit department including hiring, monitoring, evaluating, and if necessary firing the CAE, whereas for other public sector organizations those duties are the responsibility of the governing board. The IIA New Zealand survey (2005) found that few audit committees are involved in appointment of the CAE. Regardless of involvement with personnel matters for the internal audit department, the audit committee should work closely with internal audit.

One of the most important factors for the internal audit function to be effective is the independence of the CAE. The AGA (2008) best practice is having the CAE report to either the audit committee or to the CEO of the organization. Having the CAE report only to the highest level of the organization helps ensure that the internal audit function will be as independent of the government as possible and will be able to perform its responsibilities without pressure from either the governing board or from management. It is a non-best practice for the CAE to report to the CFO.

For an effective internal audit function, the internal audit department normally performs a full range of audits, including financial, operational, contract, compliance, IT, performance, and agreed-upon procedures, as well as providing assistance to the external auditors. The operational audits typically go beyond just performance and include economy, efficiency, and program results audits.

The audit committee should be kept appraised of the internal audit department's progress and findings by receiving summary reports of the work. Key members of the internal audit function should attend audit committee meetings to provide updates on their work as well as share significant findings with the audit committee members. It is also common and a best practice for audit committees to review and approve the internal audit department's audit plan for the coming year. This involvement allows the audit committee to provide input into auditing areas or functions of the organization that should be reviewed.

Other common responsibilities of public sector audit committees over the internal audit function include:

- conduct executive sessions with the internal auditors
- review internal audit department's budget and staffing for adequateness of resources
- review internal audit department's charter
- review internal audit department's hiring policies and procedures, training, and CPE requirements
- review adequacy of internal controls
- review any difficulties encountered from the operating departments of the entity such as restrictions in scope or denied access to information
- review entity's fraud policy
- review entity's whistle blowing program and any submissions received, follow up work performed, and disposition of the submissions
- review entity's ethics policy to ensure it is up to date and adequate

Meetings and Notifications

The meeting frequency for an audit committee will be a function of the scope of the committee's mission statement. Since the entity is in the public sector all meetings of the audit committee should be held in the open (and are often required by law to be open meetings), except for executive sessions as permitted under the jurisdiction's laws and regulations. The AGA (2008), AICPA (2008), GFOA (2008), and UK Treasury (2007) all recommend no fewer than four meeting per year. Some audit committees meet as often as monthly, but most audit committees meet four to six times per year. The IIA New Zealand survey (2005) found that 71 percent of public sector audit committees meet four times per year. Meeting dates should be selected well in advance or follow a well defined meeting schedule to minimize conflicts for committee members and others attending the meetings.

Decision-Making Process

The audit committee charter must specify if a vote of a simple majority of the total membership is used for all matters voted upon or if there are items requiring more than a simple majority. As well, the definition of a quorum must be specified in the charter.

Compensation

Although audit committee members commit significant time fulfilling their responsibilities, it is highly unusual for the members to be compensated. Of all the references cited in this paper, only the ANAO (2005) guidance, KPMG (2003) guidance, and the UK Treasury (2007) handbook suggest that compensation for the members of the audit committee may or should be considered because of the time requirement expected of committee members and the ability to attract quality candidates for the committee. Not compensating audit committee members is an interesting characteristic of public sector organizations since most of the organizations hire external audit firms and external legal representation at market rates. This may be a factor that results in less effective committee performance.

Reporting Requirements

The audit committee should prepare an annual report that summarizes all of the committee's responsibilities as defined in the charter and the committee’s opinions in all areas where the committee has responsibilities. As well, the report should address the committee’s effectiveness in meeting those responsibilities. Nearly all guidance indicates this evaluation of effectiveness should take place every year, but the ANAO (2005) suggests this may take place only once every two years.

The report should also include recommendations for improving the committee’s future effectiveness, and this is what makes the audit committee charter a living document and helps the committee manage its agenda. The annual report should be submitted to the governing board as well as made available to the general public. The annual report completes the feedback loop on the responsibilities of the audit committee.

The AICPA (2009) has an audit committee charter matrix available on its website. This form was designed for a nonprofit organization but would work equally well for a public sector organization. The form is used to list all objectives and responsibilities of the committee and a way to define the steps to accomplish each objective. The matrix includes columns for listing each objective of the audit committee as specified in the charter, the steps carried out to accomplish the objective, any deliverables created in meeting the objective, the due date to achieve the objective, and the date the objective was completed.

Review of the Charter and Annual Plan

An audit committee should review its charter annually and make changes as needed. Committee members should stay abreast of best practice guidelines provided by authoritative bodies as well as to review the adequacy of the charter in meeting the responsibilities specified by the governing board. An audit committee should also prepare an annual operating plan for the upcoming year's activities. The advantages of an annual plan are that it engages the audit committee in thinking through what it wants to accomplish in the upcoming year, it alerts participants to when they must appear before the committee and it ensures that all committee business will be accomplished during the year (AGA 2008).

CONCLUSION

All governments should consider establishing an audit committee. With the broad scope of activities governmental entities are responsibly for, the audit committee is a practical means for a governing body to provide much needed independent review and oversight of the entity's financial reporting process, internal control structure, external audit, and internal audit activities. An audit committee also provides a forum independent of the governing board and management where auditors and others can discuss concerns. An audit committee charter must be adapted to each government's specific circumstances to effectively meet the government's needs. The charter provides direction to the audit committee and informs entity officials and the public of the committee's role. By effectively carrying out its functions and responsibilities, an audit committee can provide valuable contributions to a governmental entity's financial management and overall governance.

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