



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY
DEPARTMENT OF AUDIT
DIVISION OF COUNTY AUDIT
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September 16, 2010

MEMORANDUM

TO: County Mayors and Finance Directors

FROM: Jim Arnette
Director 

SUBJECT: Audit Committees

The Local Government Modernization Act of 2005, Section 9-3-405, Tennessee Code Annotated (TCA), encourages local governments to consider establishing an audit committee and provides that the Comptroller may require an audit committee be established under certain conditions. The two conditions are when a local government is in noncompliance with the accounting and financial reporting standards required by the Governmental Accounting Standards Board or have recurring findings from the annual audit for three or more consecutive years as determined by the Comptroller to be a material weakness in internal control or material noncompliance with Government Auditing Standards.

We believe well structured audit committees can improve the financial management and overall governance of governmental entities in Tennessee. Our office has encouraged the establishment of an audit committee in local governments for many years. However, very few local governments have an effective audit committee. We believe in today's environment of fewer resources and increased demand for transparency and accountability, it is time to focus on the audit committee as an effective tool to improve the operations of local governments.

Beginning with the audits for the fiscal year ended June 30, 2010, when it has been determined that either of the conditions described in Section 9-3-405(a), TCA exists, there will be findings that address the county's noncompliance with accounting and financial reporting standards and/or the existence of recurring audit findings. Both findings will include a recommendation encouraging the establishment of an audit committee under provisions of Section 9-3-405(a), TCA. If either of these conditions continue to occur, the county may be required to establish an audit committee. This committee will be responsible for addressing financial and other reporting practices, internal control, compliance with laws and regulations, and ethics. The audit committee should provide management with guidance to correct all reported material weaknesses in internal control and material noncompliance.

We will provide counties with guidelines regarding the establishment of effective audit committees. Please contact our office if you have any questions.

Comptroller of the Treasury
Division of County Audit
Audit Committee Guidelines
September 2010

These guidelines were developed for local governments to establish an Audit Committee under provisions of Tennessee Code Annotated (TCA), Section 9-3-405.

Background

The Local Government Modernization Act of 2005 (TCA, Section 9-3-405) provides for the establishment of an audit committee in local governments. This statute encourages local governments to consider establishing an audit committee and under certain conditions the comptroller may require that an audit committee be established. The two conditions are when a local government is in non-compliance with the accounting and financial reporting standards required by the Governmental Accounting Standards Board or a local government has recurring findings from the annual audit for three (3) or more consecutive years as determined by the comptroller to be a material weakness in internal control or material noncompliance under government auditing standards.

Purpose of Audit Committee

The audit committee is established to provide independent review and oversight of the government's financial reporting processes, the government's internal controls, and a review of the external auditor's report and following up on corrective action, and compliance with laws, regulations, and ethics.

Audit Committee Guidelines

- 1) The legislative body shall approve the resolution or charter establishing an audit committee.
- 2) The audit committee members shall be external to management. The members may be members of the governing body, citizens of the local government, or a combination of both. The members should be appointed by the legislative body for staggered terms. There should be no fewer than three members on the committee.
- 3) The members should possess sufficient knowledge and experience in finance, business, and accounting to discharge the committee's duties.
- 4) The resolution or charter shall provide for the responsibilities and duties of the committee. These duties shall address financial and other reporting practices, internal control, compliance with laws, regulations, and ethics.

- 5) The resolution or charter creating the duties and responsibilities of the audit committee shall be submitted to the comptroller prior to approval by the legislative body. The comptroller shall review the proposed resolution or charter and report back to the local government on whether it follows recommended guidelines. The resolution or charter adopted by the legislative body must conform to the report issued by the comptroller.
- 6) The audit committee shall provide a written report to the legislative body each year on how it has discharged its duties.
- 7) The audit committee shall establish a process for handling employees, taxpayers, or other citizens confidential reporting of suspected illegal, improper, wasteful, or fraudulent activity under provisions of TCA, Section 9-3-406.
- 8) The audit committee should carefully review all audit findings in the audit report and have consultation with the external auditor regarding the irregularities and deficiencies disclosed in the annual audit. The committee should satisfy itself that appropriate and timely corrective action has been taken by management to remedy the identified weaknesses. The committee should determine what corrective action, if necessary, should be recommended to the legislative body.
- 9) The meetings of an audit committee shall abide by the notice requirements adhered to by the local government to which the committee is attached, except as provided in subsection (d) of TCA, Section 9-3-405.
- 10) All meetings of the audit committee shall be subject to the meeting provisions of subsections (d),(e),(f),(g),(h), and (i) of TCA, Section 9-3-405.

Audit Committee and the Internal Audit Function

In many larger governments there is an established independent internal audit function. In those governments that establish such an internal audit function the audit committee must always be afforded access to the internal audit annual work plan, as well as to any and all individual audit reports.

There are varying positions on the reporting relationship between the audit committee and the internal audit function. One position is to have the internal audit function completely independent of management and therefore report directly to the audit committee. Another position is to have the internal audit function report to the audit committee and administratively to the county mayor/county executive.

In smaller governments it may not be practical to establish a formal internal audit function. In that case, the local government may consider either assigning internal audit responsibilities to its regular employees or obtaining internal audit services from an accounting firm.

If a local government establishes an internal audit function, the charter for its operations should be tied to the charter of the audit committee.

**RESOLUTION TO ESTABLISH AN AUDIT COMMITTEE
FOR _____ COUNTY**

WHEREAS, *Tennessee Code Annotated* (T.C.A.) Section 9-3-405, encourages county governments to establish an independent Audit Committee, and provides that the Tennessee Comptroller of the Treasury (Comptroller) may require an Audit Committee in counties that (1) are in noncompliance with the accounting and financial reporting standards required by the Governmental Accounting Standards Board or (2) have recurring findings from the annual audit for three or more consecutive years that are determined by the Comptroller's office to be a material weakness in internal control or material noncompliance with government auditing standards; and

WHEREAS, the Comptroller and the Government Finance Officers Association of the United States and Canada recommends that all county governments establish an Audit Committee as a best practice and to assist the County Commission in the oversight of the public funds and financial reporting process; and

WHEREAS, the _____ County Commission realizes the need, especially in today's current environment of fewer available resources, for increased transparency and accountability of public funds, and that the County Commission is ultimately responsible for ensuring that management is meeting its internal control and financial reporting responsibilities; and

WHEREAS, the County Commission finds it to be in the best interests of _____ County to establish an Audit Committee;

NOW THEREFORE BE IT RESOLVED by the County Commission of _____ County, meeting this _____ day of _____, 20____, that:

SECTION 1. Pursuant to the provisions of T.C.A. § 9-3-405, the County Commission of _____ County does hereby establish an Audit Committee to provide independent review and oversight of the county's financial reporting processes and the county's internal controls, a review of the external auditor's report and follow up on management's corrective action, and compliance with laws, regulations, and ethics.

SECTION 2. The Audit Committee will consist of ____ () members [*no fewer than three members*], to be comprised of members of the County Commission, citizens of _____ County, or a combination of both. To insure the committee's independence and effectiveness, no Audit Committee member will be an elected official (with the exception of elected county commissioners), employee, spouse of an official/employee, or person that comingles assets with an official/employee of _____ County. While committee members need not be accountants, they should possess sufficient knowledge and experience in finance, business, and accounting to discharge the committee's duties. The members of the Audit Committee shall be appointed by the County Commission to staggered ____ () year terms. To establish staggered terms, the initial members of the

committee shall be appointed so that half of the members serve ___ year terms and half serve ___ year terms. Thereafter all members shall be appointed to serve ___ year terms.

SECTION 3. Meetings of the Audit Committee shall be held in accordance with the provisions of T.C.A. § 9-3-405. Meetings shall be subject to the open meetings provisions of T.C.A. Title 8, Chapter 44, except that upon a majority vote of those members in attendance for the public portion of a meeting, the Audit Committee may hold confidential, nonpublic executive sessions to discuss the following items as authorized in T.C.A. § 9-3-405:

- (1) Items deemed not subject to public inspection under T.C.A. §§ 10-7-503 and 10-7-504, and all other matters designated as confidential or privileged;
- (2) Current or pending litigation and pending legal controversies;
- (3) Pending or ongoing audits or audit related investigations;
- (4) Information protected by federal law; and
- (5) Matters involving the reporting of illegal, improper, wasteful, or fraudulent activity under T.C.A. § 9-3-406, where the informant has requested anonymity.

The Audit Committee will follow Roberts Rules of Order. Each year at its first meeting, the committee will elect a chairman, vice-chairman, and secretary. Meeting agendas will be prepared by the chairman and provided in advance to members along with appropriate briefing materials. Minutes of the Audit Committee meetings will be filed in the Office of County Clerk.

SECTION 4. The committee shall have access to the services of a financial expert, either through a committee member or an outside party engaged by the committee for this purpose. Such financial expert should, through both education and experience, and in a manner specifically relevant to the county government sector, possess (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.

SECTION 5. The duties and responsibilities of the Audit Committee are:

(a) To carefully review, upon completion of the county's annual audit, all audit findings in audit report and consult with the external auditors regarding any irregularities and deficiencies disclosed in the annual audit. The Audit Committee is empowered to meet with management to discuss audit findings and/or disagreements with the external auditors. The committee should satisfy itself that appropriate and timely corrective action

has been taken by management to remedy any identified weaknesses. The committee should determine what corrective action, if any, should be recommended to the County Commission.

(b) To consider the effectiveness of the internal control system, including information technology security and control, review the effectiveness of the system for monitoring compliance with laws and regulations, and review the process for communicating the county's ethics policies to county personnel and monitoring compliance therewith.

(c) To establish a process by which employees, taxpayers, or other citizens may confidentially report suspected illegal, improper, wasteful or fraudulent activity under provisions of T.C.A. § 9-3-406.

(d) To annually present a written committee report detailing how it discharged its duties and any committee recommendations to the full County Commission.

SECTION 6. The Audit Committee will be adequately funded to carry out the duties and responsibilities as set out in this Resolution and under applicable law.

SECTION 7. This resolution creating the duties and responsibilities of the Audit Committee has been submitted to the Comptroller prior to approval by this legislative body, and this resolution conforms with the report issued by the Comptroller.

Adopted this ____ day of _____, 20__.

APPROVED:

County Mayor

ATTEST

County Clerk

9-3-405. Establishment of audit committee — Notice requirements — Open meetings — Confidential, nonpublic executive sessions.

(a) Local governments are encouraged to consider establishing an audit committee. The comptroller may require that an audit committee be established in any local government in this state that:

(1) Is in noncompliance with the accounting and financial reporting standards required by the GASB on or after the prescribed date of June 30, 2008; or

(2) Has recurring findings from the annual audit for three (3) or more consecutive years as determined by the comptroller to be a material weakness in internal control or material noncompliance under government auditing standards.

(b) The governing body of the local government shall create the audit committee. The audit committee members shall be external to management and may be members of the governing body, citizens from within the boundaries of the local government, or a combination of both. Members of the audit committee shall be selected by the legislative body. The audit committee shall establish responsibilities and duties that are stated in a resolution approved by the legislative body. The responsibilities and duties, at a minimum, shall address financial and other reporting practices, internal control, compliance with laws and regulations, and ethics. The resolution, or any subsequent amendments to the resolution, creating the duties and responsibilities of the audit committee shall be submitted to the comptroller prior to approval by the legislative body. The comptroller shall review the proposed resolution, or any subsequent amendments to the resolution, and report back to the local government on whether the resolution, or subsequent amendments to the resolution, follows recommended guidelines for an audit committee. The resolution, or subsequent amendments to the resolution, adopted by the legislative body must conform to the report issued by the comptroller. Notwithstanding the requirements of this subsection (b), if an audit committee was created by the legislative body of a county whose charter requires charter changes to be approved in a referendum, and if such actions occurred and were approved in a referendum prior to January 1, 2011, then such an audit committee shall be considered created pursuant to this part.

(c) Except as provided in subsection (d), all meetings of an audit committee created pursuant to this chapter shall abide by the notice requirements adhered to by the local government to which the audit committee is attached.

(d) All meetings of an audit committee created pursuant to this chapter shall be subject to the open meetings provisions of title 8, chapter 44, except, upon a majority vote of those members in attendance for the public portion of the meeting, the audit committee may hold confidential, nonpublic executive sessions to discuss the following items:

will be discussed, shall be exempt from title 8, chapter 44; provided, that the full governing body of the local government shall abide by the same executive session notice requirements imposed upon the audit committee by this section, and shall not make a decision or deliberate toward a decision on any matter.

Acts 2005, ch. 191, § 1; 2009, ch. 368, § 1; 2011, ch. 97, § 1.

Cross-References. Confidentiality of public records, § 10-7-504.

9-3-406. Establishment of process for confidential reporting of suspected illegal, improper, wasteful or fraudulent activity — Retaliatory activities prohibited.

(a) An audit committee created pursuant to this chapter shall establish a process by which employees, taxpayers or other citizens may confidentially report suspected illegal, improper, wasteful or fraudulent activity. The detailed information received pursuant to such a report of illegal, improper, wasteful or fraudulent activity or any investigation of this activity, except those matters disclosed in the final reports, shall be considered audit working papers and shall be confidential under title 10, chapter 7.

(b) Section 50-1-304 shall apply to all local government employees. In addition, no local government employees shall suffer any of the prohibited retaliatory actions specified in § 50-1-304 for reporting or cooperating with the audit committee, internal auditors, or auditors from, or approved by, the comptroller of the treasury, or for reporting any facts to the local government to which the audit committee is attached. Any person who knowingly and willingly retaliates or takes adverse action of any kind against any person for reporting alleged wrongdoing pursuant to this chapter commits a Class A misdemeanor.

Acts 2009, ch. 368, § 2.

Cross-References. Confidentiality of public records, § 10-7-504.

Penalty for Class A misdemeanor, § 40-35-111.

Section to Section References. This section is referred to in § 9-3-405.