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## **Audit Committees and Accountability in Local Government: A National Survey**

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### **ABSTRACT**

Financial scandals in city governments have received increased publicity in recent years. Audit committees have been suggested as a way review and improve standards and procedures for financial accountability. Audit committees assist local government managers in overseeing and monitoring the financial accounting and auditing process. They provide a communication link between elected officials, municipal managers, and independent auditors. This study relies on national survey data to examine the prevalence, role, and composition of audit committees in cities with populations over 65,000 and the conditions affecting their use and effectiveness. Interviews and a brief case study supplement survey data to provide richer detail regarding the performance of audit committees in ensuring improved accountability.

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*Key Words:* Accountability; Audit committee; Local government; Ethics; Best practices.

## INTRODUCTION

Well-publicized financial debacles in the 1990s in Miami, Florida and Orange County, California,<sup>[1]</sup> have prompted Federal, state, and local legislators, together with government and professional accounting bodies, to review and improve standards and procedures for financial accountability. Among the recommendations issued by these groups is the increased use of audit committees in local government. Audit committees oversee and monitor the financial accounting and auditing process, and also serve as a communication link between the city council, as representative of citizens, on the one hand, and the independent auditors on the other hand. Although the tasks of audit committees vary, they are thought to be useful in enhancing the credibility of auditors, facilitating implementation of standards, improving the quality of audits, and ensuring accountability to citizens.

Audit committees received some attention in the early 1990s in connection with the need for greater oversight of both the internal and external audit process and financial reporting disclosures.<sup>[2]</sup> A survey taken in the mid-1990s indicated that ~18% of cities had audit committees.<sup>[3]</sup> Yet, despite heightened concern with financial accountability, no recent research has been undertaken that examines the extent of their current use. This study addresses the following questions: How widespread are audit committees in local government? What do they do? What is their role in ensuring accountability? Who serves on audit committees? To whom are audit committee members accountable? What conditions are associated with the use and effectiveness of committees? This research examines these questions for municipalities with populations over 65,000.

Previous research on the presence of audit committees in local government indicates that despite recommendations, they are not nearly as ubiquitous as in the private sector.<sup>[4]</sup> In the private sector, audit committees are commonplace, following the statutory and regulatory requirements from governmental bodies and the recommendations from professional associations. Scholars and practitioners have examined such issues as ways to improve corporate audit committee effectiveness;<sup>[5]</sup> however, less is known about the role and functions of audit committees in the public sector. Public sector researchers have examined the reasons why performance audits preceding scandals were ignored,<sup>[6]</sup> but this has not been related to the presence or absence of an audit committee.



## **FRAMEWORK**

Accountability is a fundamental value of American democracy; the legitimacy of democratic government requires officials to render an accounting of their activities to the public. The public needs to be informed that government monies are being handled properly and in conformity to legal and regulatory requirements. Government audits seek to promote accountability. Such actions and assurances enhance the credibility of financial reporting by the city, put public officials on notice that they are responsible for efficient, economical, and effective use of public resources, and help to ensure that city's are in compliance with relevant laws and regulations.<sup>[7]</sup>

The structure of local government audits, which promotes accountability, includes internal auditors, external auditors, finance directors, and audit committees. In this regard, audit committees occupy an important "niche" or place. Compared with finance directors and internal auditors, they may enjoy greater independence from city officials, even though they may include the finance director. Compared with external auditors, they are thought to provide a heightened level of oversight because they assist the city officials in monitoring the financial reporting process and in keeping open lines of communication among the officials, financial management, external auditors and internal auditors. Audit committees help elected officials safeguard resources and maintain stewardship accountability to outside constituencies.

It is obvious that the range of specific auditing activities and rules is extensive. The type of activities that are generally subject to auditing include planning (e.g., review audit plans in the initial, pre-audit and post-audit phase), monitoring (e.g., oversee the internal auditing function, accounting controls, conflicts of interest, financial disclosures), and reporting (e.g., prepare reports for the council on financial accounting policies and practices, assess reports from internal and external auditors, determine governmental compliance, report on special investigations) functions.<sup>[8]</sup> A framework of potential auditing activities, and their importance, is provided below.

### **Audit Committee Activities**

The following is indicative, not exhaustive, of the type of activities that audit committees may undertake.

#### **Internal Auditing**

Audit committees receive reports from internal auditors. Local governments need people inside the organization to make independent appraisals and assessments of its activities. Internal auditors assess the government's internal



control structure and/or its adherence to policies. They also assess whether the city's financial position is fairly presented and whether program results achieve desired levels. Ideally, internal auditors are free from political pressure, able to conduct objective audits and report results without adverse political backlash. In reality, internal auditors typically work for management and help management to operate efficiently and effectively.<sup>[9]</sup> In some cases, internal auditors might be elected officials or appointed officials who carry another official job title. As employees of the jurisdiction, internal auditors lack independence from management.

To increase independence and objectivity of internal auditors, professional bodies have recommended that they report to audit committees as well as to municipal finance officers and city officials.<sup>[10]</sup> Audit committees may be informed about, review and render opinions regarding results of internal auditing activities (e.g., internal control procedures, necessary policy changes, internal auditing plan or reports, need for operational adjustments). The Government Finance Officers Association (GFOA) recommends that internal auditing functions be legally authorized by charter or enabling resolution, that those heading this function be professionally certified, and that auditing work conform to professional standards. Existing research is silent on whether these recommendations are put into practice in cities.

There are various types of audits, each with its own purpose. Pre-audits are internal procedures typically restricted to checking on the availability of authorized spending amounts and assessing the accuracy of resource revenues and expenditures. Post-audits occur following payments or transactions; they focus on conformity with appropriations, emphasize fairness of activities, and report results to relevant governing bodies.<sup>[11]</sup> Audit committees examine and help schedule the work of both internal and external pre- and post-audits.<sup>[12]</sup> However, while researchers have explored the financial reporting practices of local governments,<sup>[13]</sup> auditor assessments of internal control,<sup>[14]</sup> and determinants of audit quality,<sup>[15]</sup> scholarly studies of audit committees' contributions to internal auditing activities in city government are dated or nonexistent.

### Ethics

Audit committees may also request or collect information and examine evidence of ethical problems relating to finance (e.g., financial misstatements, extraordinary transactions, illegal activities, and fraud). It is expected that they will play a role in dealing with ethical issues related to financial management. Best practices of jurisdictions in this area would include the presence of an ethical code of conduct and the implementation of ethics management practices (e.g., employee training, explicit policies, monitoring compliance, enforcing discipline). Audit committees focusing on ethics-related activities



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would review and monitor internal/external audit responsibilities for detecting errors, illegalities, abuse, and noncompliance.

Ethical irregularities and illegalities might appear in city financial statements. Ethical irregularities include financial statements that omit amounts or disclosures; illegal acts are violations of laws or regulations. Abuse differs from illegal activity; according to the GAO abuse occurs when government actions fall “. . . far short of societal expectations of prudent behavior.”<sup>[16]</sup> Audit committee members as well as auditors need to be aware of legal and ethical requirements and to remain vigilant in detecting wrongdoing in all its forms. Included in this category is material noncompliance with provisions of grant or contract agreements.

Audit committees should be alert to ethical and legal issues in carrying out each of their planning, monitoring and reporting functions. Areas of potential problems, according to the GAO, could be unauthorized acquisition, use or disposition of assets.<sup>[17]</sup> This requires that committees consider prevention, detection, and correction of any misuse of municipal financial assets. Committees should be sure that proper controls are in place and that risk factors (e.g., poor monitoring, inadequate communication of policies, delay in investigations) are recognized and minimized. Also management actions should be examined to be sure they react in a timely and appropriate way to correct irregularities or illegal acts.

### Management of Auditing

The audit committee may be asked to review and render its judgment on the city’s relationship with external auditors (e.g., the role and responsibility of external auditors, the plans, procedures and reports of external auditors, the implications of conclusions from external auditor’s reports). External auditors are meant to be independent of the entity being audited. They typically examine financial statements and accounting records, giving their appraisal of the accuracy and fairness of presentation and of conformity with generally accepted auditing standards. While extant research examines issues such as the selection of external auditors,<sup>[18]</sup> determinants of auditor change,<sup>[19]</sup> and links between audit engagement and audit failure,<sup>[20]</sup> there is a dearth of information about the relations between audit committees and external auditors in the public sector, especially with attention to practitioner concerns. Indeed, prior research on government accounting in general, and auditing specifically, has been faulted for not addressing issues relevant to the practicing professional.<sup>[21]</sup>

As advisors to the governing board, audit committees limit reliance of city officials on the technical expertise of external auditors, but they can also aid professional auditors by validating their conclusions. The effectiveness of



audit committees in assessing activities of external auditors will vary greatly depending on the training and attributes of audit committee members.<sup>[22]</sup> Some committees may be very skillful in reviewing audit scope, reports, procedures, and internal controls; others may lack the requisite knowledge or background to meet responsibilities in this area.

The committee may also review the jurisdiction's overall control environment, including management's attitudes about controls, important documents and communications, and the adequacy, accuracy, and timeliness of information. To be effective, committees should be informed about issues and risks in financial statements as well as management strategies for dealing with them. Audit committees may benchmark against the financial management practices of comparable jurisdictions. They need to be aware of compliance monitoring programs operating within the city and the auditors' approach to detecting noncompliance or nonconformity with regulations or approved codes of conduct. According to GFOA's best practices, audit committees need to report annually to the city council and management, preferably in writing and for public distribution, its activities, the ways it met its responsibilities, and any recommendations to improve the city's financial management policies and procedures. The extent to which local government audit committees perform these functions requires verification.

### Conditions for Success

Clearly, audit committees engage in a broad range of activities; some achieve success and others fail. Prior research, largely based on private sector studies, suggests certain characteristics are crucial to the effective operation of audit committees. Among these are, first, selecting audit committee members who are knowledgeable about the organizational context, experienced with financial reporting or auditing, aware of relevant laws and regulations, and adept at interpersonal communications.<sup>[23]</sup> Obviously, familiarity with auditing may increase the effectiveness of the audit committee. In this regard, audit committee rules may vary regarding the requisite qualifications and appointment. Some may require extensive specialized background prior to appointment; others may offer detailed orientation, training, and updating following appointment. Information regarding current issues, developments, trends, risks, regulations, and processes is crucial for audit committee members.

Second, the GFOA, GAAS, GAGAS, and others makes it clear that auditors of local government's finance statements should be objective, apolitical, and independent in both reality and appearance.<sup>[24]</sup> The Institute of Internal Auditors and the GFOA recommend that municipalities create standing audit committees, and that committee members be independent of management.<sup>[25]</sup> One way in which this can be accomplished is to select most



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members from outside management, while still including some representation from both the executive and legislative branches of government. Furthermore, care should be taken to avoid any potential conflicts of interest when, for example, the finance director is also a member of the audit committee. Impairments to independence should be avoided. It is anticipated that audit committees in local government would seek members who exhibit these characteristics and qualities.

Third, little is known about the extent to which various stakeholders support the presence of city audit committees, or about the specific internal, external, or ethics auditing activities undertaken by committees. Such support is important because each actor can facilitate or impede audit committee activities. Specifically, elected officials could disregard or interfere with audit committee activities, compromising their independence and applying undue political pressure for particular outcomes. Conversely, they could share information, heed recommendations coming from the committee and act on them promptly. If the audit committee is to effectively perform its role as a communication link between the governing body and the internal and external auditors, all parties need to share information and develop trusting, mutually supportive relationships. Similarly, the city manager and chief finance officer must respect the independence of the audit committee and accept the legitimacy of the committee's planning, monitoring, and reporting functions.

A final focus of this research is whether community conditions or characteristics of elected officials are linked to activities performed by city audit committees. For example, do community conditions such as citizen dissatisfaction with municipal services have any relationship to the extent of external auditing activities? Are cities characterized by high levels of citizen trust or experiencing substantial numbers of law suits filed against them more likely to audit the ethical behavior of city government? Are high levels of cynicism or turnover among elected officials associated with the types of activities pursued by ethics audit committees?

### **METHODS**

The data for this study were collected from a national survey. Both paper and electronic copies of the survey were used. Mailings were sent in the Spring of 2000 to city managers or chief administrative officers (CAOs) and chief financial officers in all 338 cities with populations over 65,000. Usable responses were received from 156 cities for a response rate of 46.1% (see Table 1). Respondents were either the addressee or others who operated under their direct supervision (e.g., deputy city manager, assistant city manager, assistant finance officer, budget officer) (see Table 2). Pilot surveys determined



**Table 1.** Demographics of the sample and population.

	Sample (%)	Population (%)
Size		
Over 250,000	20.8	18.9
100,000–249,999	40.9	38.8
75,000–99,999	38.3	42.3
Region		
Northeast	7.7	16.2
South	25.8	28.5
Midwest	27.1	22.5
West	39.4	32.8
Form of Government		
Council-manager	65.8	58.8
Mayor-Council	31.0	39.3
Other	3.2	2.7

*Note:* Source of population statistics is *Municipal Yearbook 1999*; ICMA, Washington, D.C., 1999. Demographics for population region and form of government statistics are estimates.

**Table 2.** Sample breakdown by job title.

Titles	Count	Percentage (%)
Analyst	2	1
Assistant/Clerk	21	12
Budget Director/Manager	3	2
Business Administrator	3	2
Chief of Staff/Administrator	10	6
Accountant/Auditor/Controller	19	11
City Manager/CAO	34	20
Deputy Manager	5	3
Finance Officer/Director	47	27
Accounting/Audit Manager	15	9
Other	13	8
Totals	172*	100

\*Of the 172 surveys received, 156 contained usable responses for purposes of analysis. Sixteen surveys were either duplicates or contained incomplete responses.

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that the questionnaire instructions and phrasing of survey items was clear and easily interpretable by respondents. A profile of respondents indicates: 7.7% are located in the northeast, 25.8% in the south, 27.1% in the midwest, and 39.4% in the west. This indicates a slight overrepresentation of respondents from the west and under-representation from the northeast. Sixty five percent work in council-manager cities; 38.3% of cities have populations between 6500 and 99,999; 40.9% of cities are between 100,000 and 249,999; and 20.8% of cities have populations over 250,000. Thirty in-depth telephone interviews were completed among selected cities with audit committees to better assess their characteristics and effectiveness.

Respondents are familiar with financial reporting practices in their jurisdictions. For example, 75.5% are very familiar with financial reporting, 9% are familiar, and 15.5% are somewhat familiar with such practices. To test for sample bias, comparisons were made between the level of familiarity of addressees (city managers and CAOs) and other respondents. No significant differences in respondent awareness were discovered. Differences on items discussed subsequently were examined as well, but there was no basis for concluding that the mix of respondents influenced the results below.

**FINDINGS****Use of Audit Committees**

Table 3 shows the extent of the use of audit committees in local government. Slightly less than half of the cities have audit committees. In the overwhelming majority of cases independent external auditors meet with the audit committee, and in most cases the internal audit director has private access to the committee as well. The latter finding is consistent with recommendations from Price Waterhouse.<sup>[26]</sup> Regarding the composition of the committee, it is the prevailing practice to allow elected city officials to serve, but slightly less than half of cities allow appointed city officials on the committee. Despite recommendations from professional bodies that such groups remain independent of management, such independence is required in just less than half of cities. The finance director or controller is a member in 42.5% of cities, and the city manager or his/her assistant belongs to the committee in 27.4%. Again, contrary to GFOA recommended "best practices," less than a third of cities have the functions and authority of the audit committee outlined in the city charter.

Respondents were asked who makes the decisions to select such important actors as the chairperson of the audit committee, committee members, and the external auditor. The selection of the audit committee chair is typically done by one of three parties: the mayor (37.2%), the city council (25.6%), and/or

**Table 3.** Audit/advisory committee: constitution.

Does your city have an audit/advisory committee?	48.1%
If yes,	
Do the independent external auditors meet with the audit/advisory committee?	93.0%
Are elected city officials allowed to serve on the audit/advisory committee?	83.6%
Does your Internal Audit Director have private access to the audit/advisory committee?	71.0%
Are appointed city officials allowed to serve on the audit/advisory committee?	47.9%
Are audit/advisory committee members required to be independent of city management?	47.2%
Is the Finance Director or Controller a member of the audit/advisory committee?	42.5%
Do audit/advisory committee members require some financial, accounting or business background?	35.6%
Does your city charter outline the functions and authority of the audit/advisory committee?	31.9%
Is the City Manager (Chief of Staff or Chief Admin.) a member of the audit/advisory committee?	27.4%

the audit committee itself (25.6%). In very few instances is the city manager or the finance director involved in choosing the chair. In most instances, it is a single actor who makes the selection (81.9%); however, two actors choose the chair in some instances (16.7%). Selection of the committee members themselves is principally in the hands of the city council (45.6%) or the mayor (34%), with the finance director and/or city manager playing a minor role. Selection of committee members is the province of one actor only in two-thirds of cases, but in one-third of cities this responsibility is shared by two sets of actors.

Do those charged with responsibility to select audit committee members and the chair also have the authority to dismiss such people? In general, that does appear to be the case. Authority to dismiss committee members or chairpersons typically falls under the authority of elected officials—the city council (46.2%) or mayor (37.4%)—and is seldom given to the city manager or finance director. It is usually the responsibility of a single actor (74.3%), but in a quarter of the cases it involves two actors.

There is a broader range of actors involved in the selection of the external auditor. Here the city council (29.4%) and the finance director (26.1%), followed by the city manager (13.5%) assume the principal role; the audit committee (11.6%), and the mayor (10.6%) are less likely to make such



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decisions. In this instance, the more common practice is to have multiple actors making the selection: two actors are most often involved (35.9%), followed by three actors in a third of cases, and a single actor in 30.7% of cities. Thus, responsibility for selection and dismissal of the audit committee members as well as the committee chair rests principally with elected officials, while appointed officials assume increased responsibilities in choosing the external auditor, often sharing such responsibilities with elected officials.

In-depth interviews provided more details about the composition and operations of municipal audit committees. Figure 1 provides a thumbnail profile of the audit committees in 10 cities. The formally stated activities performed by these committees are indicated along with information about membership selection, qualifications, terms of appointment, frequency of meetings, compensation, and ethics policies. Audit committee's range in size from three to seven members, sometimes with a distinction between voting and non-voting members. This is consistent with private sector surveys that report the median size of audit committees is either 4 or 4.5 depending on the industry<sup>[27]</sup> and with recent recommendations regarding audit committee "best practices."<sup>[28]</sup> Similarly, the GFOA recommends between five and seven members with committees large enough so members have the requisite skills, but small enough to operate efficiently.<sup>[29]</sup>

In four of the ten cities the mayor appoints and the city council approves members; in the remainder, the city council acts on its own to appoint members. No cities compensate members and no cities have ethics standards exclusively developed for audit committee members; however, members are often subject to the same ethics requirements as other board and commission members. Meeting frequency ranges from twice yearly to monthly, with committees in three cities meeting on an "as needed" basis. A brief case study of the audit committee in Kansas City is found in Appendix 1.

### **Audit Committee Activities**

While Figure 1 lists the formally stated activities of audit committees based on interviews, our mail survey instrument presents respondents with a more complete list of activities and asks them whether their committee performed such activities. Table 4 reports responses with activities related to external audits, ethics, internal audits, and management-related matters. Committees in virtually all cities (97.1%) review external auditor's reports, and in three fourths of the cities committees review the external auditor's assessments about the reasonableness of management's financial estimates. However, it is surprising that committees review the external auditor's plan and procedures in less than one-third of the sample cities, and in just more than half of the cities (52.5%) the committee fails to examine the level of



City	Audit Committee Activities	Statement on Ethics	Members	Appointed By	Approved By	Terms of Position	Membership Requirements	Frequency Of Meetings	Compensation
Foster City, CA	To advise and assist the City Council and other regarding tax, finance, and audit procedures, as well as the data processing guidelines, and to advise on other financial matters as requested.	None	7	Mayor	City Council	3 years	In the fields of accounting, law, or data processing	Twice yearly	No
Las Vegas, NV	Review the financial and audit reports. Advise mayor and different administrative agencies on different issues.	None	5	Mayor	City Council	2 years	1 mayor, 1 city council member, and 3 outside with no specific requirements	Quarterly with special meetings as needed	None
Austin, TX	Assist City Council in oversight and improvement responsibilities relating to financial and performance reporting, internal controls, legal compliance, and initiatives to improve city performance.	Not directly applicable to audit committee	4 voting members	City Council	N/A	2 years	City Council Member	Monthly	Not paid extra for audit committee duties



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Toronto, Canada	By reviewing and reporting on programs, functions, activities and organizations, the auditors provided the public, elected officials and management with fair, objective, and reliable assessment of government performance. Independent review strengthens managers' credibility when they provide information about performance and the results of the services they provide.	No	5	City Council	N/A	3 years	Member of City Council	Every two months	Not paid extra for audit committee duties
Lake Forest, IL	Independent audit of all financial records, using independent audit committee serving as an oversight body on behalf of the city council.	Same as for all other Board and Commission members	6	Mayor	City Council	2 year terms with maximum of 3 terms allowed	Financial Administration, Auditing	As Needed	No
Tallahassee, FL	Oversees the activities of the city auditor and the auditing department and assists the City Commission in supervision of the audit function.	None directly applicable to audit committee.	3	City Commission	N/A	3 years/ not more than 2 consecutive terms	Fields of accounting, research, and industry	Quarterly with special meetings as needed	No

Figure 1. Profit of audit committees in ten cities.

(continued)



City	Audit Committee Activities	Statement on Ethics	Members	Appointed By	Approved By	Terms of Position	Membership Requirements	Frequency Of Meetings	Compensation
Orange, CA	Assist the City Council in discharging its responsibilities for the overall stewardship of the City's financial affairs. Includes reviewing financial information, ascertaining the existence and adequacy of accounting and internal control systems and related safeguards over the City's assets, and overseeing the audit function.	Audit Committee members are subject to the State's Political Reform Act	7 members 5 voting	City Council	N/A	2 years	CPA with no financial interest in city contracts or conduct any type of business with any member of City Council, the City Manager, the Finance Director, the Treasurer, the City, or any of its Agencies.	At least twice annually or as much as needed	No
Anchorage, AK	Approve annual audit plan and meet with external auditor during audits and review of annual financial reports	None directly applicable to audit committee.	6 (3 from administration - 3 from city council)	City Council	N/A	For as long as their terms in other offices	None other than being member of city council or in certain administrative positions	3 times	None



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Stillwater, OK	Review the annual financial reports of the City and its Trust Authorities on an annual basis with the counsel of staff and the external audit firm. The audit committee participates in the selection of firms to conduct the annual audit.	None	5 voting and 2 non-voting	City Commission	N/A	3 years	1 is a city commissioner serving the second year of a 3-year term. No commissioner can succeed himself. The 4 remaining should be bankers, businesspersons, and non-practicing CPAs. No more than 2 of the 4 appointees can be from any one of these groups	As Needed	No
Scottsdale, AZ	Facilitate the role of the internal auditors, consult with city auditor, and ensure needs of city manager are being met.	None	3	Mayor	City Council	4 Years	None other than being member of city council	As Needed	None

Figure 1. Continued.



**Table 4.** Audit/advisory committee: activities.

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<i>A. External auditing</i>	
Reviews external auditor's report	97.1%
Reviews external auditor conclusions assessing reasonableness of management estimates	73.8%
Examines level of assumed responsibility assumed by external auditor	47.5%
Examines external auditor's audit plan and procedures	31.3%
<i>B. Ethics</i>	
Informed of material financial misstatements	94.4%
Informed of significant unusual transactions	72.9%
As relating to:	
Budgeting	81.2%
Controversial or emerging accounting policy areas	80.6%
Related party transactions	67.2%
Revenue Recognition	68.8%
Off-balance sheet financing	66.7%
Examines illegal activities	65.2%
Examines all instances of fraud	60.0%
<i>C. Internal auditing</i>	
Informed of reportable conditions related to internal control	98.6%
Reviews results of internal auditing	84.3%
As relating to:	
Financial reporting	82.3%
Internal control	85.5%
Significant operational audits	85.5%
Informed of significant audit adjustments	80.3%
Reviews internal audit program	67.8%
Examines significant accounting policy changes	67.7%
Meets privately with Internal Audit Director	63.0%
<i>D. Management/other</i>	
Reviews management letter	92.3%
Informed of disagreements with management	90.5%
Informed of management judgements and accounting estimates	59.4%
Informed of significant matters regarding consultations with other accountants	58.8%
Reviews engagement letter	44.4%
Discusses with management regarding application of accounting principles	42.2%

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responsibility assumed by the external auditor. This suggests that audit committees are more likely to react after external auditors have completed their work, and less likely to exercise initiative in the pre-audit phase.

Ethics-related activities of various types are undertaken in a majority of cities. The most common type of information gathered or made available to the committee deals with material financial misstatements (94.4% are so informed). Significant unusual transactions come to the attention of audit committees (72.9%), especially those dealing with budgeting (81.2%) and controversial or emerging accounting policy areas (80.6%). Two-thirds of city audit committees are informed about significant unusual transactions involving related parties, revenue recognition, and off-balance sheet financing. Similar proportions examine illegal activities, with slightly fewer examining all instances of fraud. Clearly, a host of ethical concerns occupy the attention of most municipal audit committees.

Audit committees frequently monitor internal auditing activities as well. Virtually all committees (98.6%) keep abreast of reportable conditions related to internal control and most (84.3%) review results of internal auditing. Eight in ten review results related to financial reporting, internal control, and significant operational audits. Most committees monitor significant audit adjustments, with two-thirds reviewing the internal audit program and examining significant accounting policy changes. In most cities the audit committee meets privately with the internal audit director. Relevant information regarding management's financial activities is accessible to most audit committees. For example, nine out of ten committees review the management letter and keep informed regarding disagreements with management on audit matters. Review of the engagement letter is less frequent (44.4%). In most cases, committees are informed of significant matters regarding management consultations with other accountants and regarding management judgments and accounting estimates. The above forms of communication occur frequently; however, more general discussions with management regarding application of accounting principles occur with less frequency.

### **Conditions**

Having considered the use of municipal audit committees, their composition, characteristics, and activities, attention now shifts to the qualities desired for members, the committee's role in assuring accountability, the extent of support such committees enjoy, and the associations between organizational culture and/or relations with elected officials and audit committee activities. Respondents were provided a list of desired audit committee member qualities and asked to select those that were considered most important. Table 5 shows that two traits were most frequently selected: objectivity and personal integrity,



**Table 5.** Audit/advisory committee: desired members' qualities.

Objectivity	79.5%
Personal integrity	74.4%
Independence from city officials	41.8%
Voter confidence and support	36.4%
Technical knowledge	36.1%
Work experience in the field	28.7%
Professional certification	4.1%

each selected by three-fourths of respondents. While the literature repeatedly stresses the need for independence from management or city officials and the need for technical knowledge, less than half selected independence (41.8%) and only slightly more than a third chose technical knowledge. The latter was the same proportion that selected voter confidence and support. Surprisingly, professional certification, one indicator of technical competence, was identified as important by 4.1%. It appears that general character traits (integrity, objectivity) are more crucial qualifications than professional expertise as qualities for prospective audit committee members.

As noted in the framework, audit committees are created in part to ensure greater accountability on financial matters. Respondents were presented a list of actors with a stake in city financial matters and they were asked to rank them in terms of their importance for accountability. Separate rankings were made for four different types of accountability: legal, hierarchical, external and professional.<sup>[30]</sup> A majority of respondents judged audit committees to be important or very important in ensuring three types of accountability, specifically, legal (71.9% responded important or very important), professional (62.8%), and external accountability (57.1%). It is not surprising that, given the committee's independence, less than half (40%) thought audit committees helped achieve hierarchical accountability. However, it is surprising that professional accountability was considered to be so important in light of the low rating given to professional certification in Table 5. It may be that professional accountability signifies the demands of specific programs and state agencies rather than the qualities required of committee members. It should be noted that compared to other relevant stakeholders (i.e., finance directors, external auditors, city manager, department heads, internal auditors, mayor, city council, the general public and the media), audit committees were typically ranked in the lower half of stakeholders in terms of ensuring each of the four types of accountability.

The effectiveness of audit committees is likely linked to stakeholder support. Respondents were asked to indicate the extent of support received

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from various actors. Results in Table 6 show that the extent of such support is modest at best, no doubt because slightly fewer than half of cities have an audit committee. The greatest support is shown from city managers or CAOs (48.8%), elected officials (47%), and those at higher levels of government (46.3%), with the city government as a whole showing slightly lower levels of support (42.7%). Public managers and citizens were weaker in their support (34.3% and 37.8% respectively), and weaker still was support from local business leaders (25.2%) and local blue ribbon committees (21%). Given the low visibility and narrow but important role of such committees, together with the nature of our sample, this relatively low level of support might be expected. As shown in Table 4, support from these various stakeholders has a statistically significant positive relationship with the existence of a municipal audit committee. In other words, not surprisingly, support from stakeholders is more evident in cities that have audit committees.

**Table 6.** Audit/advisory committee: support.

“Please evaluate the following statements regarding support for an audit/advisory committee.”	Strong agree/agree <sup>a</sup>	Ass’n with audit cmte. <sup>b</sup>
The city manager (chief of staff or chief adm.) supports the audit/advisory committee	48.8	0.757**
Elected officials support the audit/advisory committee	47.0	0.662**
Higher governments support the use of an audit/advisory committee	46.3	0.463**
Our city government overall supports an audit/advisory committee	42.7	0.781**
Citizens support the use of an audit/advisory committee	37.8	0.526**
Public managers support increased accountability through an audit/advisory committee	34.3	0.538**
Local business leaders support the use of an audit/advisory committee	25.2	0.454**
Local blue ribbon committees support the use of an audit/advisory committee	21.0	0.275**

<sup>a</sup>Scale 7, strongly agree; 6, agree; 5, somewhat agree; 4, don’t know, can’t say; 3, disagree somewhat; 2, disagree; 1, strongly disagree.

<sup>b</sup>Tau-c measures shown: \*\* $p < 0.01$ .

**Table 7.** Nature of audit/advisory activities: associations.

	All activities	Ext. ethics auditing	Int. auditing
<i>A. Organizational culture</i>			
City employees within financial reporting are encouraged to be a CPA	0.277*	0.300**	0.275*
City has a code of ethics		0.312*	
City provides ethics training to all employees	0.785**		
Employees are careful what they say around here	-0.479*		
Employees are encouraged to take risks in our organization			
Employees have so much job security that they don't have to earn their rewards		0.275*	
<i>B. Relations with elected officials</i>			
Elected officials are cynical about city government		-0.352**	
There is high turnover among city council members	-0.479*		
<i>C. Community conditions</i>			
Citizen trust in government is high		0.387**	
Citizens are satisfied with our service quality		-0.177*	
Community leaders frequently collaborate with the city			0.175*
Lawsuits against the city have increased			0.448**
There is much political competition between different groups			

\*Tau-c measures shown as 5% significant.

\*\*Tau-c measures shown as 1% significant.

What are some factors that are associated with the various activities pursued by audit committees? As specified in the framework, certain organizational culture variables might logically be related to particular audit-related activities. Community conditions and relations with elected officials could be linked to pursuit of certain activities as well. The nature of these associations is reported in Table 7. Most of the significant associations are found in the



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“ethics” column. Audit committees pursuing ethical irregularities are more likely to be found in cities defending themselves against an increase in lawsuits, requiring professional certification (CPA) for employees doing financial reporting, providing ethics training to all employees, and experiencing high levels of citizen trust in government. There is a positive association between audit committee involvement in ethics-related activities and the existence of collaborative relations involving community leaders and the city; however, pursuit of ethical matters by audit committees is negatively associated with cynical attitudes of elected officials about government. Organizational culture, community conditions, and relations with elected officials are all linked to this type of audit committee activity.

There is a positive relationship between all audit committee activities (summary variable) and the presence of ethics training as well as the encouragement of financial reporting employees to be CPAs. The rationale for the existence of audit committees’, heightened emphasis on enhancing public accountability, is consistent with these indicators of ethics and professionalism. Negative associations are reported between all audit committee activities and organizational cultures of fear (“employees are careful what they say around here”) as well as high turnover rates among city council members. The summary variable for all activities is more often linked to organizational culture indicators than to relations with elected officials or community conditions. Committee activities in the area of external auditing are negatively associated with only one item—citizen satisfaction with service quality. Similarly, committee activities in the area of internal auditing are positively associated with a single item—city employees doing financial reporting are encouraged to be a CPA.

### **Effectiveness of Audit Committees**

Interviews were conducted to get a firmer grasp on the role and effectiveness of audit committees. Among the issues explored were the benefits, composition, role of elected officials, and contribution of committees. When asked about the benefits resulting from audit committees numerous advantages were mentioned: “broadened public participation,” “accountability,” “independent perspective,” “safeguard assets,” “enforce policies,” “avoid abuse,” “clout in implementing recommendations,” “diversity of input,” “open avenue of communication,” “consensus building,” “objectivity,” “priority setting,” and “catalyst for change.” Interviewees stressed that audit committees provide a forum or sounding board for feedback, a mechanism for avoiding conflict of interest, a vehicle for coordination, a means of tapping local expertise, an arena for making assignments, and a tool for increasing efficiency and economy.



A spokesperson for one Florida city alluded to efficiency gains: "One benefit of having an audit committee is that specific auditing and financial matters may be addressed in a small group setting rather than taking up valuable and scarce time at the full city commission sessions." She observed that these results and conclusions could then be presented at subsequent commission meetings in summary form. A finance director from a city in Texas echoed this advantage: "Being able to present audit and finance issues in a smaller forum than to the whole city council. Receiving feedback on these issues will help in presentation and discussion with the entire council." An interviewee from California said the audit committee enables senior managers to discuss the financial goals of the city and to explain the importance of financial controls within the organization. He noted, "It provides an opportunity for the committee members to ask questions about the statements and any accounting changes that have to be implemented. In addition our audit committee is given the opportunity to ask for work to be done in a specific areas of concern." Two additional benefits were cited by a Florida respondent: "The audit committee can coordinate the work of the city's independent auditors with the internal auditors and financial management;" and "The provision of independent oversight to the internal audit function by reviewing the audit plan and any major audit findings as well as directing the internal auditor to include other specific areas in his review." Regarding coordination, one respondent noted: "The audit committee can work to help achieve maximum coordination between the work of the internal auditor's office and the needs of the city commission, the mayor, and the city departments."

When interviewees were pressed for specific examples, these benefits were fleshed out. An accounting manager from Louisiana offered a hypothetical: "Assume that the internal auditor reports directly to the city council. The president of the council has a pet project that the auditor gets a complaint on. The council president tells the internal auditor that he will take care of the matter himself. Without a committee the internal auditor's hands are tied." Another manager cited benefits resulting from presenting the five-year revenue and expenditure forecast to the audit committee and receiving their input on it prior to preparation of the budget. Another observed: "At the request of the commission, the audit committee performed a review of the city's acquisition of a payroll software package. Results of this review were then presented before the commission."

Three examples refer to the committee's relations with internal and external auditors: First, "With regard to the independent, external audit, the city's external auditors routinely discuss their annual audit plan with the audit committee. Further, they present their management letter comments to the committee, and the committee reviews the city's corrective actions in order to determine if they adequately address the comments;" second, "As an example



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of helping to achieve maximum coordination between the internal audit and the rest of the city, the audit committee worked to achieve modification of the way in which city commissions requests information and analyses from internal audit (as well as other city departments) so as to avoid undue and sometimes duplicate efforts;" and third, "The audit committee's oversight of the internal auditor brings to the attention of senior elected officials certain financial activities including internal controls on cash and, in certain instances, a limited ability to undertake examination of possible fraud and negligence."

An assistant city manager from an East coast city said the audit committee helps to assure that all interests of the community are respected, citing examples of modified proposals for rate increases and service adjustments resulting from community feedback given to the committee. A West coast assistant city manager observes, "The current release of GASB Statement 34, which will dramatically change the look of the statements, has been an important topic for the committee for the past couple of years. It enables them to ask questions of the outside auditors regarding the changes and how they will affect the city statements. It helps to provide an independent authority on the need for implementation and to address expectations." A deputy city manager from the Midwest notes: "Determining weaknesses in internal controls and taking corrective actions (proactive) is more effective and easier than dealing with actual fraud and abuse resulting from lack of controls."

What happens when audit committees detect wrongdoing or noncompliance? In other words, interviewees were asked to whom this information is communicated and who is responsible for correcting the situation. Respondents indicate that such information is frequently reported to either the department in charge of the operation where the incident of wrongdoing or noncompliance occurs or to the city manager or chief administrative officer or elected officials. In some instances a special fraud and abuse committee receives such reports. A California respondent stated: "Generally, the auditee is responsible for correcting any noncompliance or wrongdoing. Depending on the situation the Personnel Department may be involved in pursuing disciplinary action or the Police Department or City Attorney's Office will be involved if there are any legal violations or issues." A respondent from a north Florida city said: "This has not happened but it would be reported to the commissioners and city manager. The city manager would assure the situation was corrected or would delegate it to the appropriate department director if it was a simple noncompliance issue." One suburban finance officer noted: "These issues are usually brought to the committee's attention during their regular meetings by either the city administration, the internal auditor and/or the city's external auditors. In most instances, corrective action has already been discussed with the administration and action has been taken. If the committee itself discovers these issues, then they are communicated to the





administration for corrective action.” A finance officer from Minnesota said, “If wrongdoing or noncompliance is detected it must be reported to the elected State Auditor and the city council. The council would be expected to assign appropriate officials to take corrective action and report results.” A respondent from Virginia said that his city audit committee does not function to detect wrongdoing, but that when such behavior is noted by outside auditors or city staff, the committee is advised of the wrongdoing and the corrective action taken. A California assistant city manager said their process is for the outside audit partner to communicate directly with the chairperson of the audit committee who then directs the city manager to correct the situation.

The benefits that audit committees bring to a city are partially dependent upon the composition of committee membership. When asked whether it is more important to have influential people from the community serve on the audit committee or people with technical skills in public finance, the responses were mixed. Some allude to technical skills and others to personal qualities or occupational positions as critical qualifications. These differences are noted in responses from both south and north Florida respondents. Our south Florida respondent said: “Having individual with technical skills is more important. However, at the same time we have members of our city commission on the committee. This allows some of the commissioners to have a direct role in financial oversight while as the same time providing the committee with a balance of experience;” Her upstate counterpart observed: “Our committee is comprised of people with the skills and experience to ask tough questions and be able to interpret financial information and audit reports.” A Texas-based finance director stressed the importance of having elected officials represented: “It’s more important to have council members serve on the committee because they are representative of the political body.” In one Minnesota city the audit committee includes only elected officials: “By definition these are ‘influential people from the community.’ Influential community leaders (elected officials) are appropriate to receive and provide an official response to highly sensitive matters, however, these elected officials may not always understand or appreciate certain subjects including internal controls and third party contractual reviews as well as community leaders who have broader financial management expertise.” A California-based internal audit manager stressed technical skills: “It is more important to have people with technical skills who understand public finance, auditing, and internal controls. It is their expertise in those areas that makes them valuable in providing the city council and citizens the assurance that proper internal controls are in place and the city’s assets are safeguarded.”

Interviewees from two California cities mentioned the need for a ‘blending of skills:’ “Technical skills can be provided by staff; however, a certain



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level of understanding of what an audit is would be needed;" and "A blend of both (community influence and technical skills) is necessary. In addition the finance director is a member of the committee, which guarantees that technical skills in public finance are part of the committee. Two members of the city council are also members of the audit committee, which provides various areas of expertise. Their presence has always provides different vantage points and has been valuable in rounding out the perspective of the committee. The council members are deeply interested in the welfare and the future of the city as well as how resources are used and protected." A Louisiana official concurs with the need for a "blend" of skills: "The influential community people will be more effective in making sure corrective action is taken. However, the knowledgeable finance people are even more important because they are better prepared to assess risk factors to individual situations in developing internal controls."

This led to follow-up questioning regarding the role of the mayor and elected officials in financial oversight. One respondent stressed that ultimately the mayor and elected officials are responsible for financial oversight of the city: "The audit committee is a mechanism from the council to have an independent body, with the appropriate technical expertise, providing oversight and advice to help provide assurances that staff is handling fiscal matters prudently." Another respondent said that the mayor and council members are involved in long range planning, the annual budget, and the annual financial report and audit reports are provided to them for review and approval. She noted that workshops are often held involving elected officials for issues requiring more discussion or planning. In two other cities the mayor chairs the audit committee and city council members serve on them. It is not uncommon for city council members to serve on other committees involved in financial oversight as well (e.g., the finance committee, the bond oversight committee). The inclusion of elected officials is considered valuable, according to interviewees, because they ask good questions, provide useful feedback, become more actively involved in city financial matters, and are better able to make informed decisions. In one city, a commissioner serving on the audit committee took an active role in monitoring the various hardware and software acquisitions made by the information technology department and the associated implementation costs. As a result, additional studies are being conducted to verify effective operation of certain new applications (e.g., payroll and utility billings). In the same city another commissioner is active on the G.O. Bond Oversight Committee that oversees the newly acquired funds for capital improvements. This committee meets monthly and reviews all upcoming project items and their status.

A final question asked interviewees how they respond to the criticism that audit committees are mainly window dressing and that they make very little



substantive contribution to municipal financial management. Some respondents were quick to dismiss such criticism, others were not so sure. A manager from Virginia said the criticism might have some merit, but that it would have to be examined on a case-by-case basis. An assistant finance manager from California said that the validity of the criticism "... depends on the makeup of the committee and the interest the members have in the role of the committee. Our audit committee members have always been very interested in the committee's activities and have played an important and active role in providing direction and feedback." A deputy city manager from a different city observed: "They can be window dressing or very effective. Written records of audits, reviews and outcomes should provide proof of substance if the committee is functioning effectively." A city auditor from Nevada said: "If the audit committee takes a leadership role in reviewing the audit function and a leadership role in implementation of the findings and recommendations, the facts make the criticism irrelevant." A finance director from Texas said his city's committee considers matters of substance, such as, the five-year forecast, and that he receives valuable feedback from them. An auditing manager from Louisiana opined: "If many of the audit committees in this nation are 'window dressing' it is because someone (perhaps management or the governing body) wants them to be." He said, "If audit committee members have the financial expertise, independence from management, and the time to assure that work is done properly, they can be very effective." The most vigorous defense came from a financial manager in Florida: "Our city disagrees with the criticism and values the input made by the audit committee. For example, several years ago, the audit committee addressed the problem of a lack of written policies and procedures by city departments. Since then, as a result of their input, these procedures have been written and implemented for each city department." Most respondents that we interviewed think their audit committees are performing a valuable service and making a substantive contribution.

### SUMMARY AND CONCLUSION

Audit committees are recommended by authoritative bodies to augment financial accountability in local government. Despite legal requirements, professional standards, and recommended "best practices," the use of audit committees in local government is uneven at best. Most cities do not have audit committees, and those that do vary considerably in the range of activities such committees perform. Where these committees do exist they provide an arena that is accessible to internal and external auditors and a conduit of communication with elected officials. Most committees engage in a wide range of



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activities related to external auditing, ethics, internal auditing, and management control. Membership requirements on audit committees stress positive character traits more than technical knowledge and professional certification. Audit committees are perceived to contribute to three types of accountability—legal, professional, and external—and, to a lesser extent, hierarchical accountability. Support for audit committees is strongest among top elected and appointed city officials, and weaker among citizens, public managers, and business elites. Support is linked to the presence of an audit committee. Results show that organizational culture, community characteristics and relations with elected officials are associated with pursuit of audit committee activities, especially ethics-related activities. Finally, audit committees can provide numerous benefits to financial management in cities depending on the interest and expertise of the members.

There are several areas where city audit committees conform to recommended “best practices” and several others where they fall short of such benchmarks. Most municipal audit committees do conform to certain GFOA recommended practices, including reviewing the external and internal auditor’s reports, having between five and seven members, and allowing some elected officials to serve on the committee. The GFOA recommends that every local government should establish an audit committee, but this has not happened. Also, GFOA recommends that the charter establish the committee; this occurs in a minority of instances. The qualifications stressed by GFOA are experience in accounting, auditing, and financial reporting, but in most cities these substantive requirements take a back seat to character traits, such as objectivity and integrity. Most committee members should be selected from outside management, according to GFOA, but most city audit committees do not have such a requirement. In short, the picture is mixed when it comes to conformity with GFOA recommendations.

Another basis for assessing the state of the art is comparing prevailing practice to recommendations flowing from a 1998 Arthur Andersen study of private sector audit committee best practices. While not all activities in our study are similar to those covered in the summary of the Arthur Andersen “best practices,” several are similar. Prevailing practice in city audit committees conforms to recommended practices regarding the size and composition of the committee, giving substantial appointment power to the governing board, meeting and consulting with internal and external auditors, and seeking particular qualities when selecting committee members. Recommendations for audit committee involvement in assessing internal control processes, planning, monitoring, and reporting are generally followed by city committees; however, cities concentrate less on the pre-audit plan and most on post-audit results. The Andersen study recommends that audit committees engage in a broad range of ethics management strategies. Specifically, it suggests that committees review,



approve and assess the firm's ethical code as well as the process for its administration, dissemination, and enforcement. It also calls for an assessment of ethics training and monitoring ethical compliance. Our study found that audit committees were actively seeking to detect ethical wrongdoing, what some have called the low road to achieving ethics, but found little evidence that these broader ethical concerns were occupying the committee's attention.

It is unlikely that pressures to oversee and monitor municipal financial systems will decrease in the future. Internal and external auditing functions are important accountability mechanisms, and audit committees perform a valuable bridging function between auditors and governing officials. Municipal officials charged with responsibility for financial assets can profit from the involvement of audit committees. Where committees are properly structured, adequately supported, and broadly engaged in audit activities, they help to immunize against financial scandals and ensure public accountability.

#### APPENDIX: KANSAS CITY CASE STUDY

The Finance and Audit Committee is one of seven standing committees of the city council and is comprised of four members, each appointed, as are the members of all council committees and most city boards and commissions, by the mayor. The Finance and Audit Committee meets weekly and carries out the following duties and activities:

- Leads the council in the evaluation of the city manager.
- Evaluates and makes recommendations to the full council regarding the appointment, performance, and compensation of the city clerk.
- Evaluates and makes recommendations to the full council regarding the appointment, performance, and compensation of the city auditor;
- Publicly reviews the funding and performance of the office of the city auditor.
- Reviews and makes recommendations to the full council regarding the contract with the commercial audit firm hired by the city to do the financial audit of the city.
- Reviews the financial audits of the city, including the Single Audit and the management letter.
- Reviews all audits and other reports conducted by the city auditor.
- Reviews the scope statements for all audits conducted by the city auditor whether the audits are initiated by the council or by the city auditor.



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- Receives and decides upon requests from council members, the mayor and the public for the city auditor to be directed to conduct specific audits or studies.
- Reviews all Audit Report Tracking System (ARTS) reports from departments and programs regarding their implementation of audit recommendations (see note below).
- Approves all city ordinances and contracts involving significant expenditure of city funds.
- Approves all ordinances and resolutions establishing or amending the financial policies of the city.
- Leads council working sessions and public hearings on the city budget.
- Approves all budget ordinances.

The Chair of the Finance and Audit Committee is traditionally the mayor's point person on the city council. By virtue of his office the chair is a member of a number of significant boards and commissions including the Investment Review Committee and the Economic Development Corporation board of directors and is a member of staff committees selecting and recommending to the council architectural and engineering firms to do work with the city as well as the staff committee selecting and recommending to the council the commercial auditing and accounting firms serving the city.

Over the last several years, the Chair of the Finance and Audit Committee has had a close working relationship with the city auditor and with the finance director. The city auditor and the chair meet at least once a week. Most meetings of the committee contain at least one audit related item on the agenda. In addition, the city auditor attends every meeting of the committee and may seek recognition from the chair to comment on issues before the committee. The finance director meets frequently with the committee chair and apprises him promptly regarding significant finance-related issues and finance matters which will come before the committee.

Note to case: About ten years ago, the council, by resolution, required the city manager to establish a system to track and report to them on the implementation of audit recommendations. The city manager, by administrative regulation, established the Audit Report Tracking System. The system requires departments and agencies to report on the status of open recommendations of the city auditor every six months until the recommendation has either been implemented or management has explicitly stated that the recommendation would not be implemented. Audit report tracking system reports are submitted, on forms established by the city manager, to the city manager, the Finance and Audit Committee, and the city auditor and are heard by the committee at its regular weekly meetings.



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  30. See footnote 7 for definitions.