Achieving More Independence in Government Audits

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The recent demise of Arthur Anderson, Enron, WorldCom, and other firms painfully attests to what can happen when auditors' independence is compromised and they guild or overlook poor corporate performance. Auditors should be independent of management in organizations whose financial dealings they evaluate. Independence permits auditors to give their candid opinion about the financial health of a business or a government.

A method of ensuring more independence in audits of government is to form an independent committee to oversee the audit process. Both the Government Finance Officers Association (GFOA) and the North Carolina Local Government Commission (LGC) recommend that local governments establish audit committees.[1] Such committees serve five purposes:

- They solicit proposals from prospective auditors, analyze them, and recommend a firm to the governing board, which makes the final selection.
- They monitor the performance of the auditor, ensuring that the work is conducted according to the audit contract.
- They serve as a check on management for the governing board, reporting accounting failures and differences of opinion between the auditor and management.

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- They review financial statements, noting areas for improvement.
- They monitor the work of internal auditors.[2]

By fulfilling these purposes, audit committees enhance the credibility of both external and internal auditors, facilitate the implementation of established standards, and improve the quality of audits.[3] They are little used in North Carolina, however. This article explains why and specifies conditions under which local units should consider creating an audit committee.

History of Audit Committees

Audit committees have been a longstanding topic among private corporations. In 1940 the Securities and Exchange Commission endorsed the concept of an audit committee as a standing committee of a board of directors. In 1967 the American Institute of Certified Public Accountants recommended that corporations establish audit committees composed entirely of people from outside the corporation. In 1977 the New York Stock Exchange, the American Stock Exchange, and the National Association of Security Dealers (now called Nasdaq) likewise recommended that corporations create audit committees. In 1985 the National Commission on Fraudulent Financial Reporting (the Treadway Commission) recommended that corporations establish a formal audit committee responsible for oversight of internal auditing, internal control, financial reporting, compliance with the company's code of conduct, and engagement of the external auditor. Despite these recommendations, many firms have failed to form audit committees.

Audit committees also are advisable in the governmental sector. In 1991 the Institute of Internal Auditors recommended that governments establish a standing audit committee, knowledgeable about finances but independent of daily operations.[4] In 1997, GFOA further recommended that

- governments establish an audit committee by charter, enabling resolution, or some other appropriate legal means.
- committee members have expertise and experience in accounting, auditing, and financial reporting to resolve audit issues.
- the majority of committee members be from outside management, with at least one member from the executive and legislative branches.
- the committee generally number between five and seven.
- the committee primarily oversee the independent audit of financial statements, including selection of an auditor and resolution of the audit findings.
- the committee have access to internal audit reports and work plans.
- the committee annually and publicly report its work to the governing board and management.[5]

Table 1. **Audit Committee Activities**

Activity	% of Committees Engaged in Activity
External Auditing	
Reviews auditor's report	97
Reviews auditor's assessment of reasonableness of management estimates	74
Examines level of auditor's assumed responsibility [approves scope of audit]	48
Examines auditor's audit plan and procedures	31
Ethics	
Informed of material misstatements	94
Informed of significant unusual transactions	73
Examines illegal activities	65
Examines instances of fraud	60
Management/Other	
Reviews engagement letter	92
Discusses with management the application of accounting principles	91
Reviews management letter	60
Informed of disagreements with management	59
Informed of management judgments and accounting estimates	44
Informed of significant matters regarding consultations with other accountants	42
Internal Auditing	
Informed of irregularities related to internal control	99
Reviews internal auditing results	84
Informed of significant audit adjustments	80
Reviews internal audit program	68
Examines significant accounting policy changes	68
Meets privately with Internal Audit Director	63

Source: Adapted, with permission, from Jonathan West & Evan Berman, *Audit Committees and Accountability in Local Government: A National Survey*, forthcoming in 26 INTERNATIONAL JOURNAL OF PUBLIC ADMINISTRATION, July 2003.

Use of Audit Committees

Nationally the use of audit committees seems to be increasing, varying with the size of the unit of government. A recent study found that 28 percent of cities and counties of more than 50,000 in population had a committee.[6] Another study found that 48 percent of cities of more than 65,000 in population had a committee.[7]

Audit committees in North Carolina are considerably less common. In 2001 we conducted an informal telephone survey of the 14 cities with more than 50,000 people and the 23 counties with more than 100,000 people.[8] The respondents were finance directors, assistant finance directors, and internal auditors. Only six of the thirty-seven jurisdictions (16%) had audit committees. Four—Buncombe County, Orange County, Gastonia, and Wilmington—indicated that their objective in establishing a committee was to improve the reliability of the audit process. The governing board in Mecklenburg County created a committee as a result of certain improprieties.

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Respondents' reasons for not creating an audit committee varied. Eighteen (58%) were satisfied with the status quo; 8 (27%) felt that their governing board was too small to establish a subcommittee; 2 (6%) believed that the decision making would be more complex; 2 (6%) thought that such a committee would be too political; and 1 (3%) thought that management was not interested.

The North Carolina jurisdictions with audit committees use three structures: (1) the GFOA model, discussed earlier; (2) a subgroup of the governing board; or (3) a subgroup of the management team. Buncombe and Mecklenburg counties follow GFOA guidelines regarding size (five to seven) and makeup (a majority from outside the government, with at least one representative each from the executive and legislative branches). The Buncombe County audit committee consists of one governing board member, one member of the management team, one member from another governing board in the county, one member of the banking community, and one member of the business community in general. The Mecklenburg County audit committee is made up of the county manager, the deputy county manager, two members of the governing board (one from each party), and one citizen who is a CPA.

Using the governing board structure, Cumberland County's audit committee is the board's Finance Committee. Gastonia and Wilmington each have a three-member subcommittee of their governing board.

Finally, using the management team structure, Orange County's committee consists of the finance director, the purchasing director, the budget director, the revenue director, and the assistant county manager.

Whether or not they use an audit committee, local governments and public authorities in North Carolina must conduct their audits in accordance with the Local Government Budget and Fiscal Control Act (hereinafter "the Act"). The Act specifies how often units will be audited, what auditing standards will be followed, and to whom and how the auditor will report. It also provides for state oversight of the audit process. According to T. Vance Holloman, director of the Fiscal Management Section of the LGC (which oversees North Carolina local government auditing), the Act's requirements probably explain the low use of audit committees.[9] The Act fulfills some of GFOA's five reasons for having an audit committee. However, there are circumstances in which an audit committee makes sense.

Selecting an Auditor

A primary purpose of an audit committee is to assist the governing board in selecting an auditor. Nationally, 92 percent of audit committees review the audit engagement letter; 48 percent examine the level of the auditor's assumed responsibility, approving the scope of the audit; and 31 percent examine the audit plan and procedures (see Table 1, page 25). However, North Carolina's Act largely defines the scope of the audit, specifying that

- the audit indicate compliance with federal and state grants, if required.
- the audit be conducted according to generally accepted auditing standards.
- certain assistance be provided to the auditor by the local unit.
- the contract be approved by the LGC.

The LGC further requires that

- separate fees be broken out for obtaining year-end bookkeeping assistance, performing the audit, and preparing financial statements.
- a certain time schedule be followed in awarding the contract.
- the auditor issue a "management letter" to the government (a letter highlighting areas for improvement), and a signed statement be sent to the LGC if a management letter is not needed.

Audit committees also recommend an audit firm to the governing board. Because North Carolina law is silent on the selection process, audit committees may be useful in screening audit firms and evaluating audit proposals with regard to both price and experience of the firm. Price should not be the only, or even the primary, consideration. More important is the auditor's experience conducting local government audits. The LGC recommends that the experience and the competence of the firm be established before the price of the work is evaluated.

An audit committee can serve as a traffic cop, expediting the supply of records to the auditor.

Monitoring the Auditor's Performance

Audit committees monitor the auditor's performance to ensure that the work is done according to the contract. North Carolina's Act and the LGC fulfill this responsibility by requiring that

- the auditor inform the governing board in writing of the need for any additional investigations and fees.
- the auditor immediately notify the LGC of any circumstances that will prevent the issuance of an unqualified opinion.
- the LGC preapprove payment of 75 percent of the fees and approve the remaining 25 percent contingent on its approval of the audit report.
- the auditor submit financial statements to the LGC at least four months after the end of the fiscal year, and the governing board amend the contract if financial statements are submitted after the December 1 completion date.

Serving as a Check on Management

Audit committees are a check on management, reporting accounting failures to the governing board. Nationally, 94 percent of audit committees are informed about material misstatements that affect the auditor's ability to give a clean opinion about the accounting practices; 73 percent about significant unusual transactions; 65 percent about illegal activities; 60 percent about fraud; and 59 percent about disagreements with management (see Table 1). The audit committee also apprises both the governing board and management of any significant problems, weaknesses in internal control, illegal acts, or violations of compliance with general statutes or federal and state grant requirements that are found as the audit progresses.

This role is minimized in North Carolina because the Act requires the auditor to inform the governing body if an unqualified opinion cannot be given. This alerts the governing board to significant internal control failures.

Internal auditors are employees of the local government who evaluate the quality of work performance. They assess whether program objectives have been met and at what cost, and they recommend ways to improve organizational performance.

Reviewing the Auditor's Report

Nationally, 97 percent of audit committees review the auditor's report, and 60 percent review the management letter (see Table 1). However, in North Carolina, the LGC performs these functions, extensively reviewing financial statements and the annual management letter, and recommending improvements to the governing board.

Monitoring the Work of Internal Auditors

Internal auditors are employees of the local government who evaluate the quality of work performance. They assess whether program objectives have been met and at what cost, and they recommend ways to improve organizational performance. Nationally, 68 percent of audit committees review the internal audit program, 99 percent are apprised of internal control weaknesses, and 84 percent review internal auditing results (see Table 1). Such monitoring is an appropriate function for an audit committee in North Carolina. According to an informal survey we conducted in 2002, 22 of the 37 largest city and county governments (59%) have internal auditors.[10]

Performing as a Traffic Cop

Audit committees can, and should, play a role not indicated by GFOA, namely that of audit traffic cop.[11] In the course of an audit, questions inevitably arise about the availability of records, invoices, and other documents. The inability to promptly clear up such questions leads to overdue financial reports. The LGC recommends that governments with perennially late financial reports prepare a schedule for completing the audit. A useful function of an audit committee is to monitor compliance with the schedule. Although the LGC plays an important audit oversight function, the ultimate responsibility is with the local units themselves. An audit committee can facilitate the performance of this responsibility.

Recommendations

Relatively few local governments in North Carolina have audit committees, principally because the Act fulfills many of the responsibilities that audit committees perform in other states, including designing the audit contract, monitoring the auditor's performance, serving as a check on management, and reviewing the audit report. Still, North Carolina governments should consider establishing an audit committee to perform several important responsibilities.

To eliminate tardy audits. According to the LGC's standard audit contract (which local governments must use), the local government should supply the auditor with the necessary records. When the government is slack in providing files, records, and invoices, the audit process slows down. Some governments regularly send their audits to the LGC after the deadline. The audit committee can serve as a traffic cop, helping to resolve questions between the auditor and management, expediting the supply of information, and ensuring timely financial reports.

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To follow up on the management letter. LGC staff annually compare the two most recent management letters to determine whether the local unit has made progress in correcting internal control failures. Most governments promptly correct weaknesses. However, some lack the ability or will to do so. The audit committee can assist management in improving financial management practices.

To evaluate a unit's fiscal condition. The LGC reports the financial condition of each town and county on its website (www.nctreasurer.com). It compares each local unit with units of comparable size regarding such indicators as property tax rate, revenues and expenditures per capita, general obligation debt per capita, and financial performance of water and sewer operations. Although it reports useful data, the LGC does not evaluate financial performance. An audit committee *can* perform this responsibility, however.

To ensure the independence of internal auditors. External auditors can only sample transactions to see if accounting principles and the law are being followed. Accordingly, they make a disclaimer that they cannot detect all illegal activities while performing their audit. Internal auditors, in contrast, exhaustively examine operations that involve considerable exposure to the risk of theft. To be effective, internal auditors should be able to set their own work program, independent of management. In practice, however, internal auditors typically report to the finance director, whose operation is foremost among those that internal auditors should scrutinize. Hence there is a potential conflict of interest. Even if internal auditors report to the city or county manager, a potential conflict of interest exists. An audit committee consisting of governing board members, management representatives, and citizens can ensure independence.

Notes

1. Government Finance Officers Ass'n, Establishment of Audit Committees (Chicago: GFOA, 1997), available at www.gfoa.org (last visited Dec. 19, 2001); North Carolina Local Gov't Comm'n, Memorandum #878 (Raleigh: N.C. State Treasurer, 1999).
2. Stephen J. Gauthier, Evaluating Internal Controls (Chicago: Government Finance Officers Ass'n, 1996).
3. Jonathan P. West & Evan M. Berman, *Audit Committees and Accountability in Local Government: A National Survey*, forthcoming in 26 International Journal of Public Administration, July 2003.
4. Institute of Internal Auditors, The Audit Committee in the Public Sector. Position Statement (Altamonte Springs, Fla.: IIA, 1991).
5. GFOA, Establishment of Audit Committees.
6. Katherine S. Eckhart et al., *Governance and Local Government,* Internal Auditor, no. 3, at 51 (2001).
7. West & Berman, Audit Committees.
8. Charles K. Coe & Martha Rodgers, Informal Telephone Survey of Large North Carolina Counties and Cities re Use of Audit Committees (Raleigh: Dep't of Political Science and Public Admin., N.C. State Univ., 2001).
9. Letter from T. Vance Holloman, Director, Fiscal Management Section, North Carolina Local Gov't Comm'n, to Charles K. Coe (Dec. 10, 2001).
10. Charles K. Coe & Martha Rodgers, Informal Telephone Survey of Large North Carolina Counties and Cities re Use of Internal Auditors (Raleigh: Dep't of Political Science and Public Admin., N.C. State Univ., 2002).
11. Letter from Holloman.