



STATE OF TENNESSEE
COMPTROLLER OF THE TREASURY

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John G. Morgan
Comptroller

November 23, 2005

Chairperson of the Board
Agency Name
Agency Address
City, State, Zip

Dear Chairperson:

As you know, much has been written and said about ethics in state government in recent months. Fortunately state departments and agencies in Tennessee have not been subject to the scandals that have troubled Wall Street over the years. Those issues have given rise to calls for increased scrutiny of businesses, both through enactment of federal legislation such as The Sarbanes-Oxley Act of 2002, and through a new auditing standard on fraud promulgated by the American Institute of Certified Public Accountants. In addition, the Institute has issued an exposure draft containing far-reaching changes regarding auditors' responsibilities for auditing internal controls. This draft, when finalized, will among other things increase the auditor's work relative to internal controls and will require the auditor to be even more critical of the entity's management when their risk assessment is not adequate.

Tennessee government officials have long realized and accepted that the responsibilities associated with public dollars should be even greater than those related to private investments. It is essential that the public does not lose confidence in the government agencies and departments that are supported by its tax dollars.

Although The Sarbanes-Oxley Act is only applicable to publicly traded companies, the principles underlying the law are applicable to many other situations, including government. One of the key elements of the Act is the requirement of independent audit committees for boards of directors.

In recognition of the benefits of audit committees for government, the Tennessee General Assembly has enacted legislation known as the "State of Tennessee Audit Committee Act of 2005." Section 4-35-101 et seq., *Tennessee Code Annotated*, requires the creation of audit committees for those entities that have governing boards, councils, commissions or equivalent bodies that can hire and terminate employees and/or are responsible for the preparation of financial statements. Applicable entities are required to develop an audit committee charter and appoint an audit committee in accordance with the legislation.

This law was signed by the Governor on June 6, 2005, and became effective upon becoming a law. Although the law was effective immediately, the Division of State Audit will not take audit findings on the failure to follow this law if an entity is in the active process of implementing the law during the current audit cycle. We expect each applicable entity to have a functioning audit committee no later than June 30, 2006. At that time auditors will be asking to see the documented risk assessments noted in the attached materials as well as the other related documentation discussed in those materials.

Attached to this letter is guidance for your audit committee and top management relative to their responsibilities under the law. In general, there are two types of responsibilities for each group: actions to be taken and documentation of those actions.

The attachments are:

- A. The Audit Committee Act
- B. Overview of the Key Responsibilities of the Board, the Audit Committee and Top Management
- C. Audit Committee Member Proxies and Voting Reps
- D. Guidelines for Audit Committee Charters

The concept of “audit committees” is not new. Audit committees were first mentioned in auditing standards over twenty years ago. And many entities already have committees that have been informally acting as audit committees. However, the new law formalizes the creation of distinct audit committees and clarifies their responsibilities.

You will read in the attached guidance that we do not expect every entity to have assessed every risk and implemented every mitigating control by June 30, 2006. However, we expect to find a good-faith start, focusing on principal risks, such as those already identified through internal or external audits or other means. And the assessments and the controls should be documented in writing and approved in writing by the audit committee.

We want to thank you, in advance, for your commitment to the spirit as well as the letter of the law. Serving on an audit committee is a major responsibility. And, as we begin the process, it may be difficult to identify individuals to serve on the committees that have all of the background and independence that is desired. Over time, those issues will be addressed as current members become more informed and experienced about their responsibilities and as other individuals are identified to serve on the committees. Whatever an individual committee member may lack in technical experience or formal academic background, the most essential trait of an effective committee member is a proactive approach to understanding and carrying out the duties of the committee to the best of his or her ability.

In this regard, the members of the audit committee will not be expected to figure out their roles without advice from this office. We will be available to assist you as you establish and optimize your audit committee, consistent of course with our responsibilities to remain independent of the entities we audit.

In fact, one of the main outcomes of an effective audit committee should be a closer relationship between the board and the auditors of the entity, both internal and external.

We are looking forward to the opportunities that the new law provides to ensure the continuous improvement of internal controls within state government and to foster greater and more effective communications between and within state agencies.

In the final analysis, the act is only a mechanism to provide further assurances to the public that its investment in state government is reasonably protected from fraud, waste and abuse. What has always set Tennessee apart, and what we know will set us on a course of success with regard to the new law, is the vigor of our citizens, including government leaders, to do more than the minimum requirements. The work ahead of us may be difficult at times, but there is no option except success.

The requirements of the new law are not really new. These precepts are based on long-standing principles of internal control and management's responsibilities for those controls. In fact, to the extent the provisions of the new law appear to be arduous to management, it suggests a gap between what management should have been doing all along and what they were in fact doing.

In this regard, it may be helpful to you to review past audits of your agency to read any findings and recommendations we may have taken related to controls. And in particular, you might wish to read management's comments to those findings and recommendations, especially for repeated findings.

There is no question that the new law, like Sarbanes-Oxley, is seeking to bring new clarity to the actions of management in safeguarding their agency from fraud, waste and abuse. The law also seeks to focus the actions of the board, through the audit committee, in effectively overseeing those efforts by management. All of these notions are consistent with the often-heard call for greater transparency in government.

We are sending a copy of this letter and the attachments to the commissioner or the head of the agency that you oversee. Without the same proactive commitment by top management and through their efforts and example, all staff of the entity, the efforts of the board and the audit committee will not be successful.

We know that the attached information is lengthy. However, it is essential that we all start out on the same footing. We encourage the members of the board and top management to read all of the information and consider how to put it into action. And we encourage all of you to share the information with all of your staff and ask them to read it and to consider how to implement it. Unless everyone is on board, there will be the danger that the synergies represented by the implementation of the act will be lost. Considering the efforts that are involved, all individuals should take steps to make sure that their particular area is adequately informed to carry out their part of the act. One of the simplest steps that is essential to the

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timely detection of fraud, waste or abuse is reminding all employees that it is their obligation to report odd or unusual activities, including circumvention or overriding of internal controls, to someone not involved in the actions.

We again want to thank you for your time and energies in accepting this very important position. We also want to thank the management of your entity, in advance, for their commitment to the new law regarding audit committees as well as their commitment to accountability as described in this document.

It is truly our hope and intention that as a result of our combined efforts there will be fewer internal control and compliance findings in future audit reports. We assure you that this office is committed to assisting you in your efforts in any way we can, consistent with auditing standards.

The Division of State Audit is available for further advice about the implementation of this law. Please contact the audit manager in charge of your entity's audit for assistance.

Sincerely,

A handwritten signature in black ink that reads "John G. Morgan". The signature is written in a cursive style with a long horizontal stroke at the end.

John G. Morgan
Comptroller of the Treasury

Sincerely,

A handwritten signature in black ink that reads "Arthur A. Hayes, Jr.". The signature is written in a cursive style with a long horizontal stroke at the end.

Arthur A. Hayes, Jr., CPA
Director

Attachments