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The Real Oversight is NOT Having an Audit Committee

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Everything Changes, Except When It Doesn't

Time and time again we've seen reactions to various accounting scandals, after which new policies, procedures, and legislation are created and implemented. An example of this is the Sarbanes-Oxley Act (SOX) of 2002, which was a direct result of the accounting scandals at Enron, WorldCom, Global Crossing, Tyco, and Arthur Andersen.

SOX was established to provide additional auditing and financial regulations for publicly held companies to address the failures in corporate governance. Primarily it sets forth a requirement that the governing board, through the use of an audit committee, fulfill its corporate governance and oversight responsibilities for financial reporting by implementing a system that includes internal controls, risk management, and internal and external audit functions.

Governments experience challenges and oversight responsibility similar to those encountered by corporate America. Governance risks can be mitigated by applying the provisions of SOX to the public sector.

Some states and local governments have adopted similar requirements to SOX but, unfortunately, in many cases only after cataclysmic events have already taken place. In California, we only need to look back at the bankruptcy of Orange County and the securities fraud investigation surrounding the City of San Diego as examples of audit committees that were established in response to a breakdown in governance.

Taking Your Audit Committee on the Right Mission

Governments typically establish audit committees for a number of reasons, which include addressing the risk of fraud, improving audit capabilities, strengthening internal controls, and using it as a tool that increases accountability and transparency. As a result, the mission of the audit committee often includes responsibility for:

- Oversight of the external audit.
- Oversight of the internal audit function.
- Oversight for internal controls and risk management.

Chart(er) Your Course

Most successful audit committees are created by a formal mandate by the governing board and, in some cases, a voter-approved charter. Mandates establish the mission of the committee and define the responsibilities and activities that the audit committee is expected to accomplish. A wide variety of items can be included in the mandate.

Creating the governing board's resolution is the first step on the road to your audit committee's success.

PROCESS

The Charter

Prescribes the scope of the committee's responsibilities, its structure, processes, and membership requirements.

Establishes who the members of the audit committee are, which includes members of the governing body, or individuals appointed by the governing body and include a minimum of three members.

Sets forth a schedule of meetings when the audit committee meets periodically throughout the year and provides a system for maintaining an official agenda and meeting minutes.

PURPOSE

The Audit Committee

Possesses a basic understanding of financial reporting, auditing, internal controls, governmental accounting and budgeting.

Exercises oversight of the audit plan to ensure risk coverage, its orientation with the Board's strategic goals and recognition of emerging issues.

Annually reviews the internal audit staffing level to ensure that it has adequate resources sufficient to effectively carry out its assigned responsibilities.

Ensures that Internal Audit has established a process and criteria for effectively monitoring the timely implementation of corrective in response to audit findings and recommendations.

Ensures that there are established procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters and complaints regarding the potential waste, fraud and abuse of governmental funds and activities.

Receives and reviews all reports from the External Auditor.

Follow the Leader(ship)

The Audit Committee Members

An important component of an audit committee is the make-up of its members. In current practice relating to governments, we see a wide variance in how the committee members are determined. Best practices would include the following components:

- Should have an **odd number of members** (to prevent ties if voting) with a **minimum of three members**
- Members with **specific industry and operational** background
- Members with an **understanding of the history and operations** of the government
- Members who are committed to the **success of the government and transparency**
- One member who has **governmental financial** expertise
- One member who understands the **process of auditing**

In practice we see a combination of these attributes, ranging from the full board acting as the audit committee, committees with one or more independent outsiders appointed by the board, and/or members from management and combinations of all of the above. While there are advantages and disadvantages for all of these approaches, each government needs to evaluate how to work within their own governance structure to best arrive at the most workable solution.

Strike the Right Balance Between Cost and Risk

The overriding responsibility of the audit committee is to perform its oversight responsibilities related to the significant risks associated with the financial reporting and operational results of the government. This is followed closely by the need to work with management, internal auditors and the external auditors in identifying and implementing the appropriate internal controls that will reduce those risks to an acceptable level. While the cost of establishing and enforcing a level of zero risk tolerance is cost prohibitive, the audit committee should be looking for the proper balance of cost and a reduced level of risk.

Engage Your Audit Committee With Regular Meetings

Depending on the complexity and activity levels of the government, the audit committee should meet at least three times a year. In larger governments, with robust systems and reporting, it's a good practice to call for monthly meetings with the ability to add special purpose meetings as needed. These meetings should address the following:

External Auditors

- Confirmation of the annual financial statement and compliance audit, including scope and timing.
- Ad hoc reporting on issues where potential fraud or abuse have been identified.
- Receipt and review of the final financial statements and auditor's reports
  - Opinion on the financial statements and compliance audit;
  - Internal controls over financial reporting and grants; and
  - Violations of laws and regulations.

Internal Auditors

- Review of updated risk assessments over identified areas of risk.
- Review of annual audit plan, including status of the prior year's efforts.
- Status reports of ongoing and completed audits.
- Reporting of the status of corrective action plans, including conditions noted, management's response, steps taken to correct the conditions, expected time-line for full implementation of the corrective action and planned timing to verify the corrective action plan has been implemented.

Establish Resources That Are at the Ready

Audit committees should be given the resources and authority to acquire additional expertise as and when required. These resources may include, but are not limited to, technical experts in accounting, auditing, operations, debt offerings, securities lending, cybersecurity, and legal services.

Taking Extra Steps Now Will Save Time Later

While no system can guarantee breakdowns will not occur, a properly established audit committee will demonstrate for both elected officials and executive management that on behalf of their constituents they have taken the proper steps to reduce these risks to an acceptable tolerance level. History has shown over and over again that breakdowns in governance lead to fraud, waste and abuse. Don't be deluded into thinking that it will never happen to your organization. Make sure it doesn't happen on your watch.

Author Bio

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James Godsey has over 30 years' experience in governmental auditing, training, accounting and management services. Areas of expertise include state and local governmental auditing, forensic audits, fraud audits, management audits and audits in compliance with the Single Audit Act. Jim has been asked and is currently serving on the AICPA's working group to assist in the preparation of the second edition of the risk assessment audit guide.

Jim's Professional Associations and Leadership include Advisor to the Fiscal Standards and Accountability Committee for the California Community Colleges, Member of the Board and Past President, National Association Job Training Assistance (NAJA), Advisor to the Board of Directors, Civic Center Chapter of the Association of Government Accountants, and Advisor to the Board of Directors, LAMAAA.

He has a Bachelor of Science, Business Administration from George Mason University, Fairfax, Virginia.