



# EFFECTIVE AUDIT COMMITTEES

## For Nonprofit Organizations



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Material discussed in this publication is meant to provide general information and should not be acted on without professional advice tailored to your individual needs.

"The independent audit committee fulfills a vital role in ... governance. The audit committee can be a critical component ensuring quality reporting and controls, as well as the proper identification and management of risk... Its critical role as guardian of ... integrity puts the audit committee at the core of the challenge of governance."

Report of the National Association of Corporate Directors Blue Ribbon Commission on Audit Committees

## ► PREFACE

While the preceding quotation was written in a business context, a well-functioning audit committee is important to every nonprofit organization as well - for the very same reasons noted. Adopting and maintaining an audit committee is a best practice for nonprofit organizations and is actually required by some states.

Effective audit committees are not merely formalities to receive lip service. They can be of significant help to governing boards in effectively performing their fiduciary and oversight roles in ensuring reliable financial reporting, reducing risk, and maintaining donor and public confidence (e.g., avoiding legal problems and preventing the negative consequences that inevitably result from financial fraud or irregularities).

This Guide, *Effective Audit Committees for Nonprofit Organizations*, incorporates many specific recommendations, guidelines and rules of governmental and private sector bodies concerned with such matters. Its purpose is to provide you with an overview of the common functions and responsibilities of an audit committee to help you and your nonprofit organization: (1) form and maintain an effective audit committee and (2) set an appropriate agenda for its ongoing activities. However, your organization's specific circumstances, as well as the distinctive nature of the relationships among the audit committee, organization management, leadership volunteers, internal auditors (if you have them) and outside professionals, should dictate the role of your audit committee.

This booklet is intended for use by all types and sizes of nonprofit organizations. However it recognizes that smaller organizations may not need as extensive a set of procedures as a larger or more complex organization. For example, some organizations may find that their finance committee can also function effectively as an audit committee, or you may conclude that less extensive responsibilities or fewer meetings per year are adequate for your needs. What is important is not the form, but the substance. On the other hand, large or complex nonprofit organizations are every bit as challenging to manage and govern effectively as are large businesses, and these organizations need the full range of audit committee functions described herein.

In several places reference is made to internal auditors, which, it is recognized are probably found only in larger organizations; smaller organizations may want to have some internal auditor functions performed by the audit committee, the finance committee, members of management or the governing board, members or other volunteers. Each organization should decide what method will best serve its needs.

Your BDO USA, LLP advisor is ready to assist you in structuring your audit committee, or in evaluating the suitability of your present audit committee practices, in light of your nonprofit organization's particular needs and objectives.





## ▶ THE WHYS

### WHY ARE AUDIT COMMITTEES SO IMPORTANT TO AN ORGANIZATION'S OVERALL GOVERNANCE?

The current economic environment has heightened the need for effective audit committees. The financial debacles and alleged fraudulent activities at established organizations – even some nonprofits – along with phenomena such as the credit crunch and continuing economic turbulence are well known to the public. Young, growing organizations also face a unique set of challenges triggered by their less-developed internal control structures. As a result, both established organizations as well as emerging organizations have an even greater need for independent oversight.

A study released in 2010 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) concluded that fraud is NOT limited to companies of a certain size and found that companies charged with fraudulent reporting by the Securities and Exchange Commission (SEC) included startups with no assets or revenues, as well as much larger companies.<sup>1</sup> Although the study did not specifically analyze nonprofit organizations, these findings are mirrored in the nonprofit sector.

Today's economic environment has shifted the focal point for governing bodies from simply overseeing operations to assessing strategies and risk management processes, understanding the complexity of operations and being prepared to handle crises. We will explore all of these in more detail in the following pages.

Under the COSO internal control framework, “**the control environment**” sets the tone for an organization. It is the foundation for all other components of internal control, providing discipline and structure.”<sup>2</sup> A key element of the control environment is the “**tone at the top**,” the message from the highest levels of the organization regarding the ethical and compliance behaviors of management and employees. We believe that for an audit committee to truly exercise proper oversight, it must influence the tone at the top. Key steps that the audit committee should take in this direction include the following:

- Ensure management clearly communicates to all employees that financial misreporting is absolutely unacceptable
- Insist on receiving all news, especially bad news, promptly and fully
- Ask tough questions
- Be skeptical
- React quickly to issues and take preventive measures for the future

#### ▶ BDO INSIGHT

**A strong audit committee is important for all organizations. Growing organizations, as well as established organizations, benefit from the experience, oversight and direction that an audit committee may provide.**

"It is imperative that audit committees develop strong organization ethics programs that clearly communicate expected behavior, promote candor with management, and require immediate attention to issues."

Wayne Berson, CPA  
CEO-elect, Presiding Member of the BDO USA, LLP Board of Directors

## WHY SHOULD A NONPROFIT ORGANIZATION CONSIDER FORMING AN AUDIT COMMITTEE?

Many nonprofit organizations have formed audit committees in response to the Sarbanes-Oxley Act (the Act), and certain states require an audit committee if the organization solicits charitable donations. In addition, the Internal Revenue Service (IRS) now asks on the Federal Form 990 if an organization has an audit committee. Although not a requirement, this is noted as a best practice by the IRS, and if an organization does not have one, it has to answer "no" on the 990 which is a public document. Potential funders and others can see that it does not have an audit committee and can compare this to other organizations which raises the question about why an organization is not following a suggested best practice. The American Institute of Certified Public Accountants' (AICPA) *Audit Committee Toolkit: Not-for-Profit Organizations, 2nd Edition*<sup>3</sup> lists numerous reasons as to why a nonprofit organization should consider forming an audit committee, including providing better: financial results; decision-making in terms of accuracy and quality of financial reporting; ability to build stronger relationships with stakeholders; as well as facilitating transitions in leadership.

First, let's consider the application of U.S. Generally Accepted Accounting Principles (GAAP). While the debate over the appropriateness of one set of financial accounting standards used by organizations of all sizes and complexities has been going on for years, there is growing sentiment within the U.S. in support of a separate, stand-alone set of accounting standards for U.S. private organizations and nonprofit organizations alike. In October 2009, the Not-for-Profit Advisory Committee (NAC) was established to serve as a standing resource for the Financial Accounting Standards Board (FASB) in obtaining input from the nonprofit sector on existing guidance, current and proposed technical agenda projects, and longer-term issues affecting nonprofit organizations. In December 2009, a Blue Ribbon Panel charged with making recommendations on the future of standard setting for private organizations was launched by the AICPA and the Financial Accounting Foundation (FAF – the parent organization of the FASB). The Blue Ribbon Panel issued its report in January 2011, concluding that there are urgent and growing systemic issues that

The NAC, an advisory group to the FASB, has made recommendations on changes to accounting rules that would improve reporting by nonprofit organizations so that they can better report and explain their financial picture to donors and other interested parties. The key recommendations that the NAC has put before FASB include:

- Revisit the current net asset classifications to determine if there are ways that they could be relabeled or redefined to better portray liquidity on the statement of financial position and related notes.
- Improve the statements of activities and cash flows to make them clearer so that the reader can understand the financial performance of the organization.
- Create a framework for nonprofit organizations to provide commentary and analysis about the organization's financial health and operations so that the readers receive the context behind the financial story. This would be similar to the "Management Discussion and Analysis" provided by publicly traded companies.
- Streamline nonprofit specific disclosure requirements to improve their relevance and clarity.

Some of these recommendations relate to current FASB projects while others would require new projects be undertaken to address these issues.

need to be addressed in the U.S. accounting standard setting system. While some stakeholders had suggested that the Blue Ribbon Panel's work include nonprofit organizations, as well, the panel limited its work to private for-profit entities. The panel has acknowledged that many nonprofit organizations have a much broader and somewhat different set of users of their GAAP financial statements, either directly or indirectly, than do many private companies. The nonprofit organizations have to complete the Federal Form 990 which is public information. When there are federal funds involved, the GAAP financial statements are made part of the public information as well. Even though the current work of the panel does not include nonprofit organizations,

those charged with governance should be aware of these issues and keep up to date on the status of the discussions of the potential shift in the accounting and disclosure models.

Second, let's consider the inroads International Financial Reporting Standards (IFRS) are beginning to make on private organizations. In 2008, the AICPA recognized the International Accounting Standards Board (IASB) as an official standard-setter and thus, U.S. auditors are now permitted to issue opinions on private company financial statements filed using IFRS, as recognized by the IASB. More recently, in July 2009, the IASB published a 230-page condensed version of IFRS for small and medium-sized entities: *IFRS for SMEs*. The IASB defines *SMEs* as businesses that publish general-purpose financial statements for external users and do not have public accountability. *IFRS for SMEs* was developed for private companies and their financial statement users as a simplification to full IFRS. This did not address what the impact would be on nonprofit organizations. It is likely that there will be some customization of IFRS or IFRS for SMEs that would be utilized as a separate set of standards for nonprofit organizations. It should be an interesting next few years as this develops and it is determined what set of accounting rules will be followed.

Given this increased activity aimed at "simplification" of accounting standards for private companies and nonprofit organizations, encompassing both U.S. GAAP and international standards, it is easy

to understand how having a focused oversight function by means of an audit committee in place to ensure that an entity's decision-makers are remaining abreast of developments in financial reporting may be critical.

Finally, it's all in the eye of the beholder. Consider perceptions of corporate governance and the potential effects on transactions involving a nonprofit organization. Simply, nonprofit organizations that are perceived to have solid governance structures and practices are looked upon more favorably than those that are not.

#### ►BDO INSIGHT

**Nonprofit organizations can benefit greatly from the assistance, guidance and oversight an audit committee can provide. Thus, absent specific requirements to maintain an audit committee, we encourage management and boards to weigh the benefits and costs of establishing audit committees within their organizations. In doing so, we recommend a thorough reading of this and other related guidance to understand what the decision to form and run an effective audit committee really means to the organization. An organization with an established governance body becomes even more attractive to potential donors.**





## ▶ THE WHOs

**BEFORE WE GET INTO THE “WHOs” OF THE AUDIT COMMITTEE IN PARTICULAR, IT IS IMPORTANT TO ENSURE THAT YOUR ORGANIZATION RECOGNIZES THE KEY PARTICIPANTS WITHIN THE MARKETPLACE, AS THEY ALL BRING UNIQUE EXPERIENCES AND PERSPECTIVES TO THE GOVERNANCE OF FINANCIAL REPORTING.**

Let’s begin with the stakeholders within the organizations themselves, which include the oversight boards and directors; financial and operational management; and internal auditors. Independent external auditors play a pivotal role in providing assurance as to the reliability of the financial statements prepared by management. Consultants and third party advisors, such as legal counsel, also play key roles in assisting organizations to navigate the rules and regulations of the marketplace, which include key operational and financial reporting aspects.

External to the organization are the regulatory agencies (the IRS, Government Accountability Office (GAO), Office of Management and Budget (OMB), federal agencies for those organizations with federal funding and state regulatory bodies); standard-setters (FASB, AICPA, IASB, etc.); and other stakeholders including the general public, members of organizations and potential donors, all of whom

are actively concerned with the structuring and protection of fair and consistent reporting.

Members, donors and the general public, along with the media, are also viewed as key stakeholders as they continue to gain more and more power in shaping how business is transacted and communicating how organizations should be governed.

The interaction of all of these stakeholders is what makes business so intriguing and, as of late, decidedly more challenging. The ever-changing conduct and governance of business demands that these various stakeholders work together to promote the reliability of the financial reporting process.

At the center is the audit committee, in its oversight role, which is charged with fostering the appropriate tone at the top and establishing and maintaining strong relationships with the other key stakeholders.

Let's now explore this responsibility more closely...

## WHO MAKE THE BEST AUDIT COMMITTEE MEMBERS?

The best audit committees are those that set the appropriate **tone at the top** where the focus is on ensuring the organization acts in accordance with the best interests of its stakeholders. Fundamentally, this can only occur in environments where in-depth knowledge, integrity and an unbiased perspective pervade and are brought to bear at the board and audit committee, senior management and leadership levels. These members not only bring a wealth of industry, general business and financial knowledge and experience to the table, but also can very effectively apply such knowledge and experience to the organization's specific circumstances. This entails **knowing the organization and its risks**, which is fostered through **regular involvement and communications** with management and the internal and external auditors. The best audit committee members demonstrate a high level of involvement and engage in frequent communications, ensuring that a **two-way constructive dialogue** occurs at all times whereby appropriate information- and knowledge-sharing takes place between all parties involved.

Furthermore, it is imperative that the expectations of the audit committee as a governing body are understood and actions are appropriately carried out. For example, the best audit committees will take an active role in identifying financial statement areas where, given the particular circumstances, the committee may require incremental procedures to be performed by the internal or external auditors. The audit committee is also highly involved in the organization's financial reports, ensuring that presentation and disclosure matters of significance are handled fairly and transparently. Such an audit committee realizes its role in initiating communications, creating meeting agendas and following up on the results of actions taken. We will discuss these and other best practices in more detail throughout this publication.

A best practice for audit committees is to ensure that the audit committee members are independent of management in order to be truly objective in the discharge of their duties. It is not always easy to resist strong management, or tell them what they don't want to hear. It is particularly difficult to do this without an independent state of mind. The audit committee independence should be in fact, as well as in appearance. The audit committee, to be truly effective, must be able to resist any attempt by management to compromise financial reporting.

For example, the following relationships are considered to impair independence:

- An audit committee member who is or has been an officer or employee of the organization during the past three years or has otherwise accepted sizable compensation from the organization.
- A member who is an immediate family member of such a person as described above.

## THE AUDIT COMMITTEE'S RELATIONSHIPS



- A member who has a direct business relationship with the organization (e.g., a consultant) if this relationship occurred within the past three years.

Currently, the IRS Form 990 includes a question in Section XII that asks whether the organization has a committee that assumes responsibility for oversight of the audit of financial statements and selection of an independent accountant. While not required, this is considered a best practice and the Form 990 is a public document so if an organization is forced to answer "no," this may raise concern from stakeholders.

In addition, certain states have legal requirements that require an organization to have an audit committee. Certain states or other regulators also require that certain members of the audit committee can not also be members of the finance committee. For example, the State of California requires that no more than half of an organization's audit committee members may also be members of the finance committee. This requirement applies not only to organizations located in the state of California, but to all organizations that solicit charitable donations in the state. Some states require that the chair of the finance committee not be a member of the audit committee. Audit committee members should read and understand any such laws and regulations in all states where their organization does business. Although states may have varying regulations they are all designed to promote audit committee independence.



Organizations often develop Conflict of Interest policies or Statements of Independence that must be signed annually by members of not only the audit committee, but the board and management to ensure compliance with the definitions of independence, ethics and integrity that they have defined in their policies and procedures.

#### ► BDO INSIGHT

**We believe that the guidance on independence for auditors contained in Auditing Standards (AU) Section 220 *Independence* can be applied to audit committee members as well. To paraphrase, independence does not imply an attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management but also to members, donors, creditors, the general public and those who may otherwise rely on the financial statements.**

Refer to the **WHAT** section for specific audit committee responsibilities with respect to continued independence.

## WHO CAN SERVE AS A FINANCIAL EXPERT ON THE AUDIT COMMITTEE?

The inclusion of at least one audit committee member with financial expertise is a highly recommended best practice. This guidance was mandated for public companies by the Sarbanes-Oxley Act and should be a consideration for all organizations to adopt. As noted previously, the Federal Form 990 asks organizations whether they have a committee that takes responsibility for the audit and for the selection of the independent auditors. Having a member with financial expertise on your audit committee will help the organization ensure it has fulfilled all necessary requirements.

An issue sometimes encountered by nonprofit organizations is the ability to find members who possess the attributes for financial expertise. There are several resources available to find potential audit committee members with the necessary expertise. The AICPA has an Audit Committee Effectiveness Center's Audit Committee Matching System which is accessible via <http://www.aicpa.org/Volunteer/AuditCommitteeMatchingCenter/Pages/index.aspx>. The National Association of Corporate Directors (NACD) also has a Directors Registry<sup>4</sup> that can be utilized. Many state CPA societies have these resources as well. Some nonprofit organizations establish a relationship with a peer or otherwise comparable organization and have the CFOs provide the financial expertise to the other organization. For a list of other resources available to an organization to assist in attaining the financial expertise it would like should refer to *"The AICPA Audit Committee Toolkit: Not-for-Profit Organizations, 2nd Edition."*

The following are attributes that are deemed to be essential components of financial expertise:

- An understanding of generally accepted accounting principles (GAAP) and nonprofit financial statements

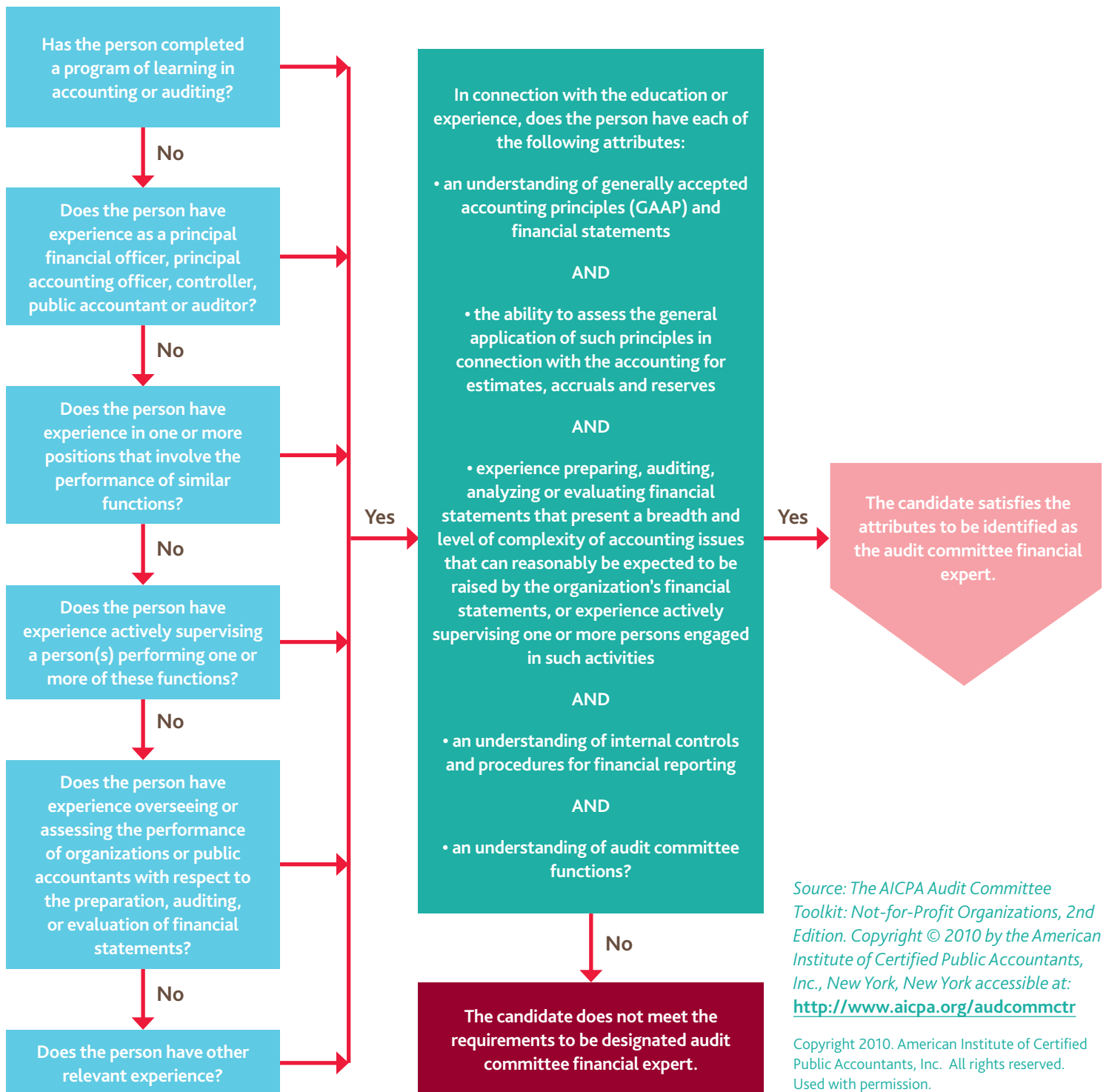
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves
- Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the nonprofit organization's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting
- An understanding of the audit committee function
- A general understanding of nonprofit financial issues and specific knowledge of the nonprofit industry (e.g., health care, education) in which the organization operates

The following points should be considered to assess whether an individual audit committee member or the committee as a whole, possesses the attributes discussed above:

- Does state law include certain requirements of audit committees regarding independence, expertise, membership and shared responsibilities with the finance committee?
- Education and experience as a chief or principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions
- Experience overseeing or assessing the performance of nonprofit organizations or public accountants with respect to the preparation, auditing or evaluation of financial statements
- Other relevant experience such as service on other boards or audit committees

The responsibility to determine whether a person qualifies to be treated as an audit committee financial expert, based on the criteria discussed previously, rests with the board of directors.

THE AICPA'S *AUDIT COMMITTEE TOOLKIT* CONTAINS THE FOLLOWING DECISION TREE THAT MAY ASSIST AUDIT COMMITTEES IN EVALUATING A CANDIDATE FOR CONSIDERATION AS THEIR FINANCIAL EXPERT:



► **BDO COMMENTARY:** If, upon reaching the bottom of the left column of the flow chart, all of the answers to the preceding questions are "NO," then the candidate would not satisfy the attributes to be designated as an audit committee financial expert.

## WHY DO AUDIT COMMITTEES NEED TO INCLUDE A FINANCIAL EXPERT?

- The audit committee should be responsible for making a formal recommendation to the board that the audited financial statements be approved. In addition, the external auditors should discuss their judgment about the quality, not just the acceptability, of the organization's accounting principles with the audit committee. Moreover, auditors are required to communicate significant issues identified to the audit committee. The audit committee must be active in asking knowledgeable and probing questions about these matters and not merely listen to presentations by the auditors and management.
- Business transactions are increasingly complex, making it difficult to understand the proper accounting treatment or related economic risks.
  - Generally, an individual who has past experience in finance and accounting along with the requisite industry knowledge can be a crucial and invaluable addition to the audit committee.
  - The body of accounting rules and complexity of such rules is increasing dramatically, coupled with the potential convergence to one set of worldwide acceptable accounting standards (i.e., IFRS).

We are all acutely aware of the accounting and disclosure complexities faced by organizations today. This issue is only going to become increasingly more challenging as the FASB and IASB continue to set aggressive agendas for release of new standards. The number of expected major changes is unprecedented and causes great concern that such changes will consume significant amounts of management time and will carry a high risk of mistakes. Organizations will be expected to disclose the impact of these changes and audit committees will need to “get up to speed” quickly on changing accounting rules that cover a broad range of matters from revenue recognition to accounting for leases. For IASB and FASB project updates, refer to <http://www.ifrs.org/Home.htm> and <http://www.fasb.org/home>, respectively.

Coupled with the release of complex technical accounting and reporting guidance is the expectation of more transparency in disclosure by regulators and stakeholders.

### ►BDO INSIGHT

We believe boards need to assess the specific and unique circumstances and experiences of the organizations they serve in selecting candidates for service on committees of the board. The selection of audit committee members, and particularly the decision regarding whether to include more than one financial expert, must take into account various factors, including weighing the risks and complexities of the financial reporting of the organization as well as the current composition of the audit committee, along with careful consideration of its strengths and perceived weaknesses. The board needs to consider the broad experiences – financial, industry, leadership, etc. – that potential candidates bring to the table, and financial expertise is one of many attributes that need to be weighed. Furthermore, in considering whether an audit committee should have an “accountant” in the mix is dependent on the types of experiences that all members, as a group, bring to the table. However, experience in accounting matters and the propensity to remain current in the increasingly complex and mounting accounting technical literature are attributes that should be weighed heavily in the candidate selection process.

### Liability of Financial Experts

An audit committee financial expert has no greater obligations or liability than the members of the audit committee and board of directors who are not designated as financial experts, and the presence of an audit committee financial expert does not reduce the other members' obligations or liability. However, we advise audit committee members to seek advice from legal counsel on questions of legal liability.

## WHO SHOULD FILL THE ROLE OF THE AUDIT COMMITTEE CHAIR?

The role of the audit committee chair is without question a demanding one. This role requires a strong, independent and competent communicator who is willing to **ask tough questions** of management and others in order to truly understand and ensure that the audit committee is **focused on risk management and financial oversight** of the organization and that the organization's strategic direction is in line with reality. The audit committee chair should be financially literate. This is not to say that the audit committee chair needs to be the financial expert of the committee, but more often than not this may be the case. In addition to being financially literate, a chair should be an experienced leader who can be forward-thinking and have the time to set agendas and conduct both regularly scheduled and special meetings, as necessary, that effectively involve all of the key stakeholders (management, auditors and the board) and get to the heart of organizational governance and financial reporting matters.



► **BDO INSIGHT**

A best practice that we continue to see is the audit committee chair setting aside the time to meet individually with the external auditors, internal auditors and management, as necessary, prior to audit committee meetings to not only better understand matters to be discussed with the audit committee but to assist the chair in prioritizing the topics to be discussed and the time allotted to them.

## **WHO ELSE IS NEEDED TO SERVE ON THE AUDIT COMMITTEE?**

To obtain a balanced perspective, in addition to the financial expert, we recommend two to five additional members with diverse backgrounds and experience. These other individuals should be “financially literate.” This generally means that the committee member must be able to read and understand fundamental financial statements sufficiently to recognize when the numbers along with associated disclosures do not make business sense. This ability, coupled with diligence and an inquisitive attitude, will enable members to ask insightful questions and thoughtfully assess the responses.

As noted previously there are various resources and methods available for finding the right members for your organization.

► **BDO INSIGHT**

In addition to financial expertise, serious consideration should be given to one's expertise within a certain industry. For example, charitable organizations have concerns that are unique in comparison to trade associations, while educational institutions and health care organizations have very different issues as well. In addition, some nonprofits operate in more than one industry. These many include, for example, universities that operate a hospital, religious organizations that may operate a broadcasting station or a school, museums that have gift shops, a charity that also owns low-income housing facilities, an association with a publishing affiliate, etc. When evaluating whether members have the required expertise, we believe that audit committees should assess if its candidates have the capacity or background to fully grasp the issues relative to the specific industry or industries that the nonprofit operates in.



## ▶ THE WHATs

### WHAT SHOULD BE THE MISSION OF AN EFFECTIVE AUDIT COMMITTEE?

Quite simply, the audit committee's mission is **oversight**. More specifically, this oversight should be focused on the following areas:

- **Financial reporting** – Conduct and integrity of financial reporting
- **Risk management** – Inclusive of internal accounting and disclosure controls
- **Audit function** – Oversight of and communication with independent auditors, both internal and external

### WHAT ARE THE BASIC RESPONSIBILITIES OF AN AUDIT COMMITTEE?

- **Independence** – In addition to helping define WHO an audit committee member should be, independence is considered a basic continuing responsibility of an audit committee member, and each member of the audit committee must be independent and remain so under specified narrow criteria. See prior discussion on independence.
- **Responsibilities relating to the Independent Auditor** – The audit committee should be directly responsible for the appointment, compensation, retention and oversight of the work of auditors who provide audit services to the organization (whether the services are provided by the principal auditor or another firm).

- **Procedures for handling complaints** – The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential anonymous submission by employees (whistleblowers) of concerns regarding questionable accounting or auditing matters.
- **Authority to engage advisors** – The audit committee must have the authority to engage independent counsel and other advisors as it deems necessary to carry out its duties.
- **Funding** – The organization must provide appropriate funding for the audit committee to compensate the outside auditors and any independent counsel and advisors it employs and to fund ordinary administrative expenses of the audit committee that are necessary in carrying out its duties.

The following discussion is organized around these basic responsibilities and is somewhat expanded to encompass the fuller scope of actual audit committee responsibilities in keeping with the broader concept of oversight.



## WHAT SUGGESTED SPECIFIC ACTIVITIES OR DUTIES SHOULD AN AUDIT COMMITTEE UNDERTAKE TO MAXIMIZE ITS EFFECTIVENESS AND CONTRIBUTION TO THE ORGANIZATION IN LIGHT OF ITS RESPONSIBILITIES?

### ► INDEPENDENCE

An awareness of the independence rules is essential to maintaining audit committee independence. To that end, we recommend 1) that audit committees and the organizations they serve work with their legal counsel to develop a process whereby independence rules are communicated on a regular basis, and 2) audit committee members annually confirm their independence in writing. Many organizations regularly circulate a questionnaire to audit committee members that asks detailed questions to enable members to assess and confirm their independence. Often, an explanation of the independence rules is attached to these questionnaires.

### ► RESPONSIBILITIES RELATING TO PUBLIC ACCOUNTING FIRMS

#### Evaluating the capabilities of auditors

The audit committee is considered the public accounting firm's "client" with the responsibility to hire and fire, pre-approve services, review compensation and conduct regular communications with the auditors. In deciding whether to retain and, as applicable, recommend ratification of the auditors, the audit committee should consider a number of factors that impact the auditors' capabilities in the context of the organization's needs. Refer to the chart on the following page which

outlines BDO's recommended considerations to be made by audit committees.

In addition, the AICPA's *Audit Committee Toolkit: Not-for-Profit Organizations, 2nd Edition* contains a practice aid entitled, *Evaluating the External Auditors: Questions to Consider*, for further reference. The toolkit is available for purchase and accessible from the AICPA's Audit Committee Effectiveness Center at: <http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/Pages/ACEC.aspx>.<sup>5</sup>

#### Pre-approval of services by audit committees

Audit committees should consider the need to pre-approve all audit and permitted non-audit services.

The audit committee can either approve a service (1) directly before the accountant is engaged, or (2) indirectly via pre-approval policies and procedures it establishes.

An organization may designate one or more audit committee members who are independent to pre-approve services and report these decisions to the full audit committee at each of its scheduled meetings.



AS PART OF ITS **INITIAL** AND **CONTINUING EVALUATION** OF THE CAPABILITIES OF ITS AUDITORS, WE SUGGEST THAT AUDIT COMMITTEES CONSIDER THE FOLLOWING:

SPECIFIC CONSIDERATION	QUESTIONS TO ASK
<p><b>Technical, industry and nonprofit organization reporting knowledge and depth, including geographic reach and specific type of nonprofit (e.g., trade association, school, etc.)</b></p>	<p>Does the firm have experienced staff and depth of resources to handle the complexity of accounting, reporting and tax matters (including the greatly revised Form 990, unrelated business income tax and exempt status issues) required in today's environment and as it relates specifically to the organization's industry, operations and business?</p> <p>Does the firm participate in industry-related forums (specifically with regard to financial, accounting, reporting and tax matters) that have input into the evolving accounting and reporting practices and guidance?</p> <p>Does the firm have the geographic reach necessary to service the organization fully and efficiently?</p>
<p><b>Independence</b></p>	<p>What are the firm's policies and procedures for ensuring independence of its partners and personnel with respect to the organization?</p> <p>Does the firm, in conjunction with the organization's operating environment, have adequate mechanisms in place to ensure that independence violations (e.g., with respect to employment of former audit engagement team members, pre-approval of services, etc.) do not occur?</p>
<p><b>Quality control policies and procedures</b></p>	<p>Does the firm have adequate quality control policies and procedures in place to ensure services rendered meet professional and regulatory requirements as well as client expectations?</p> <p>What incremental policies and procedures, above those required by professional and regulatory requirements, does the firm employ to provide added quality in the process of rendering professional services?</p>
<p><b>Engagement team composition</b></p>	<p>What is the ratio of staff to partners, and staff to partners plus senior managers?</p> <p>How does the audit firm manage continuity on engagements?</p> <p>What are some of the metrics that the firm uses to monitor performance of its engagement team members?</p>
<p><b>Training and technical support</b></p>	<p>What are the firm's professional credentials (breadth, depth and presence of national office providing support internally)?</p> <p>How does the firm prepare its personnel with respect to meeting professional standards and servicing clients?</p> <p>How does the firm ensure its professional personnel remain up-to-date on evolving technical rules?</p>
<p><b>Frequent and meaningful communications and interactions with audit committees and management</b></p>	<p>What methods and tools does the firm employ to ensure frequent, meaningful communications and interactions with the audit committee and management?</p> <p>More specifically, how does the firm ensure that all required communications occur between the auditors and the audit committee?</p> <p>What programs does the firm have in place to help audit committees and management keep up-to-date with respect to evolving issues of significance and relevance?</p>

## WHAT SERVICES ARE AUDITORS NOT ALLOWED TO PROVIDE TO NONPROFIT ORGANIZATIONS?

Generally audit services provided must be performed by CPAs who are deemed independent. Generally, CPAs are not independent if they are in a position to influence, make management decisions, provide accounting services or have financial interests in a nonprofit organization. Auditor independence requirements are determined by the American Institute of Certified Public Accountants, state boards of accountancy, state CPA societies, the Government Accountability Office (GAO) where a law, regulation, agreement, policy or contract requires the CPA's report to be filed under *Government Auditing Standards* and any other organization that issues or enforces standards of independence that would apply to the engagement.

The GAO has established independence requirements under *Government Auditing Standards*, otherwise known as the Yellow Book. The Yellow Book was most recently revised by the GAO in December 2011. The Yellow Book covers federal entities and those organizations receiving federal funds. The Yellow Book contains a conceptual framework for independence to assist auditors in determining whether they are independent with regard to activities that are not expressly prohibited. The conceptual framework should be considered by audit committees when they are evaluating whether the external and internal auditors can provide certain services.

The following services involving the preparation of accounting records always impair auditor independence per the Yellow Book:<sup>6</sup>

- Determining or changing journal entries, account codes or classifications for transactions for an organization without obtaining management's approval
- Authorizing or approving the organization's transactions
- Preparing or making changes to source documents without management's approval

Other nonaudit services that always impair external and internal auditors' independence with respect to the audited organization include:

- Accepting responsibility to authorize payment of entity funds that are non-tax related disbursements, electronically or otherwise, signing or co-signing checks and maintaining an organization's bank accounts, and approving vendor invoices for payment
- Performing benefit plan administration that includes making policy decisions, dealing with plan participants, making disbursements on behalf of the plan, having custody of plan assets and serving as a plan fiduciary
- Performing investment advisory or management functions that include investment decisions or having discretionary authority over investments, executing buy or sell transactions and having custody of investments

- Providing corporate finance services that include committing an organization to a contract, acting as a promoter, underwriter, broker-dealer or guarantor of an audited entity's securities, and maintaining custody of an organization's securities
- Providing executive or employee personnel services including committing to compensation or benefit arrangements and hiring or terminating employees
- Performing business risk consulting including making or approving business risk decisions and presenting business risk considerations to those charged with governance

With these rules in mind, audit committees are well-served by establishing formal yet flexible pre-approval policies with regard to audit and non-audit services that are reflective of the nature of the organization's operations and business needs. The *Report of the NACD Blue Ribbon Commission on The Audit Committee* contains a sample of audit committee pre-approval policies that may be helpful.<sup>7</sup> In addition, the *AICPA Audit Committee Toolkit Not-for-Profit Organizations, 2nd Edition* contains useful tools in the chapter entitled "Independence and Related Topics: Conflict of Interest, Related Parties, Inurement, and Other Issues."

## ► REQUIRED COMMUNICATIONS

### WHAT ARE THE REQUIRED AND OTHER DESIRABLE COMMUNICATIONS THAT AUDIT COMMITTEES SHOULD HAVE WITH THE AUDITORS?

Auditors are required to communicate the following matters to the audit committee:

- The auditors' responsibility under generally accepted auditing standards (GAAS). This essentially covers the nature and limitations of an audit.
- Critical accounting policies and practices used by the organization
- Alternative accounting treatments within GAAP related to material items that have been discussed with management
- Other material written communications between the accounting firm and management (e.g., management representation letters, engagement letters, etc.)
- Overview of the planned scope and timing of the audit
- Significant findings from the audit, which include:
  - a. Accounting policies\*
  - b. Management judgments and estimates\*
  - c. Corrected and uncorrected material misstatements
  - d. Other information in documents containing audited financial statements. This refers to auditors' limited responsibility for other information containing audited financial statements (e.g., selected financial data, data collection forms, annual reports, etc.).

**“Accounting rules are not always precise. Quite often there is great latitude in the judgments that produce financial statements. We believe in open, regular discussions with the audit committee, presenting opportunities for direct questions about how different issues are handled by the organization.”**

**– William Eisig, CPA, Partner and National Practice Leader, Nonprofit and Governmental Services**

- e. Disagreements with management. These include accounting or auditing matters, whether resolved to the auditors' satisfaction or not. This is a particularly important area because it can shed light on the aggressiveness of executives in attempting to manage the change in net assets or the true financial picture of the organization.
  - f. Consultation with other accountants. This involves evaluation of the appropriateness of management seeking a second opinion on significant accounting or auditing issues
  - g. Major issues discussed with management prior to retention. This requirement is aimed at detecting whether management might be prone to “opinion shopping.”
  - h. Significant difficulties encountered in performing the audit. This area may encompass such issues as delays in providing information to the auditors and lack of cooperation.
  - i. The quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting\*
- Representations requested from management
  - Illegal acts
  - Fraud\*
  - Internal control matters – specifically, significant deficiencies and material weaknesses\*

\* Refer to further, more in-depth discussions below.

As required by AICPA Statement of Auditing Standards (SAS) 114, auditors are further required “to participate in open and frank discussions with the audit committee about auditors' judgments of the **quality**, not just the acceptability, of the organization's accounting principles as applied in its financial reporting throughout the audit.” This includes “such matters as the consistency of the organization's accounting policies and their application, and the clarity and completeness of the organization's financial statements, which include related disclosures... also includes items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.”

#### ►BDO INSIGHT

**Accounting rules are not always precise. Quite often there is great latitude in the judgments that produce financial statements. These quality discussions present a great opportunity for the audit committee to ask direct questions about how different issues are handled by the organization and should be an integral part of the communications process with the auditors.**

Refer to the [Appendix](#) for a tabular listing of Auditor Required Communications with Audit Committees and reference to applicable technical guidance.

#### ►BDO INSIGHT

**In regard to the planned scope and timing of the audit, we feel that communications should occur on a timely basis prior to the start of fieldwork and include discussion of the auditors' approach to risk, materiality and internal control as well as the extent of interaction between the external and internal auditors, if any, to better equip those charged with governance to more fully understand the scope of the work to be performed and determine whether adjustments to this scope may be required, as necessary.**



## WHAT SHOULD AUDIT COMMITTEES BE FOCUSED ON IN CONSIDERATION OF RELIABLE AND TRANSPARENT FINANCIAL REPORTING?

The audit committee must have an **UNWAVERING MANDATE** for financial statements that **TRANSPARENTLY** and **MEANINGFULLY** portray the organization's circumstances.

Identifying and managing risk across an organization is one of the chief aspects of sound corporate governance. Risk management is the process by which management, subject to **oversight** by the board and audit committee, assesses the nature and scope of risks applicable to the organization, designs and applies appropriate controls to minimize risks and monitors the controls to ensure that they are working effectively.

In order to achieve its goal of risk management and combatting financial fraud, the audit committee must have an unwavering mandate for financial statements that transparently and meaningfully portray the organization's circumstances. Some steps in achieving this include:

- Ensure adequate review of the annual audited financial statements and the Federal Form 990 and other required tax returns before they are finalized. The audit committee should clearly understand the following:
  - Significant accounting judgments made and estimates included in the financial statements
  - Accounting treatment of significant or unusual transactions
  - Impact of changes in accounting rules
  - Required disclosures
- Evaluate the appropriateness of management seeking a second opinion on significant accounting or auditing issues.
- Look for “red flags” which may signal improper revenue recognition management or worse, fraudulent financial reporting, misappropriation of funds or illegal acts. In that regard, question management and the auditors about such matters as unusual fluctuations in revenue and expenses, inexplicable reserves, changes in accounting principles or business terms, and significant new sources of revenue.
- Review audit adjustments made and those waived because of immateriality. The audit committee should understand the quantitative, as well as qualitative, factors used to make this decision.
- Ensure that the financial reports clearly reflect true organization performance. In doing so, the committee should be familiar with critical performance indicators such as industry trends and ratios.

Critical accounting estimates are under closer scrutiny than ever before. Given the current economic environment, all parties are paying close attention to estimations of fair value and impairment; reserves for excess inventory/obsolescence; allowances for doubtful accounts and uncollectible pledges; liabilities for employee benefit plans; liquidity; as well as other sensitive areas. Audit committees need to focus their attention on how management is applying judgment within accounting standards and, specifically, on the assumptions that underlie these critical accounting estimates.

## WHAT SPECIFIC STEPS MIGHT THE AUDIT COMMITTEE UNDERTAKE IN ASSESSING THE TONE AT THE TOP AND ENSURING ETHICAL BEHAVIOR WITHIN AN ORGANIZATION?

We will continue to stress the importance of understanding an organization's **tone at the top** because it provides the basis for ethical behavior within an organization. Under Section 406 of the Sarbanes-Oxley Act, an organization is required to disclose whether or not it has adopted a **code of ethics** for senior financial officers. While nonprofit organizations are not subject to this provision, this is a best practice that should be considered. A “code of ethics” encompasses such standards as are reasonably necessary to promote:

1. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships
2. Full, fair, accurate, timely and understandable disclosure in the financial reports and tax returns prepared by the organization
3. Compliance with applicable governmental rules and regulations

Most audit committees believe that they can assess the tone at the top from their periodic meetings with management. However, best practices continue to develop which, in addition to these periodic meetings, may include more formal assessments, such as conducting confidential employee surveys, focus groups, one-on-one discussions with second and third levels of management, as well as holding separate discussions with internal and external auditors.

## WHAT CAN AUDIT COMMITTEES DO TO BETTER UNDERSTAND THE ORGANIZATION'S RISKS, INCLUDING FRAUD RISKS, AND THE ADEQUACY OF CONTROLS IN PLACE TO MITIGATE THOSE RISKS?

The global financial crisis and economic turbulence continues to expose organizations that have poor risk assessment and management practices and should serve as a warning to all organizations. The seeds of financial fraud are sown in the combination of business and financial

risks facing an organization and the inability of existing internal controls to cope with them. The most prevalent means for committing fraud is an override of internal controls by management, especially senior management.

In order for the audit committee to monitor risks effectively, it must first understand the risks that the organization faces. Within its *Effective Enterprise Risk Oversight* guidance (see link below), COSO indicates that monitoring of risk cannot be done effectively in an ad hoc fashion but rather, requires an approach that looks broadly at the organization (through an enterprise framework) that encompasses: a comparison of the organization's strategies with its *appetite for risk* (that is, the level of risk an organization may be willing to accept in order to increase donor or member value); an understanding of the processes employed by management to identify, assess and manage risk; and a means for reviewing and appraising management's response to significant risks. Then, by recognizing that **a strong internal control system is the key to risk management**, it can create the right **tone at the top** to foster the growth of suitable controls. Some considerations:

- Review risk assessments developed by management. Risk comes in many forms, including economic, legal, financial, environmental, market, technological and competitive. The audit committee cannot be expected to be responsible for continuous monitoring of all business and financial risks, but rather should rely on the special skills and research of other parties to provide input. The audit committee should ask management and the internal and external auditors about their assessments of business and financial risks in areas relating to the audit committee's responsibility. The audit committee should perform these inquiries on a regular basis and receive updates whenever there is a significant change in the risks the organization is facing.
- Receive internal auditors' reports directly with no management filtering. Direct interaction with the internal auditors can give the committee a sense of the effectiveness of the organization's internal control and its compliance with laws, regulations and organization policies.
- Review internal and external auditors' recommendations for improving controls as well as management's responses and follow-up to those recommendations. In doing so, the audit committee should focus on more significant control weaknesses. Understanding management's actions and attitudes toward improving control procedures enables the audit committee to better understand management's tone at the top.
- Ensure that the organization's financial reporting infrastructure can support its current and future needs. The management information systems must be able to provide management with all the information it needs to run the business while producing clear, accurate and timely external financial reports.
- Work with the full board and other committees of the board, as necessary, to ensure that a broad assessment of risk is understood and considered by all.

### Some resources to consider include:

COSO's *Effective Enterprise Risk Oversight – The Role of the Board of Directors*

[http://www.coso.org/documents/COSOBoardsERM4pager-FINALRELEASEVERSION82409\\_001.pdf](http://www.coso.org/documents/COSOBoardsERM4pager-FINALRELEASEVERSION82409_001.pdf)

COSO's *Enterprise Risk Management – Integrated Framework (Executive Summary)*

[http://www.coso.org/documents/COSO\\_ERM\\_ExecutiveSummary.pdf](http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf)

COSO's *Strengthening Enterprise Risk Management for Strategic Advantage*

[http://www.coso.org/documents/COSO\\_09\\_board\\_position\\_final102309PRINTandWEBFINAL.pdf](http://www.coso.org/documents/COSO_09_board_position_final102309PRINTandWEBFINAL.pdf)

Refer to the internal control section on the next page for further information.

#### ► BDO INSIGHT

The audit committee should be alert for areas where management and senior management have the ability to override otherwise effective internal controls. Potential ways to mitigate override are included within the AICPA's "*Management Override of Internal Controls: The Achilles Heel of Fraud Prevention*"<sup>8</sup> and include independent review of financial reports, internal and external audit procedures and analytical review procedures. The audit committee should understand and assess how the auditors, both external and internal, as well as the organization's compliance department, address the risk of management override of internal controls. For organizations that have experienced issues in the past with respect to errors, fraud and/or management override of controls, audit committees are further encouraged to perform look-backs on historical breaches of internal control and inquire as to how the organization is better prepared to address those risks today.

## WHAT IS THE EXPECTED RESPONSIBILITY OF THE AUDIT COMMITTEE AS COMPARED TO THE BOARD WITH RESPECT TO RISK OVERSIGHT?

Currently, there is debate over the division of responsibilities between the board of directors and other committees of the board (e.g., audit, compensation, finance and nominating committees), specifically with respect to risk oversight. While most agree that risk management is a shared responsibility, many would agree that audit committees should focus on risks related to financial reporting and not be overloaded with an organization's entire risk matrix. Generally, the full board should oversee the strategic risks facing the organization and the audit committee's responsibility for risk is narrowed to risks within the audit committee's core areas of oversight – financial reporting, compliance, IT and sometimes, financial risks.

## WHAT IS THE AUDIT COMMITTEE'S ROLE IN THE PREVENTION, DETERRENCE AND DETECTION OF FRAUD?


No discussion of risk would be complete without a direct consideration of the risk of fraud and the responsibilities for dealing with fraud. AICPA Statement on Auditing Standards No. 99, outlines the following roles with respect to fraud: Auditors have the responsibility to *consider* the risk of fraud in planning and performing their audits, specifically as it relates to misstatements arising from fraudulent financial reporting (e.g., falsification of accounting records) and misstatements arising from misappropriation of assets (e.g., theft or fraudulent expenditures) that may lead to a material misstatement within the financial statements. However, *"it is management's responsibility to design and implement programs and controls to prevent, deter and detect fraud... Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee, board of trustees or board of directors), should set the proper tone, create and maintain a culture of honesty and high ethical standards and establish controls to prevent, deter and detect fraud. When management and those responsible for oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly."*<sup>9</sup>

Audit committees need to understand the following fraud risk factors that are generally present when fraud occurs: **incentive** or **pressure** to commit fraud (e.g., pressure to meet revenue and/or budgetary goals); **opportunity** to commit fraud (e.g., absence/lack of controls, ability for management to override controls, etc.); and **rationalization** (e.g., attitude or lack of ethics that allows a person to commit fraud). Together, these factors make up what is widely known as the **fraud triangle**.

There are several variations, currently in circulation, to the fraud triangle. One such alternative is summarized in a report published by David T. Wolfe, a forensic accountant, and Dana R. Hermanson, a professor of accounting, adding a fourth element – **human capability**, thus, forming the **fraud diamond**,<sup>10</sup> to consider an individual's personal traits and abilities that play a major role in determining whether fraud will actually occur in the presence of pressure, opportunity, and rationalization. For audit committees, at the core of these fraud models is recognizing *the presence and interaction of the risk factors underlying fraud* as the key to oversight responsibilities for the detection, deterrence and prevention of fraudulent activity.


Building upon various fraud models and based upon its own investigative experience, BDO Consulting (BDOC) – a division of BDO USA, LLP – has identified certain conditions that often create a fertile environment for fraud and negatively impact the audit committee's ability to oversee management's anti-fraud initiatives. Such conditions include:

- Lack of awareness of fraud risk factors and warning signs
- Inadequate control activities to mitigate identified fraud risk
- Inadequate screening practices (for employees, vendors, customers and/or business partners)
- Insufficient understanding of ethical duties at all levels



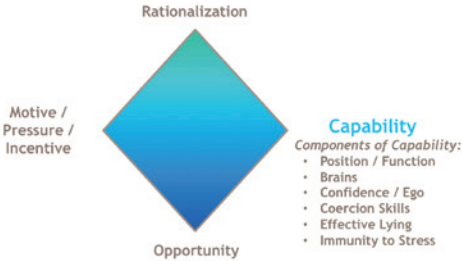
### Environment That Encourages Fraud

- **Pressure** or an incentive to commit fraud
  - Meet expectations
  - Avoid criticism
  - Cover a mistake
- **Perceived opportunity**
  - Poor internal controls
  - Lack of oversight
- **Rationalization**
  - Low compensation
  - Company is profitable



**Excerpted from the BDO Ac'sense 2009 self-study course – Focus on Fraud: Fraud and Misconduct in the Corporate World accessible at: <http://www.bdo.com/acsense/events/Focus-on-FraudSept09%20.aspx>.**

### The Fraud Diamond: Considering the Four Elements of Fraud



**Excerpted from the BDO Ac'sense 2010 self-study course – Focus on Fraud: The Series Continues... accessible at: <http://www.bdo.com/acsense/events/Focus%20on%20Fraud%20-%20Lessons%20Learned.aspx>.**

- Ineffective mechanisms for reporting and investigating fraud
- Ineffective board and audit committee oversight

Fraud continues to be a hot topic and a focus in the area of risk management for organizations and particularly those charged with governance. **BDOC's Fraud Prevention Program**<sup>11</sup> is based upon the belief that the effectiveness of board and audit committee oversight is a key element in significantly reducing the risk of fraud at an organization and increasing the likelihood that, if fraud does occur, it will be detected at an early stage. To achieve this, audit committees may consider employing the following best practices:<sup>12</sup>

- Understand significant fraud risks that the organization's business is facing via fraud risk assessment and education
- Understand the programs and controls that management has developed for managing fraud risks, including relevant policies and procedures



**“Audit committees need to develop strong organization ethics programs that communicate expected behavior, candor with management and immediate attention to issues.”**

– Jack Weisbaum, CEO, BDO USA, LLP

- Develop alternative sources of information about what is happening in the organization with respect to fraud risks
- Seek supporting documentation and be willing to ask difficult questions
- Have mechanisms *in place* for both reporting (e.g., “whistle-blower hotlines”) and conducting independent investigations of fraud
- Independently assess and monitor the effectiveness of those mechanisms

Audit committees should be aware of the motivations that can cause personnel to commit financial statement fraud at nonprofit organizations. Many of the reasons are similar to any other entity. However, the following items are unique situations found only at nonprofit organizations.

**Reason:** To meet fundraising goals

Many nonprofit organizations have set fundraising goals and the desire to show that these goals have been met can be an impetus to commit fraud to make it appear as if the goals have been met. This is often desirable so that an organization can receive matching grants that will only be provided by the donor if the organization reaches a specific goal first.

**Reason:** To show donor restrictions being met and grant terms complied with

Nonprofit organizations are required to meet the donor restrictions placed on funds they receive and ensure that all grant terms, both federal and nonfederal, have been complied with. The failure to meet the required restrictions may mean an organization cannot report the amounts as revenue in the financial statements as well as the possibility that they may have to return the funds to the grantor. Failure to comply with grant terms can result in findings in the reports and return of the funds.

**Reason:** To show more expenses as program versus supporting activities

An organization may be subject to the requirement to maintain certain program versus supporting service ratios, so they may commit financial fraud to record expenses in the program service category, although they may not qualify, in order to show that they have satisfied these ratios. In addition, an organization with a larger ratio of program expenses to supporting services is viewed more favorably in the eyes of donors and the organization may want to raise more funds, so they want to report better expense ratios.

**Reason:** Make the organization appear less financially rich

At times, organizations may be deemed to be “too rich” by donors if they show large net assets. This will cause donors to decide not to donate funds to the organization since they appear not to need the funds. This can lead to financial statement fraud where revenues are understated in order for the organization to show its needs better.

**Reason:** Misclassify expenses to reduce any unrelated business income

Certain organizations may conduct activities that result in unrelated business income and incur a tax. The misclassification of expenses to the activity can make it seem that no net revenue was generated and no taxes are necessary.

These are all examples that are unique to the nonprofit industry that should be considered by the audit committee when it is considering the risk of fraud at the organization.

“The audit committee’s oversight responsibility for financial reporting risks transcends most enterprise risks faced by the organization. A financial reporting failure due to fraud often adversely impacts reputation, employee morale and the ability to achieve strategic objectives.”

– Glenn Pomerantz, Partner, BDO Consulting

## FOCUS ON FRAUD: COSO FRAUDULENT FINANCIAL REPORTING STUDY

In February 2010, COSO issued *Fraudulent Financial Reporting: 1998-2007*, a report<sup>13</sup> which provided a comprehensive analysis of fraudulent financial reporting investigated by the SEC between January 1998 and December 2007. The study reviewed certain key organization and management characteristics involved in instances of financial reporting fraud identified in SEC Accounting and Auditing Enforcement Releases (AAERs) and compared these organizations to a non-fraud control group. The study further provided insights related to preventing, deterring and detecting fraudulent financial reporting.

The report contains some interesting overall findings: Compared to the previous study conducted by COSO, which covered the period from 1987-1997, the number of alleged cases of financial reporting fraud increased from 294 to 347, an increase of approximately 18 percent. The median fraud of \$12 million in the recent study compares to a median fraud of \$4 million in the previous study. Organizations allegedly engaging in fraudulent financial reporting (which included start-ups through established organizations) had median assets and revenues of just under \$100 million compared to \$15 million reported previously. These facts seem to indicate that the frequency of fraud is increasing; the size of the impact of fraud is increasing; and the size of the organizations involved in alleged financial reporting fraud is also increasing. Improper revenue recognition continued to be the leading method of perpetrating financial reporting fraud within 61 percent of the cases (up from 50 percent of the cases in the previous study). No particular industry dominated the organizations that experienced financial reporting fraud, however, “computer hardware/software” organizations and “other manufacturing” organizations each represented approximately 20 percent of the organizations identified in the study. The exchanges on which organizations that allegedly engaged

in financial reporting fraud were traded also provide interesting information. Approximately 50 percent of the “fraud” organizations in the current study were traded on NASDAQ. However, only approximately 24 percent of all publicly traded organizations are registered on NASDAQ, which indicates a higher proportion of organizations experiencing financial reporting fraud are traded on this exchange.

For a statistically significant number of cases of fraud noted in the COSO study, the organization had been experiencing financial difficulties. In the majority of the cases, senior management was involved in the fraud and, specifically, in 89 percent of cases, the AAERs named the CEO and/or CFO as being associated with the financial statement fraud. The most commonly cited motivations for fraud included the need/desire to: meet earnings expectations, conceal deteriorating financial condition, increase stock price, bolster financial performance for pending financings, increase compensation based on financial results, and cover up asset misappropriation. Other “red flags” highlighted in the report for fraud organizations as compared to the non-fraud control group included higher rate of related party transactions and higher rate of change in external auditors.

BDO notes the key takeaway from this report for **all** audit committees is the need to remain vigilant – be mindful of fraud risk factors, financial stress/pressures and other motivators of fraud, management’s tone at the top, etc. – and be willing to challenge management with respect to fraud.

“The benefits of an engaged and active audit committee as a component of the control environment cannot be over emphasized. An audit committee needs to be aware of the areas where bias in the financial statements could occur, and the motivations or pressures that could lead to such bias. They should “walk the talk” of the organization's core ethical values, ask probing questions of both management and the auditors and apply a challenging attitude to the financial information presented for review. This attitude will permeate the organization and its advisors and send a strong message to potential fraudsters.”

– Sue Lister, Partner, National Director of Auditing, BDO USA, LLP

## WHAT CAN THE AUDIT COMMITTEE DO TO STRENGTHEN THE AUDIT FUNCTION?

As indicated previously, the audit committee's oversight responsibility for the audit function covers work performed by both external and internal auditors.

### External Auditors

In addition to the questions posed earlier regarding continually evaluating the capabilities of the external auditors and communications, the audit committee should:

- Interview and evaluate the external auditors from the following perspectives:
  - **Audit and tax approach** – how the firm plans the audit, the timeliness of its services, the efficiency of its performance and how effectively it coordinates the work of other offices, both domestic and international. Also, how it polices its own performance, internal review approach and consulting procedures.
  - **Accessibility and location** – the ability of the firm to respond to issues in a timely manner, including the relative proximity of the auditors to the organization's operating facilities and corporate headquarters. This can facilitate cooperation, understanding and face-to-face contact.
  - **The management letter** – the content of the firm's letter of recommendations to management, including insights into the organization's business and internal accounting control needs, and the completeness of its approach.
  - **Working with the audit committee** – the degree of initiative, cooperation and effectiveness of the firm's work with the audit committee.
  - **Major litigation** – the likely effect on its business of any significant pending lawsuits against the audit firm.
- Obtain agreement from the auditors that the board (and, therefore, the audit committee), rather than management, is the auditors' primary client. To that end, the audit committee needs to make sure

the auditors understand the need for a diligent, unbiased audit and an honest appraisal of management. This agreement can help provide free-flowing, candid discussions between the audit committee and the auditors.

- Review the audit fee to ensure that it is in line with the scope of the audit. Based on the review of the auditors' scope and auditing techniques, subsequent discussions with management about problems encountered and the auditors' efficiency in handling the audit, the audit committee should be in a good position to evaluate whether the engagement time and resulting fees are reasonable. While it may be natural to review the fee solely from the perspective of being “too high,” a fee that is too low may actually provide more risk to the organization. An “overly aggressive” negotiated fee can put significant pressure on the auditors when determining an appropriate audit scope that adequately addresses the higher risk areas.

### Internal auditors

Much of the following can be likened to the responsibilities of the audit committee for external auditors, in that the audit committee should:

- Be apprised of the scope of internal auditors' work and their specific responsibilities. This would include review and approval of the internal audit department charter, which should describe the mission, accountabilities, independence, responsibilities, authority and standards for the department.
- Be involved in the hiring/termination, selection and compensation of the internal audit department
- Evaluate the adequacy of the internal audit department personnel, the department budget, as well as when appropriate changes in audit coverage should be made
- Review any plans to outsource the internal audit function. Challenge the pros and cons of such a proposal.

In addition, the audit committee should review the degree of coordination between the activities of the external and internal auditors. The audit committee should feel confident that the combined audit scope can be relied on to identify weaknesses in internal controls that could expose the organization to fraud or material financial

**“The audit committee plays a critical role in fostering a strong tone at the top, which is the foundation for a robust control environment.”**

– Wayne Kolins, Partner, Global Head of Audit and Accounting, BDO International Limited

reporting errors. Moreover, the committee should encourage open and direct communications with the auditors. Internal auditors, as well as external auditors, must feel free to report control weaknesses (particularly those resisted by management) to the audit committee on a confidential basis without fear of reprisal.

The AICPA's *Audit Committee Toolkit* contains two tools that may facilitate the audit committee's evaluations: “*Evaluating the Independent Auditor – Questions to Consider*” (see prior discussion) and “*Evaluating the Internal Audit Team – Guidelines and Questions*.”<sup>14</sup>

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Communication is a two-way street that should be designed to ensure that all of the parties involved understand each other's responsibilities and that each receive relevant and timely information to allow those responsibilities to be fulfilled.

## ► INTERNAL CONTROL OVER FINANCIAL REPORTING

### WHAT ROLE DOES THE AUDIT COMMITTEE PLAY IN THE ORGANIZATION'S INTERNAL CONTROL ENVIRONMENT?

Internal control over financial reporting is crucial to the governance of an organization. The audit committee's primary responsibility with respect to internal control is the internal control over financial reporting.

In order to be knowledgeable about management's evaluation and assessment of internal control, the audit committee needs a good understanding of the organization's framework and related components

of internal control. One framework used in practice includes the following key integrated components:

- **Control environment** – tone of the organization
- **Risk assessment** – identification and analysis of relevant risks
- **Control activities** – policies and procedures
- **Information and communication** – relevance and timeliness
- **Monitoring** – ongoing assessment of controls

Understanding of the organization's control environment; how robust the risk assessment process employed by management is; what activities in the form of policies and procedures have been put in place by the organization to meet risk management objectives; whether information and communications are relevant and timely to ensure adequacy of the internal control system; and how well the organization is able to monitor existing controls to ensure they are operating effectively and efficiently is paramount for the audit committee to then be able to understand how and where things may go wrong.

In this regard, auditors are required to report all significant deficiencies and material weaknesses, in writing, to the audit committee. A **significant deficiency (SD)** is defined as a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the organization's financial reporting.

A **material weakness (MW)** is defined as a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the organization's financial statements will not be prevented or detected on a timely basis.<sup>15</sup>





## WHAT IS THE AUDIT COMMITTEE THEN EXPECTED TO DO WITH SUCH INFORMATION ON REPORTED SDs AND MWs?

If SDs or MWs are identified, the audit committee should ask the following:

- Are these issues pervasive throughout the organization or limited to specific location(s), account(s) or types of transaction(s)?
- Were any of these issues noted in previous years and, if so, what does this mean for establishment of an appropriate tone at the top and oversight of internal control?
- What is management doing to remediate the issues? Is the scope and timing of this remediation adequate?
- What additional controls, policies and/or procedures need to be implemented to ensure a more robust control environment?
- Given the issues noted, are there other areas that need re-evaluation?

## WHAT IS THE AUDIT COMMITTEE'S ROLE WITH RESPECT TO IMPLEMENTATION OF IFRS?

The International Accounting Standards Board (IASB) has developed International Financial Reporting Standards (IFRS) to address the variability in reporting standards between countries. While over 120 countries now require or permit IFRS, the U.S. remains the one major economy that has not yet committed to adoption of IFRS. Most U.S.-based organizations are taking a wait and see approach to IFRS implementation. The FASB and IASB are currently working on over a dozen different projects designed to bring convergence to the standards that govern accounting for such items as leases and financial instruments. In addition, there are proposals to develop IFRS for Small and Medium Size Enterprises (SMEs) which are currently referred to as IFRS for SMEs. Within the adoption and implementation of IFRS or IFRS for SMEs, the role of the audit committee will remain one of risk management and oversight. As such, while management is responsible

for the preparation of IFRS or IFRS for SMEs financial statements, the audit committee is expected to be knowledgeable in determining: how implementation of IFRS or IFRS for SMEs will impact an organization's controls over risks; sufficiency of the level of management expertise; adequacy of plans to integrate the organization's business practices as well as its systems (e.g., IT, taxation, legal, contracts, etc.); how estimates and judgments are being made by management related to accounting policy choices in the initial adoption of IFRS or IFRS for SMEs; and how effects/results of IFRS or IFRS for SMEs reporting should be communicated to shareholders and analysts in ensuring integrity of financial reporting.

As indicated previously, there are significant differences between existing U.S. GAAP and IFRS or IFRS for SMEs, many of which may be wholly or partially eliminated prior to U.S. organizations adopting IFRS or IFRS for SMEs and some of which will not. It is, thus, not too early for organization management along with its governing bodies to begin getting up to speed with not only the IFRS or IFRS for SMEs standards, but the way in which the IASB works and its objectives.

## WHAT IS THE AUDIT COMMITTEE'S ROLE WITH RESPECT TO CONSIDERATION OF INCOME TAX MATTERS?

The Internal Revenue Service (IRS) Federal Form 990 (Form 990) asks in Part VI, Section B whether the organization provided a complete copy of the Form 990 to all members of its governing board before filing the form. Additionally, the Form 990 asks organizations to describe their process for reviewing the Form 990. Many organizations will assign the responsibility for review of the Form 990 to the audit committee. The audit committee may review the Form 990 with management and/or the tax accountants to ensure that all information has been accurately included and presented on the Form 990 and that all questions have been answered appropriately. This review should include independent tax experts who can answer the committee's questions and provide the technical background related to the questions being asked on the form.

A nonprofit organization must not permit any portion of the organization's assets to benefit any individual. This is referred to as

“In addition to failure to comply with disclosure rules and government reporting requirements, I counsel my clients to consider if there is anything about their organization or its operations that they would be embarrassed to read about in the local newspaper or hear discussed on the evening news. Reviewing all aspects of financial reporting, tax and internal controls through this perspective is key for those charged with governance.”

– Laura Kalick, JD, LLM in Taxation, National Director, Nonprofit Tax Consulting

private inurement and can result in the loss of an organization's tax exempt status. Examples of private inurement include, but are not limited to, unreasonable compensation, unreasonable fringe benefits, improper use of the organization's assets, personal expenses being paid by the organization, loans made at low- or no-interest to organization personnel or related parties, unreasonable housing allowances and any other transactions which are not conducted at arm's length between the organization and its personnel or related parties. If it is deemed that a person has benefited personally a 25 percent tax will be imposed on the benefit the person was deemed to have received and the individual is personally liable for this penalty. If a correction is not made in a timely fashion, an additional 200 percent tax on the benefit will be imposed on the individual. In addition, organization managers who are deemed to have participated in a transaction that results in private inurement will be personally liable for a 10 percent tax on the benefit deemed to have occurred.

In addition, the audit committee should review the assessment completed by management as to whether the organization has any uncertain tax positions as discussed in Accounting Standards Codification 740-10, “Accounting for Uncertain Tax Positions.”

The audit committee has a responsibility to ask questions about transactions to ensure they are being conducted at arm's length and that all appropriate documentation required by the IRS to substantiate transactions exists. The audit committee should understand the financial information and responses provided on the Form 990 and ensure that they are accurate.

## ► PROCEDURES FOR HANDLING COMPLAINTS

### WHAT ARE THE BEST PRACTICES FOR ESTABLISHING PROCEDURES FOR HANDLING COMPLAINTS?

The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential anonymous submission by employees of concerns regarding questionable accounting or auditing matters. This is one of the two provisions of Sarbanes-Oxley that is applicable to all organizations including nonprofits.

We recommend that audit committees adopt a formal “**whistleblower policy**” that includes the following:

- Responsibilities of the audit committee
- Procedures for receiving and investigating complaints
- Policy for protecting whistleblowers
- Confidentiality policies for whistleblowers
- Policy for publication of whistle-blowing procedures

Organizations may consider an anonymous telephone hotline as a means for employees to report complaints.

For further information on assessing whistleblower policies and oversight, refer to BDO Consulting's Fraud Prevention Program at: <http://www.bdoconsulting.com/services/fraud-prevention-consulting.aspx>.



## ► AUTHORITY TO ENGAGE ADVISORS

### UNDER WHAT CIRCUMSTANCES IS IT ADVISABLE FOR THE AUDIT COMMITTEE TO ENGAGE INDEPENDENT COUNSEL AND CONSULTANTS?

Audit committees should have the authority to engage independent counsel and other consultants as they deem necessary to carry out their duties. While one cannot predict all of the scenarios in which the audit committee may need to engage third parties, it is highly advisable to develop these third-party relationships early on and, if possible, *before* their services may be needed to conduct an internal investigation or in conjunction with significant business transactions or other matters. This becomes particularly important when confronted with instances of suspected or known fraud for which independent investigations may need to be assembled expeditiously.

In cases of suspected or discovered illegal or fraudulent activities, the audit committee may also consider the need to engage forensic accountants to provide a variety of skills with respect to proficiencies in accounting, investigative skills, computer technology and data analysis, interviewing and litigation support. Legal counsel as well as public relations specialists are additional examples of third-party service providers often consulted in contemplation of business transactions or in times of crisis. Whenever use of third-party services is being considered, the audit committee should bear in mind the following best practices prior to engagement:

- Evaluate skills, competence and experience of service provider
- Evaluate independence/objectivity of service provider
- Establish specific roles/responsibilities of management, audit committee and service provider with respect to issue being addressed
- Document agreement between audit committee and service provider regarding execution of services to be provided, timing of services and fees to be paid

It is important to note that regardless of any outside assistance that the audit committee may engage, the audit committee has ultimate responsibility. It should be proactive by taking the lead in investigations into alleged fraudulent activity and illegal acts to ensure that the evaluation of such matters is escalated and receives immediate attention, is properly communicated to all parties involved and that investigations are executed properly and in a timely manner. For further guidance on this, please refer to BDO's practice aid on *Effective Mechanisms for Reporting, Investigating and Remediating Fraud* within the [Appendix](#).

For further information on how BDO Consulting's investigations and compliance practice may be able to assist those charged with governance (i.e., audit committees), refer to: <http://www.bdoconsulting.com/services/consultingservices.aspx>.

### Funding

The organization must provide appropriate funding for the audit committee to compensate the outside auditors and any independent counsel and advisors it engages and to fund ordinary administrative expenses of the audit committee that are necessary in carrying out its duties.



## ▶ THE WHENS

### WHEN SHOULD THE AUDIT COMMITTEE MEET WITH MANAGEMENT, INTERNAL AUDIT AND THE INDEPENDENT AUDITORS?

We recommend that audit committees establish a timeline for essential meetings, yet be flexible and willing to meet more frequently as circumstances warrant or as issues arise. At a minimum, we recommend that the audit committee, together with management and the independent auditors, meet at least two to three times per year: at the start of the annual audit; and at the end of the audit to discuss its results. In addition, audit committees should meet formally with internal auditors at least twice a year – once to discuss the internal audit plan, and once to discuss the results of the internal audit work. The audit committee is encouraged to hold executive sessions with the auditors, without management present, as often as deemed necessary. We further encourage more frequent contact between meetings between the audit committee and relevant parties, as circumstances warrant.

Who is required to attend and the frequency and duration of such meetings should be adjusted on an as-needed basis to address risks and complexities faced by the organization. Ample time should be reserved during the meetings so that the audit committee may speak freely and candidly with each of these parties and plan for executive or separate sessions (see following discussion) in which the audit committee may speak directly to these individual groups without the others present. To underscore the importance of the initial planning meeting in setting the tone and understanding with the auditors, the planning meeting typically would address the following items:

- Auditors' proposed audit plan and scope, including areas identified as key risk areas
- Expectations of the audit committee as to areas of focus or procedures it would like to have the auditors address

- Expectations of what kind of items, in addition to those required, that the audit committee would like to have the auditors communicate back to them
- A timeline for meetings, deliverables and other communications
- Agreement as to the format of items to be reported to the audit committee (e.g., verbal, written or both)

It should be noted that the resulting audit plan and scope that are developed at the planning phase are not static, and changes to this plan as a result of circumstances (either anticipated or otherwise) may dictate the need for additional meetings with the external auditors. The same risk management concept holds true for sessions with management and the internal auditors (see following section). These planning meetings, thus, serve as a good reference/check to refer to in future meetings to ensure that the risks identified either prior to the audit or as the year progresses are being addressed in a timely manner and that the audit is tracking according to plan, and findings are being handled in a timely fashion to reduce the likelihood that "surprises" are uncovered in the wrap-up phase of the reporting period. As a further point, if regularly scheduled meetings do not cover the results of auditors' "management letter," we recommend that an additional meeting be scheduled to encompass noted areas for improvement. Please refer to the [Appendix](#) for a sample of BDO's *Model Audit Committee Meeting Agendas* which provides a recommended timeline for various meetings including objectives, action planning and reporting to the board of directors.

**Now, let's turn to the HOWs of an effective audit committee...**





## ▶ THE HOWs

### HOW SHOULD AN EFFECTIVE AUDIT COMMITTEE BE GOVERNED?

An audit committee should adopt a formal written charter that is focused on the mission of the audit committee. The charter should document the scope of the audit committee's specific responsibilities, how those responsibilities are carried out and the audit committee's membership requirements. Rather than a "check the box" type of document, the primary purpose of the charter is to create a practical roadmap to help the audit committee achieve its goals. Thus, drafting a seemingly endless list of responsibilities may actually be counterproductive.

The sample *Audit Committee Charter* provided in the [Appendix](#) is for illustrative purposes only. As such, it may be a useful starting point for an audit committee to use in developing its own charter. In addition, we also recommend consideration of the AICPA's *Audit Committee Charter Matrix*, which is available within the Audit Committee Toolkit accessible from the AICPA's Audit Committee Effectiveness Center. The audit committee charter represents a "living" document that audit committees may use in managing their meeting agendas.<sup>16</sup>

### HOW MUCH TIME SHOULD AN AUDIT COMMITTEE MEMBER EXPECT TO SPEND ON COMMITTEE WORK?

The complexity of the organization's activities, its stage of development and magnitude of its issues will determine the audit committee's agenda. In addition, familiarity and experience of the audit committee members with the organization's operations are important factors in determining adequate time allotment. On average, the audit committee should plan for at least two meetings per year, but that number may be on the "lighter" side, as discussed previously. The audit committee should meet to discuss scheduled matters, such as planning, and the year-end audit, but be prepared to schedule ad hoc sessions as circumstances warrant. Most audit committees try to schedule their meetings to coincide with regular meetings of the board, which may result in a more effective use of time. However, be wary of meetings that are squeezed into other agendas as this is usually an ineffective practice and sends the wrong message as to the tone at the top.

Further thoughts about audit committee meetings and suggestions for their agendas are outlined in Model Audit Committee Meeting Agendas within the [Appendix](#).

## HOW DOES ONE MAXIMIZE THE BENEFITS IN CONDUCTING AUDIT COMMITTEE MEETINGS?

Audit committee meetings need to be well organized. The audit committee needs to participate in the agenda-setting process up front along with other appropriate individuals (e.g., external and internal auditors and management), and the audit committee chair needs to preside over these meetings to ensure adherence to this agenda. Agendas should focus on the following:

- Risk management
- Accounting judgment/estimates and disclosures
- Information technology (IT) governance
- Internal controls
- Internal and external auditor effectiveness
- Legal/regulatory compliance

Receiving and reviewing meeting materials prior to audit committee meetings is an effective and efficient way to ensure that the high-priority items get covered in the time allotted. A related best practice is to request highlighted materials in advance of meetings that focus on what has changed at a top level so that audit committee members do not get "lost in the details." Supporting detail should also be provided, particularly with regard to complex areas, for review.

Holding audit committee "executive sessions" is another best practice. Executive sessions are one-on-one meetings held between the audit committee and separately with key members of management, the internal audit function and the external auditors. These sessions give the audit committee the opportunity to direct questions to individuals that may be awkward for the respondents to answer in the presence of others.

Within the [Appendix](#), we have included *Sample Audit Committee Questions to Ask of Auditors and Management*, a suggested listing of common questions that the audit committee may pose to management and auditors during its periodic meetings. We have also included *Other Questions an Audit Committee Should Ask* which details some very specific questions that nonprofit audit committee members should ask that can identify signs of trouble in a nonprofit organization in the [Appendix](#). In addition, within its Audit Committee Toolkit, the AICPA provides illustrative questions for audit committees to ask during executive sessions with management, the internal auditors, and the external auditors. The Toolkit is accessible from the AICPA's Audit Committee Effectiveness Center at: <http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/Pages/ACEC.aspx>.<sup>17</sup>

National Association of Corporate Directors' (NACD)  
"Ten Principles of Effective Audit Committee Oversight"

"The independent audit committee fulfills a vital role in... governance. The audit committee can be a critical component ensuring quality reporting and controls, as well as the proper identification and management of risk...Its critical role as guardian of ...integrity puts the audit committee at the core of the challenge of governance."

Report of the NACD

The NACD Blue Ribbon Commission on the Audit Committee recommends the following principles that it believes provide "a foundation for engaged, effective audit committee oversight":

1. Be proactive in focusing the agenda on what's important – *financial reporting risk* – and make the most of audit committee meetings.
2. Insist on transparency, both external transparency and internal transparency – among the audit committee, management, and the internal and external auditors.
3. Focus closely on external financial communications – beyond the financial statements.
4. Question the continuing validity of assumptions that underlie critical accounting judgments and estimates, and be up-to-speed on key financial reporting issues and developments affecting the organization.
5. Assess the audit committee's role in the oversight of risk management, with an eye to clarifying the scope.
6. Set clear expectations for the external and internal auditors.
7. Make sure the CFO and the entire finance organization, as well as internal audit, have what they need to succeed, and be sensitive to the strains on these organizations.
8. Assess the tone at the top and throughout the organization, including the effectiveness of compliance and anti-fraud programs.
9. Help link change and risk management, and monitor critical alignments (controls and risks).
10. Take a hard look at the audit committee's effectiveness, including its composition and leadership, and find ways to continuously improve.

Although the commission focused on audit committees from a business context, a well-functioning audit committee is important to every nonprofit organization as well – for the very same reasons noted.

Source: "2010 Report of the NACD Blue Ribbon Commission on The Audit Committee."

## HOW SHOULD AN AUDIT COMMITTEE EVALUATE ITS OWN EFFECTIVENESS?

We believe that an audit committee should conduct an annual assessment of its own effectiveness. There are a number of ways to conduct this self-assessment. We recommend that audit committee members complete a questionnaire such as the *Audit Committee Self-Assessment* practice aid we have provided within the [Appendix](#). The topics and issues for consideration within this questionnaire have been developed in conjunction with this publication, review of other widely available self-assessment tools and our knowledge and experience in working with nonprofit organizations.

As there is always room for improving quality and performance, we recommend that the *Audit Committee Self-Assessment* practice aid be used in conjunction with your organization's Audit Committee Charter (or similar document) to ensure that governance responsibilities are adequately aligned with the charter and are being fulfilled appropriately. You may choose to customize this self-assessment further to reflect specific attributes of your organization and develop specific action steps and estimated completion dates to enhance your committee's performance.

Additionally, the AICPA Audit Committee Toolkit contains a sample questionnaire accessible from the AICPA's Audit Committee Effectiveness Center at: <http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/Pages/ACEC.aspx>.<sup>18</sup>

In addition to using the *Audit Committee Self-Assessment* practice aid, audit committee members may consider further performing evaluations of each other (with or without assistance from third-party consultants) and seek specific feedback from members of management, the external auditors and the internal auditors. Honest self-assessments may uncover the need for a change in the composition of committee members to meet the strategic needs of the organization.

As mentioned previously, the audit committee charter should be viewed and used as a working/living document. Thus, as part of the audit committee's assessment of itself, the audit committee charter should also be updated, as necessary.

## HOW SHOULD AN AUDIT COMMITTEE REMAIN CURRENT WITH REGARD TO TECHNICAL GUIDANCE?

The complexity and proliferation of today's financial accounting and reporting guidance is mind-boggling. Continuing education of audit committee members is imperative to their effectiveness. This responsibility does not just reside with the designated "financial expert" but rather is shared by all members of the audit committee. We recommend periodic meetings between the audit committee and the external auditors, particularly the engagement partner, be scheduled to highlight issuances of new accounting and reporting standards and other "hot topic" areas and what the anticipated impact may mean to the organization in light of consummated or contemplated business transactions. For a current listing of upcoming programs along with archived webcasts please visit <http://www.bdo.com/industries/nonprofit> or speak with your BDO audit engagement team.



## ► CONCLUSION

**WE HAVE COVERED A LOT OF GROUND. THE MARKETPLACE, IN WHICH ORGANIZATIONS AND THEIR AUDIT COMMITTEES FUNCTION, CONTINUES TO EVOLVE AND CHANGE.**

You now must ask yourselves: Is your organization prepared to meet the challenges that lie ahead for those in governance positions to **oversee** your organization in achieving its goals and meeting its responsibilities to your members, your donors and the general public and the regulatory community? As the rules of the marketplace continue to be enhanced, risks grow and the financial, economic and ethical pressures continue to mount, audit committees' responsibilities widen and take on even more significant meaning in ensuring the health and longevity of the organizations and boards that they serve.

We hope you have found "*Effective Audit Committees For Nonprofit Organizations*" a helpful tool in directing you toward the important questions to be asked to better assist you in understanding the significant role of the audit committee and the positive impact it can have on an organization.





## ▶ APPENDIX

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## ► ILLUSTRATIVE AUDIT COMMITTEE CHARTER

The following illustrative Audit Committee Charter is intended as an example to assist the audit committee in constructing its own organization-specific<sup>1</sup> charter that will be used as a working document or practical roadmap to outline its responsibilities and required duties. The charter should be assessed continually, but at least annually, to ensure that it captures and portrays the role of the audit committee accurately.

Note: The information below may further be converted to a matrix to allow listing of specific action steps and defined deliverable dates.

### COMMITTEE ROLE

The committee's role is to act on behalf of the governing board and oversee all material aspects of the organization's financial reporting, internal control and audit functions, except those specifically related to the responsibilities of another standing committee of the board. The audit committee's role includes a particular focus on the qualitative aspects of financial reporting and on organization processes for the management of business/financial risk and for compliance with significant applicable legal, ethical and regulatory requirements. The role also includes coordination with other board committees and maintenance of strong, positive working relationships with management, external and internal auditors, counsel and other committee advisors.

### COMMITTEE MEMBERSHIP

The committee shall consist of at least three, and no more than six, independent, non-executive board members. Committee members shall have: (1) knowledge of the primary activities of the organization; (2) the ability to read and understand fundamental nonprofit financial statements, including a statement of financial position, statement of activities and statement of changes in net assets, statement of cash flows and key performance indicators; and (3) the ability to understand key operational and financial risks and related controls and control processes. The committee shall have access to its own counsel and other advisors at the committee's sole discretion. At least one member, preferably the chair, should be literate in nonprofit financial reporting and control, including knowledge of tax and regulatory requirements, and should have past or current employment experience in finance or accounting or other comparable experience or background. While a nonprofit is not required to have a financial expert on their audit committee it is recommended. Committee appointments shall be approved annually by the full board upon recommendation of the nominating committee. The committee chairperson shall be selected by the committee members or by the nominating committee.

### COMMITTEE OPERATING PRINCIPLES

The committee shall fulfill its oversight responsibilities within the context of the following overriding principles:

#### Communications

The chair and others on the committee shall, to the extent appropriate, maintain an open avenue of contact throughout the year with senior management, other committee chairs and other key committee advisors (e.g., external and internal auditors, etc.), as applicable, to strengthen the committee's knowledge of relevant current and prospective organization issues.

#### Education/Orientation

The committee, with management, shall develop and participate in a process for review of important financial and operating topics that present potential significant risk to the organization. Additionally, individual committee members are encouraged to participate in relevant and appropriate education to ensure understanding of the organization's activities and risks.

#### Annual Plan

The committee, with input from management and other key committee advisors, shall develop an annual plan responsive to the "primary committee responsibilities" detailed herein. The annual plan shall be reviewed and approved by the full board.

<sup>1</sup> In constructing its charter, the audit committee needs to consider the specific responsibilities and requirements of the audit committee and should include consideration of additional facts and circumstances specific to the organization.

## ► ILLUSTRATIVE AUDIT COMMITTEE CHARTER continued

### Meeting Agenda

Committee meeting agendas shall be the responsibility of the committee chair, with input from committee members. It is expected that the chair will also ask for management and key committee advisors, and perhaps others, to participate in this process.

### Expectations and Information Needs

The committee shall communicate committee expectations and the nature, timing and extent of committee information needs to management, internal auditors and external parties, including external auditors. Written materials, including key performance indicators and measures related to key operational and financial risks, shall be received from management, auditors and others at least one week in advance of meeting dates. Meeting conduct will assume committee members have reviewed written materials in sufficient depth to participate in committee/board dialogue.

### External Resources

The committee shall be authorized to access internal and external resources, as the committee requires, in carrying out its responsibilities. This includes the authority to hire and terminate internal and external auditors and advisors, as well as the responsibility to approve services and fees paid to such resources.

### Meeting Attendees

The committee shall request members of management, counsel, and internal and external auditors, as applicable, to participate in committee meetings, as necessary, to carry out the committee's responsibilities. Periodically, and at least annually, the committee shall meet in private sessions with only the committee members. It shall be understood that meetings between the committee and/or the committee chair with either internal or external auditors or counsel may, at any time, be deemed necessary, with or without management's attendance. In any case, the committee shall meet in executive sessions separately with internal and external auditors, at least annually.

### Meeting Frequency

The committee shall meet at least twice a year. Additional meetings shall be scheduled as considered necessary by the committee or chair.

### Reporting to the Board of Directors

The committee, through the committee chair, shall report periodically, as deemed necessary, but at least semiannually, to the full board. In addition, summarized minutes from committee meetings, separately identifying monitoring activities from approvals, shall be available to each board member at least one week prior to the subsequent board of directors meeting.

### Self-Assessment

The committee shall review, discuss and assess its own performance as well as its role and responsibilities, seeking input from senior management, the full board and others. Changes in role and/or responsibilities, if any, shall be recommended to the full board for approval.

## COMMITTEE RESPONSIBILITIES

### Financial Reporting

- Discuss, review and assess the annual financial statements with management and the auditors before they are released to the public or filed with funders or regulators.
- Discuss, review and assess the key financial statement issues and risks, their impact or potential effect on reported financial information, the processes used by management to address such matters, related auditors' views and the basis for audit conclusions.
- Approve changes in important accounting principles and the application thereof in both interim and annual financial reports.
- Advise financial management and external auditors that they are expected to provide a timely analysis of significant current financial reporting issues and practices.

### Risks and Controls

- Review and assess the organization's operational and financial risk management process, including the adequacy of the overall control environment and controls in selected areas representing significant risk.

**► ILLUSTRATIVE AUDIT COMMITTEE CHARTER** continued

- Review and assess the organization's system of internal controls for detecting accounting and financial reporting errors, fraud and defalcations, legal and tax code violations, and noncompliance with the organization's code of conduct. In that regard, review the related findings and recommendations of the external and internal auditors, together with management's responses.
- Review with legal counsel any matters that may have a material impact on the financial statements.
- Review the results of the annual audits of directors' and officers' expense accounts and management perquisites prepared by the external or internal auditors.

**External and Internal Auditors**

- Recommend the selection of the external auditors for approval by the board of directors.
- Instruct the external auditors that they are responsible to the board of directors and the audit committee as representatives of the organization. In that regard, confirm that the external auditors will report all relevant issues to the committee in response to agreed-upon expectations.
- Review the performance of the external and internal auditors.
- Obtain a formal written statement from the external auditors as to their independence. Additionally, discuss with the auditors any relationships or non-audit services that may affect their objectivity or independence.
- Consider, in consultation with the external and internal auditors, their audit scopes and plans to ensure completeness of coverage, reduction of redundant efforts and the effective use of audit resources.
- Review requests for any audit-related or permitted non-audit services to be performed by the external auditors, and be advised of any other study undertaken at the request of management that is beyond the scope of the audit engagement letter.
- Review with management and the external auditors the results of the annual audit and related comments in consultation with other committees as deemed appropriate, including any difficulties or disputes with management, any significant changes in the audit plans, the rationale behind adoptions and changes in accounting principles, and accounting estimates requiring significant judgments.
- Provide a medium for the external auditors to discuss with the audit committee their judgments about the quality, not just the acceptability, of accounting principles and financial disclosure practices used or proposed to be adopted by the organization.
- Discuss the significant findings of the audit including:
  - Critical accounting policies and practices used by the organization
  - Alternative accounting treatments within generally accepted accounting principles related to material items that have been discussed with management
  - Other material written communications between the accounting firm and management (e.g., management representation letters, engagement letters, etc.)
- Review with the external auditors the audit firm's quality control policies and procedures and any material issues raised by the most recent internal quality control review of the firm.
- Approve changes in the directors of the internal audit function.
- Instruct the internal auditors that they are responsible to the board of directors through the committee.
- Review with the internal auditors any changes in the scope of their plans, if applicable.
- Review with the internal auditors the results of their monitoring of compliance with the code of conduct.

**Other**

- Establish and monitor procedures for the receipt, retention and treatment of complaints received by the organization regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the organization of concerns regarding questionable accounting or auditing matters.
- Review and update the committee's charter at least annually.
- Review and update the organization's code of conduct.
- Review and approve significant conflicts of interest and related party transactions.
- Conduct or authorize investigations into any matter within the committee's scope of responsibilities. The committee will be empowered to retain independent counsel and other professionals to assist in conducting any investigation.



## ► MODEL AUDIT COMMITTEE MEETING AGENDAS

The following Model Audit Committee Meeting Agendas suggest the timing, objectives, specific actions to be performed, and communications to be made to the board for certain audit committee meetings. The agendas were prepared assuming a two- or three-meeting schedule, and are not intended to be all-inclusive. Rather, meetings should reflect the organization's specific circumstances and the audit committee's particular concerns. Meetings typically begin with a discussion of matters of mutual interest among the audit committee, management, and external and internal auditors, if applicable. The audit committee may then meet privately with each to candidly discuss sensitive or confidential matters. It may also be appropriate for organization counsel and/or outside counsel to attend certain meetings. Material to be discussed at meetings should be clearly prepared and sent to the committee members in sufficient time for them to digest it, so the actual meeting time can be used most productively. While the audit committee's activities should be carefully planned, its operating structure should not be immutable. Even if the organization's business has not changed recently, the audit committee should re-examine its duties and performance level over the last year. This regular self-assessment and review of the audit committee charter<sup>1</sup> should be built into the meeting calendar.

### AUDIT PLANNING MEETING

#### Timing

Several weeks or months before the start of the audit.

#### Meeting Objectives

To review the external auditors' audit plan and anticipated non-audit services, and the scope and activities of the internal auditors for the past year. Consider the following:

#### Risks and Internal Controls

- Operational business and financial risks identified by management and the auditors
- Management overview
- Industry conditions
- External auditors' most recent management letter
- Problem areas noted in prior year's audit
- Sensitive matters
- Internal auditors' reports

#### Audit Scope in Light of Current Business Circumstances

- Accounting and auditing developments
- Significant changes in the organization's activities
- Changes in accounting policies
- Audit timing
- Locations to be examined
- Personnel being assigned to the audit
- Assistance to be provided by the internal auditors
- Involvement of other auditors
- Planned reliance on internal accounting controls (including computer security programs) to be used in conjunction with the integrated audit
- Use of computer assisted auditing techniques
- Areas for special procedures (i.e., senior staff and volunteer travel and expense reports)
- Review for fraud or other improprieties
- Rotation of audit procedures
- Estimated audit fees
- Proposed non-audit services
- Comparison of operating results with prior year

<sup>1</sup> Refer to the BDO Audit Committee Self-Assessment and Illustrative Audit Committee Charter practice aids.

## ► MODEL AUDIT COMMITTEE MEETING AGENDAS *continued*

### AUDIT PLANNING MEETING

#### Action

Approve external auditors' audit plan, the scope of the internal audit plan and non-audit services.

#### Report to Board

Discuss any issues carried over from the prior year; describe scope and timing of the audit which includes internal control over financial reporting; highlight all significant matters affecting the financial statements; describe non-audit services to be provided by the external auditors; and conclude whether such services could impair independence.

### POST-AUDIT MEETING

#### Timing

At completion of the audit and receipt of draft financial reports and the external auditors' management letter.

#### Meeting Objectives

To review the audit findings, the drafts of the financial statements and, if applicable, the management letter. To review the year's work and recommended improvements in internal controls not otherwise communicated; approve internal audit plan for coming year; and recommend external auditors for the coming year.

#### Review of Audit

- Deviations from audit plan
- Accounting, auditing and tax developments
- Difficulties or delays
- Auditors' judgment about the quality of the accounting policies and financial disclosure practices
- Significant matters and discoveries
- Restrictions encountered
- Unresolved matters
- Disagreements with management
- Significant audit adjustments and those waived because of immateriality
- Significant deficiencies and material weaknesses identified
- Independence issues

#### Review of Preliminary Draft of Financial Statements

- The auditors' responsibility under generally accepted auditing standards
- Management's significant judgments and accounting estimates
- Significant audit adjustments made or waived
- Consistency of other information in documents containing the audited financial statements
- Timing of release
- Completeness and transparency of disclosures, including risks and uncertainties
- Consistency of annual report text with financial statements
- Wording of auditors' report – qualifications or modifications
- Management's assessment of internal controls and suggested changes
- External auditors' management letter recommendations
- Internal auditors' recommendations and audit plan for next year
- Review of Form 990 (if responsibility of the audit committee)

## ► MODEL AUDIT COMMITTEE MEETING AGENDAS *continued*

### POST-AUDIT MEETING *continued*

#### Action

Approve audit and preliminary draft of annual financial statements. Approve internal audit plan for the coming year and decide upon the recommendation of external auditors to the board.

#### Report to Board

Discuss conduct and findings of the audit; significant deficiencies and material weaknesses identified; any disagreements between external auditors and management; and recommend approval of basic financial statements. Summarize the year's work including recommended improvements in internal controls or changes in accounting methods, discuss reporting issues, recommend external auditors for the coming year, and recommend changes to the audit committee charter, as necessary.

### OTHER MEETINGS

#### Performance Review (could be done at post-audit meeting)

- Evaluation of external auditors by:
  - Management
  - Internal auditors
- Retrospective review of prior year's audit to determine how to improve efficiency and effectiveness
- Evaluation of internal auditors and staff by external auditors
- Evaluation of financial and accounting personnel by external auditors
- Recommendations from all parties for improvements in audit approach and financial disclosure
- Review of auditors' fees for the work performed
- Self-assessment of audit committee and review of charter<sup>2</sup>

<sup>2</sup> Refer to separate BDO Audit Committee Self-Assessment and Illustrative Audit Committee Charter practice aids.

## ▶ SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT

To assist the audit committee in performing its duties, the following is a list of questions it may ask the auditors and management in the context of periodic discussions (i.e., audit planning meeting and post-audit meetings). However, committees are cautioned against falling into a checklist mentality where the basic goal is completion of the checklist itself, rather than conducting their own organization-specific investigation. Accordingly, these questions should be tailored to the circumstances of each organization. You may find many of the following questions are appropriate to ask more broadly of both the auditors and management.

### AUDIT PLANNING MEETING

#### Ask the External Auditors

- Did you discuss any major accounting or auditing issues with management prior to your retention, your responses to which were, or might be considered to be, a condition of your retention?
- (If there is a new auditor this year) What steps will be taken to ensure an orderly transition from the prior auditor?
- What is the planned scope of your audit, (i.e., will all of the subsidiaries be examined, what percentage of inventories will be observed, what percentage of accounts receivable will be confirmed, how will you verify accounts payable?) Will auditing procedures be rotated (i.e., financial statement areas, locations, etc.)?
- Are there any subsidiaries or activities that will not be audited that present operational or financial risks but are not viewed as “material?”
- How can your planned audit scope be relied upon to detect material errors, fraud, illegal acts or material weaknesses in internal control?
- How will the involvement of the internal auditors be coordinated with your audit?
- Does the organization use the services of other external auditors? What is the percentage of assets, revenues and net income for which they will be responsible? How will you determine the quality of their work? Will your report make reference to the other external auditors?
- Are there any concerns with how management controls key business processes? Have the key processes been appropriately identified?
- Are there any areas where the organization could be of greater assistance to reduce the amount of time spent by you?
- Will your risk assessment of the internal control policies and procedures enable you to reduce audit testing performed in conjunction with the integrated audit?
- What risk assessment techniques will you use?
- What criteria do you use to determine materiality?
- How will you utilize computer auditing techniques to review our computer processes?
- Will you use statistical sampling?
- How does the planned scope of your audit differ from the prior year?
- How do you intend to staff the engagement? Will there be personnel continuity from the prior year? What is the expected level of participation by the engagement partner?
- How do you plan to detect the existence of related party transactions?
- Are there any proposed accounting, auditing, tax or reporting rules that could materially affect the organization's financial statements?
- How do you ensure independence? Are there any matters that might reasonably be thought to bear on your independence?
- Are there any unresolved questions from the prior year's audit?
- Do you anticipate any special problems in this year's audit?



## ▶SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT continued

### AUDIT PLANNING MEETING

#### Ask the Internal Auditors

- Has management been responsive to your and the external auditors' previous findings and recommendations? What previous year internal control recommendations from either the external auditors or as a result of your procedures have not been adopted?
- Were there any areas of concern that were not reviewed due to budget or other limitations?
- Have your audits identified areas of concern to the overall entity environment? Have any specific locations or areas been identified?
- Does management give appropriate consideration to your views?
- What is your relationship with the external auditors?
- How would you assess the information systems control environment, including key business information systems? How is security over these systems maintained?
- What work will you be doing to assist the external auditors? Could this work be expanded for greater audit efficiency?
- How do you monitor the organization's policies and procedures to prevent improprieties?
- What were the scope and results of internal audits this past year?
- How are risks identified?
- What procedures are in place to prevent/address the risk of management override of controls?
- How is the internal audit staff remaining current with respect to changes in accounting and financial reporting requirements? Are there appropriate training mechanisms in place?
- (For multi-locations) Do you and the external auditors plan to visit all of the organization's locations this year? If not, what are your criteria for site visits?

#### Ask Accounting Management

- Were there any major changes in operations this year?
- Are there any areas that require special attention due to high business or financial risks?
- What are the organization's policies and procedures to deter conflicts of interest and illegal acts, and how are they monitored?
- How does the organization minimize the risk of fraudulent financial reporting?
- What are the organization's revenue recognition policies?
- Are there any major write-downs or other significant transactions that will affect the financial statements?
- Were there any significant changes in accounting estimates or models used in making accounting estimates? If yes, what changes were made and what are the financial statement effects?
- Is the organization contemplating any changes in accounting methods?
- Should the audit committee be aware of any problems, tax or legal difficulties?
- Does management have the appropriate resources to assess the effectiveness of internal control over financial reporting?
- Are there policies and procedures in place for disclosing internal accounting control deficiencies and frauds or illegal acts identified to the auditors and the audit committee?
- How is management remaining current with respect to changes in accounting and financial reporting requirements? Are there appropriate training mechanisms in place?
- How do you define materiality? How is this different from the auditors' determination of materiality?
- Were there any significant systems implemented or modified that could impact processing of transactions?

▶ **SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT** continued**POST-AUDIT MEETING****Ask the External Auditors – General Questions**

- Did the scope of the audit differ from the audit plan?
- Were you provided with all the information you requested? Do you have any reason to believe that information was withheld from you or that management representations were incorrect?
- Did the organization or its counsel impose any limitations on you?
- Did you observe any areas of serious concern over the corporate control environment? Were any integrity or honesty concerns noted?
- Did you detect any material errors, fraud, illegal acts or significant deficiencies or material weaknesses in the internal control system?
- Were there any significant changes in financial statement amounts from the prior year? What were the causes of the changes?
- Did you have enough time to complete all phases of your audit?
- Will your opinion be unmodified? If not, why?
- (For multi-location engagements) How did you ensure that work performed by your audit firm or other audit firm(s) in other locations has been pre-approved and does not impair independence?
- Did management consult with you on tax matters? Is the liability for taxes adequate to cover potential assessments?
- Were there any disagreements regarding accounting, auditing or reporting matters between you and management? If so, how were they resolved?
- Did management pressure you on contentious issues by threatening to "shop" for other auditors?
- Were any adjustments or disclosures proposed by you not recorded by the organization?
- Are there any unresolved matters?
- Are the accounting principles used by the organization overly conservative or aggressive? What would be the effect of using alternative principles? Do the accounting principles conform to industry practice?
- Were there any changes in accounting principles?
- How did you satisfy yourself as to the reasonableness of any significant accruals or estimates made by management (e.g., doubtful accounts, valuation allowances, environmental contingencies, etc.)?
- Were there any unusual items that affected the change in net assets? Are they properly accounted for and will they be adequately disclosed?
- Did you review information furnished to others (e.g., actuaries)?
- Are you satisfied that there is no substantial doubt about the organization's ability to continue as a "going concern?"
- When do you expect to issue your report?
- Are there any significant concerns about information systems and their ability to process, record and report financial transactions?
- Were there any related party transactions noted as a result of your audit? Are the transactions properly recognized and disclosed in the financial statements?
- How did you satisfy yourself that pending or threatened lawsuits are not likely to have a material effect on the financial statements? Has management provided adequate disclosures within the financial statements?
- In your review of other documents prepared by management (e.g., annual report, IRS Form 990, etc.), did you identify any inconsistencies or material misstatements of fact?
- What is management's attitude toward establishing strong internal controls? Does it set an effective example for the entire organization? Does it follow up on suggested changes? Were weaknesses reported by you last year remediated? Was management receptive to your recommendations?
- Are there any material weaknesses in the organization's internal controls that have not been remediated, including computer security controls? Are appropriate changes being instituted?
- Did you encounter any difficulties in obtaining the management representation letter or any specific representations?
- What is your general assessment of the integrity and competence of the organization's financial, accounting, computer and internal audit staffs? Are they respected groups within the organization? Are they effective? What improvements would you recommend?
- How do actual engagement fees incurred for the year compare to the estimated fees?
- What percentage are the audit fees for this engagement in relation to your firm's total fees? Is that material?
- What can the organization do to reduce the audit time?
- What are the advantages to the organization in continuing its relationship with your firm?
- Are there any other items that should be discussed with the audit committee?

## ▶SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT continued

### POST-AUDIT MEETING

#### Ask the Internal Auditors

- What was the extent of your work on the audit and were there any changes to the scope of work performed?
- Was there adequate coordination with the external auditors?
- Did management impose any limitations on you?
- Were any significant problems encountered?
- Are you aware of any actual or possible illegal or questionable payments?
- Are you aware of any conflicts of interest between officers or employees and the organization?
- Are you aware of any significant deficiencies or material weaknesses in internal control not identified by management or the external auditors?
- Are you aware of any related party transactions not disclosed in the financial statements?
- What are the department's goals and objectives for this year?
- What will be the scope of your activities this year?
- How will you monitor the organization's code of conduct?
- Do you feel your staffing is adequate?
- What additional work could you do to reduce the work of the external auditors?
- What is your evaluation of the external auditors' services for the past year?
- Are the organization's systems functioning with maximum efficiency at minimum cost?
- What is your assessment of the capabilities of management?
- Are there any other items that should be discussed with the audit committee?

#### Ask Accounting Management

- What was your reaction to the audit findings?
- Were there any disagreements between you and the external auditors? If so, how were they resolved?
- Are the financial statements fairly presented?
- What are the reasons for financial statement variations from the prior year?
- What was the substance of significant issues raised by either internal corporate or outside counsel, and how are these matters reflected in the financial statements?
- Did you consider any changes in accounting principles that were not ultimately adopted?
- Did you seek the opinions of other auditing firms on any accounting or auditing issues?
- Were any problems or difficulties identified as a result of the audit that we should know about?
- What is your opinion of the auditing services performed by the external auditors?
- Were any significant deficiencies or material weaknesses identified and communicated to us pervasive across the organization or were they limited to a specific location or account? Have these been remediated?
- Were there any other deficiencies identified by you that were not reported to the audit committee (whether or not they have been remediated)?
- Were there any errors or adjustments noted by you that were not recorded?
- What is your reaction to the suggestions contained in the external auditors' management letter?
- What actions do you contemplate in response to these suggestions?
- What is your evaluation of the external auditors' services this past year?
- What significant changes do you foresee for the organization this year?
- Are there any other items that should be discussed with the audit committee?

## ▶ OTHER QUESTIONS AN AUDIT COMMITTEE SHOULD ASK

Following are examples of questions which may be asked by an audit committee of management, other board members, or the external or internal auditors. Specific questions to be asked will depend on the organization's circumstances. Some questions are listed not because audit committee members are necessarily particularly interested in the answers themselves (assuming there is not a problem), but rather to be satisfied that the issue which is the subject of the question is fully understood and is being adequately addressed by management and the governing board.

Following the list of questions is a list of "signs of trouble" in a nonprofit organization. An audit committee should always be aware of and inquire about any of these which might be present, and understand how management is dealing with them, and how management and the board monitor such matters.

### Sensitive areas

- How is executive compensation set? Does the organization follow the "Rebuttable Presumption of Reasonableness" criteria as outlined in the IRS Intermediate Sanctions Regulations? Are we (the organization) satisfied that there is no situation which, if publicized, would result in adverse publicity? (i.e., nepotism, high salaries and lavish travel, related-party transactions, lack of public disclosure, diversion of assets)
  - Who reviews and approves executives' and board members' travel and other expenses, and have any questionable items been noted? (A good indicator of the appropriateness of such expenses is whether you would be comfortable discussing them with an investigative reporter from your local newspaper/TV station, or with a major donor or funder.)
  - If there are any loans to management/directors, are they appropriate and legal? What are they for?
  - Is it legal for a nonprofit to have an incentive compensation ("profit-sharing") plan? (The answer is, yes, if the plan is properly structured, and if total compensation is reasonable.)
- Has there been any adverse publicity about us lately, or is some anticipated? If so, what steps have been taken to counteract it?
- Please describe the organization's conflict of interest policy, and how it is monitored.
- Are there any transactions with related parties? What? With whom? Why? Were they approved by the board, and, if the person with the connection to the related party is a board member, did that person completely abstain from discussion and voting on the matter?
  - Is this legal under the Internal Revenue Code? (may not be if we are a private foundation)

### Accounting and financial reporting

- How adequate are the organization's internal controls [in general/over the \_\_\_\_\_ (especially ask about contributions) area]?
  - I've heard that good internal control involves segregation of duties. Given that our entire staff consists of two people, how can we adequately segregate duties?
  - Have the auditors made any recommendations for improvements in controls? What were they? Why weren't these problems discovered and fixed before the auditors noticed them?
  - Have these recommendations been implemented? If not, why not?
- Why did \_\_\_\_\_ [financial statement caption or ratio] [increase/decrease] so much from last year?
  - Are our key sources of revenue rising or falling (either in absolute dollars or as a percentage of the total), and why? Same for types of expenses - especially personnel costs.
- What is in the temporarily restricted net asset number? What is it restricted for?
- What are the types of volunteer services which are recorded in the financial statements? What types of volunteer services do we receive which are not recorded? Why not?
- How do we determine:
  - The value to be assigned to gifts-in-kind?
  - Allocation of costs to various functions?
  - The estimated allowance for uncollectible pledges? Who do we think won't pay?
- Do we use the budget as a management tool for early warning of impending problems and action needed, evaluation of management performance, identification of opportunities, etc.?
- Are there any liabilities which have not been recorded? Why not?
- What is in "miscellaneous" [income, expense, assets, liabilities]?
- Do you believe that our operating reserves are adequate? If not, what are we doing about it?



## ▶ OTHER QUESTIONS AN AUDIT COMMITTEE SHOULD ASK *continued*

- Are we better or worse off financially than we were a year ago? Why?
- Are there any concentrations of credit risk?
- Are all inter-fund (class) transfers or borrowings approved by the board?
- Do all members of the board and management *understand* the financial statements?
  - Why not? What is being done to remedy this situation?
- What steps have been taken to ensure adequate computer security in the organization? (This is especially important for organizations which use computers extensively in program activities, (e.g., universities (teaching, student records, research), health care providers (patient records), research organizations), and to maintain donor mailing lists.
- [Why are my membership dues so high/why does the organization still claim it needs to solicit contributions] when net assets are already greater than [a full year's budget]? (Variation of this question: why is the [fund balance/net assets] so high?)

### Program activities

- Why are program service expenses [such a low percentage/only \_\_\_\_\_ percent] of total expenses?
- How do our unit costs of providing services compare with those of similar [nonprofit/for-profit] organizations?
  - Why are they so [high/low]? ("low" implies organization may be skimping on quality of service)
  - We don't know our unit costs! Why not?
- Given that the fees for our services are set on a sliding scale based on ability to pay, what internal controls are in effect to ensure that people are honest about their ability to pay?
- What percent of our services is provided gratis to the needy?
- What is the procedure for reassessing community needs for the organization's services? When was this last done? Were any changes made as a result?
- Why is the college's student loan default rate so high? Are we at risk of losing our ability to participate in federal student financial aid programs?
- How is the organization satisfied that the grants it awards to other nonprofit organizations are being used for their intended purposes?

### Fund raising (see also questions under "environment" below)

- Why do I receive so many different mail solicitations from the organization every year? Isn't this a waste of money?
- Why are the organization's fundraising costs such a [high/low] percentage of each dollar raised? (Low might ordinarily seem desirable, but it is a fair question whether, if the organization spent some more on fundraising, the return would be worth the added expense.)
- Do we use deferred (split-interest) giving arrangements? If not, why not?
  - If so, has legal counsel approved the text of all agreements, and are we in compliance with state laws related to insurance contracts?
  - If we use charitable gift annuities or charitable remainder annuity trusts, what earning rate have we used to compute the amount payable to the life tenant? Is that reasonable given current interest rates?
- How dependent are we on \_\_\_\_\_ (single source of [contributions/other funding])?
  - What would we do if \_\_\_\_\_ (major donor) [died/stopped contributing]?
- Do all board members make an annual contribution to the fundraising campaign?

### Investment management

- What was the return on investments for the year?
  - Does that include [realized/unrealized] capital gains/losses?
  - If not, what would it be if such gains/losses **were** included?
  - How does that compare to the \_\_\_\_\_ market index?
  - Why was it so [low/high]? ("high" implies organization may be assuming an inappropriate degree of risk)
- How does the organization protect itself against:
  - Adverse effects of stock market fluctuations?
  - Loss of assets from failure of the [bank(s)/investment custodians] with whom it deals?
- Do we invest in "derivative" instruments? How do we monitor our exposure to market risks?

## ▶ OTHER QUESTIONS AN AUDIT COMMITTEE SHOULD ASK *continued*

- Why does the organization own any municipal bonds, since it pays no taxes anyway?

### Tax and regulatory matters

- Are we satisfied that there are no activities which might be considered to be in violation of Internal Revenue Code Section 501(c)(3) and/or other applicable code sections? (Areas of particular interest are excess lobbying or political expenditures, private inurement, fundraising practices, employee vs. independent contractor status, executive compensation and public disclosure of Form 990; also the various special rules for private foundations, if applicable.)
  - How do we satisfy ourselves that the organization is not doing more lobbying than is allowed by the IRS?
  - Do we have a 403(b) plan? If not, why not? If so, are we in compliance with all IRS rules?
  - I thought we were tax-exempt. What is this “unrelated business income” tax?
  - (for associations who engage in lobbying) Have we elected to pay the proxy tax? Why/why not?
  - Does the organization have any possible exposure from issues like unrelated business income, such as were raised in the [NCAA/Mobil Cotton Bowl/Portland Golf Club/RPI] cases?
- Have the “new tax rules” (there are always some new tax rules floating around) had any effect on our [organization/fundraising]?
- Has the organization received a clean report from the BBB Wise Giving Alliance (also from the Evangelical Council for Financial Accountability, if applicable)? If not, why not?
- Has the organization received any negative comments from state charities regulators on our fundraising practices or financial reports?
- Are we satisfied that there are no situations which could lead to [a requirement to repay any/denial of future] government funding?
  - Could the same problems that affected Stanford and other universities happen here? (unallowable costs, high overhead rates)
  - Are adequate time records being kept to allow proper allocation of personnel costs?

### The nonprofit environment

- What steps is the university taking to offset the declining number of graduating high school seniors available for admission?
  - Similar question for: performing arts group/declining attendance, hospital/declining patient numbers, church/declining membership, etc.
- How much have any of the following [hurt/helped] the organization's fundraising efforts?
  - The current economic climate [whatever it is at the moment];
  - The big fundraising campaign by \_\_\_\_\_ [other charitable organization] down the street;
  - The fallout from the [United Way/other widely-publicized nonprofit] situation (applicable whether or not the client is a local United Way or a member agency of one)
- How are we satisfied that problems such as those listed below couldn't happen to our organization:
  - Alleged sexual harassment or other forms of discrimination
  - Child molestation (similar to those which have affected some religious groups, youth organizations, performing arts groups, others)
  - Crime on/near our campus (or other facility we may operate)
  - What kind of [malpractice or other] insurance do we have to indemnify us against claims and costs of defense resulting from such occurrences? Especially high-risk areas common to nonprofits include provision of medical services, any activity involving children and taking public positions on controversial issues.
- How will [any of the pending] health care reform proposals affect the organization? (applies to any organization as an employer, and especially to any organization which is itself a health care provider)

### External auditors' relationship with the organization

- How do you determine whether you have any impairment to your independence with respect to the organization?
  - How much did we pay you in consulting (or other non-audit) fees last year, and do you think this impairs your independence?
  - I notice that [a child of the engagement partner attends the university; the engagement senior's spouse works as a volunteer in the thrift shop; the engagement manager is a member of our country club; one of your staff is a volunteer docent in our museum; or some other relationship]. Doesn't that impair your independence?
- Do you give the organization a discount on the audit fee because [it is a charity/it has a June 30 year-end]? How much?
  - I'm also on the board of \_\_\_\_\_ organization, and they get a **free** audit. (May not be phrased as a question, but it clearly is one.)

**▶ OTHER QUESTIONS AN AUDIT COMMITTEE SHOULD ASK** continued**Audit procedures**

How do the external auditors (question could also be directed to management – which should be equally prepared to answer questions like these from their perspective) satisfy [your/our]selves that:

- Substantially all contributions intended for the organization are in fact received and properly recorded?
- All assets/liabilities/revenue/expenses are included on the books?
- The allocation of joint costs of multipurpose activities is appropriate in the circumstances?
- All donor restrictions are being complied with?
  - All government funding compliance requirements are being met?
  - All federal and state tax laws are being complied with?
- Money (or other assets) sent to the organization's branch in \_\_\_\_\_ [foreign country] for [whatever purpose is relevant] is being used in accordance with the organization's intentions?

**Other topic**

- If meaningful answers to any of these questions aren't readily available, why not?

## ► SIGNS WHICH MAY INDICATE FINANCIAL TROUBLE FOR NONPROFIT ORGANIZATIONS

### Community Support:

- Decline in utilization of organization's services by the local community (fewer students, patients, visitors, members or other users)
- Decline in real dollar (inflation-adjusted) support through gifts, bequests and membership dues
- Decline in hours of time made available by volunteers
- Increasing incidence of turndown of grant requests
- Criticism of the organization or its programs by public figures or media

### Financial Independence:

- A growing percentage of expenditures for basic operations funded by restricted grants
- A growing percentage of unrestricted revenues committed to meet matching-fund requirements or needed to supplement restricted revenues for special projects
- Increasing use of "next year's" cash to pay this year's expenses, e.g., prepaid dues, ticket sales, tuition, etc.
- Increasing reliance on very few different sources of support
- A growing debt burden
- Rapid increases in fixed or semi-fixed cash costs (salaries and fringes, rent, debt service, etc.)
- Continuing decline or deficit in operating income or unrestricted net assets
- Continuing decline or, especially, overdraft in cash and equivalents

### Productivity

- Cost per unit of service rising disproportionately to inflation
- Number of employees per unit of service rising rapidly
- User fee rates rising rapidly (unless resulting from a deliberate management decision to reduce the amount by which such fees are subsidized from other revenue sources)

### Deferred Current Costs

- Proceeds of long-term debt or sales of long-term investments being used for current purposes
- Deferring needed maintenance and/or replacement of capital assets
- Default on debts (bonds, notes, mortgages, interest)
- Inability to pay salaries or other current expenses – especially payroll or other taxes – when due, or borrowing to cover such amounts shortly before payment
- Borrowing of cash or other assets from restricted funds or other diversion of restricted resources to inappropriate purposes

### Management Practices

- A pattern of budget cost overruns, either overall or in specific programs/departments
- Increasing incidence of revenue shortfalls
- Earnings on investments declining disproportionately to general trends of investment yields
- Interest rates charged by lenders increasing disproportionately, unwillingness of lenders to lend to organization or insistence by lenders on burdensome debt covenants
- Levels of receivables, inventory, or prepaid expenses increasing faster than related activity
- Increasing incidence of funding source challenge or disallowance of expenses
- Financial and operating data being provided to board members and management is delayed, unclear or incomplete. Explanations of key items and variances are unavailable or of doubtful validity
- Failure on the part of board members or management to understand and accept the seriousness of the financial situation





















## ► AUDITOR REQUIRED COMMUNICATIONS WITH AUDIT COMMITTEES

The guidance covering these requirements is located in the following sections of the revised AICPA Auditing Standards (SAS) Codification – Post Clarity (subsequent to the Clarity Project):

- AU-C Section 260, "The Auditor's Communication with Those Charged With Governance"
- AU-C Section 240, "Consideration of Fraud in a Financial Statement Audit"
- AU-C Section 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"
- AU-C Section 265, "Communicating Internal Control Related Matters Identified in an Audit"

Communications for All Audits
An overview of planned scope and timing of audit
Auditor responsibility under generally accepted auditing standards (GAAS)
Methods of accounting for significant unusual transactions and effects of policies in controversial or emerging areas (e.g., revenue recognition; off-balance sheet financing; and accounting for equity investments)
Management judgments and accounting estimates
Auditors' judgment about the quality of the organization's accounting principles
Adoption of or change in an accounting principle
Material, corrected misstatements brought to the attention of management by the auditors
Unrecorded misstatements, other than those the auditors believe to be trivial
Other information in documents containing audited financial statements (e.g., annual reports)
Disagreements with management
Consultation with other accountants
Major issues discussed with management prior to retention (initial or recurring)
Significant issues discussed with management (i.e., operational considerations/and plans and strategies)
Significant difficulties encountered during the audit
Fraud and illegal acts
Representations requested from management
Other issues arising from the audit that the auditors consider significant and relevant to those charged with governance
Significant deficiencies and material weaknesses identified during the audit
Independence



## ► STRENGTHENING GOVERNANCE: EFFECTIVE MECHANISMS FOR REPORTING, INVESTIGATING AND REMEDIATING FRAUD

There are numerous resources available that guide those charged with governance (referred to as audit committees) toward building programs to include anti-fraud controls and cultivation of anti-fraud environments.<sup>1</sup> When put into place and followed, these programs go a long way in the prevention and deterrence of fraud. However, even when the strongest fraud prevention programs are in place and operating as designed, fraud may still occur. This practice aid is intended to briefly cover the key elements of an anti-fraud environment and responsibilities for such with emphasis on the structure, policies and procedures that audit committees need to ensure are in place *before* fraud occurs and the specific action steps to take *if and when* alleged fraud is suspected.

### Let's first dispel some common misconceptions:

**Myth:** Handling alleged instances of fraud committed within an organization is solely the responsibility of organization management.

**Truth:** Establishing effective mechanisms for the reporting, investigating and remediating of fraud is a shared responsibility with the organization's audit committee:

Section 301 of the Sarbanes-Oxley Act specifically requires the audit committee *"to establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."* Nonprofit organizations can use the specific requirements for audit committees as outlined in the Sarbanes-Oxley Act and the Securities and Exchange Commission rules as a guide. The requirements can be found on the AICPA Web site at [www.aicpa.org/sarbanes/index.asp](http://www.aicpa.org/sarbanes/index.asp).

**Myth:** Fraud is primarily found in large, multinational organizations.

**Truth:** Fraud is not limited to organizations of a certain size and composition. A finding of the 2010 study released by COSO, *Fraudulent Financial Reporting: 1998-2007 – An Analysis of U.S. Public Companies*,<sup>2</sup> indicates that the organizations charged with fraudulent reporting by the SEC, as represented within the study over a 10-year period, included startups with no assets or revenues as well as much larger organizations.

**Myth:** It is not possible to predict potential fraud before it happens, so creating a plan in advance to deal with suspected fraud would be a waste of time and resources.

**Truth:** While not every instance of fraud may be predictable, organizations and their audit committees are best served by gaining an understanding of fraud risk factors and establishing a plan in advance to deal with suspected fraud expeditiously if and when it arises rather than scrambling to identify and pull together adequate resources in the midst of a crisis.

## CREATING AN ANTI-FRAUD ENVIRONMENT

Building an anti-fraud environment can serve to significantly reduce the risk of fraud and increase the likelihood that, if fraud does occur, it will be detected at an early stage.

**Step 1:** Understanding the **fraud risk factors** an organization faces. This requires an ongoing assessment of risks along with the controls that an organization has in place to mitigate those risks on an enterprise-wide basis. The activities associated with building an organization's **fraud risk profile** include:

- identifying *susceptibility* of the organization to various types of fraud (e.g., asset misappropriation, financial reporting fraud and corruption) and *who* is likely to commit fraud (e.g., internal - management, employees; external)
- understanding industry "red flags"
- determining *likelihood and significance* of potential frauds
- assessing *effectiveness* of anti-fraud controls in place

**Step 2:** Setting the **tone at the top** with regard to the effectiveness and visibility of board and audit committee oversight. The activities associated with oversight include:

<sup>1</sup> Refer to the appendix of this practice aid for a listing of several recommended anti-fraud program resources

<sup>2</sup> Refer to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) 2010 study "Fraudulent Financial Reporting: 1998-2007 – An Analysis of U.S. Public Companies" available at: <http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>

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- understanding *what the most significant fraud risks are* and where the organization may be susceptible to *pressure, opportunity and rationalization* to commit fraud ("warning signs")
- reviewing significant relevant transactions, asking difficult and probing questions, and developing alternative sources of information about what is happening in the organization with respect to fraud risks
- evaluating the programs and controls that management has developed for managing fraud risks
- cultivating an ethical corporate culture by ensuring a comprehensive and accessible code of conduct is developed and actively supported by management and the audit committee
- *independently* assessing and monitoring effectiveness of the anti-fraud environment on a periodic basis

**Step 3:** Evaluating the **organizational structure in relation to existing anti-fraud policies and procedures**. The activities associated with this step rely on consideration of the:

- *susceptibility* of the organization structure to fraud – e.g., opportunity for management override of internal controls; locations where cultural differences may overtly or inadvertently lead to the occurrence of fraud
- *effectiveness of policies and procedures* designed to prevent/detect fraud – e.g., performing background investigations of newly hired employees and existing employees on a periodic basis, establishing whistle-blower hotlines, disclosure to regulatory and law enforcement authorities, and developing controls over information security and records retention
- development of *protocols and procedures* in advance to handle suspected fraud if and when it does occur

See **CAQ Guidance** section for the Center for Audit Quality's (CAQ's) 10-question guide for audit committees in exercising *skepticism* when inquiring about financial reporting fraud.

## EFFECTIVE MECHANISMS FOR REPORTING, INVESTIGATING AND REMEDIATING FRAUD

Even when there is effective oversight and the risk of fraud within an organization is significantly reduced as a result, there is always the possibility that fraud will still occur. So, what does the audit committee need to do now to detect fraud at an early stage and be able to remediate the system of internal control and minimize damage?

As required under the Sarbanes-Oxley Act of 2002, all entities (this is one of the provisions of Sarbanes-Oxley that is applicable to nonprofit organizations) are required to maintain effective **whistleblower hotlines** to handle employees' allegations of financial reporting fraud. In addition to these hotlines, allegations of fraud can be identified through many other sources including external and internal auditors, consultants, customers, vendors, anonymous tips and others. Regardless of the source, audit committees should demand immediate access to information supporting allegations of significant fraud occurring within the organization and give such matters the highest priority.

Once suspected fraud comes to the attention of the audit committee, it should evaluate the need to conduct an independent investigation into the alleged fraud. Fiduciary responsibility is first and foremost! The focus of independent investigations involves the following protocols and scoping considerations and often needs to be a flexible and an iterative process. The audit committee may fulfill its responsibility by engaging investigative counsel and forensic accountants, as appropriate<sup>3</sup>:

- Identify who should be involved, both within and external to the organization
- Define specific roles and responsibilities of individuals
- Perform an initial assessment to gather evidence and determine the potential scope/magnitude of the fraud
- Identify individuals to interview and conduct thorough interviews
- Determine additional procedures required (e.g., computer-assisted data analysis techniques, customer calls/confirmations, etc.)
- Ensure regulatory or statutory requirements are appropriately met
- Evaluate results and remediate
- Determine whether disciplinary actions are appropriate or criminal charges should be brought
- Ensure proper disclosures are made
- Document findings (how the matter arose; who was involved; who was interviewed; what other evidence was discovered; how the matter was handled; results and why certain conclusions were reached and how they were communicated)
- Based upon above, take preventive measures for the future, including making enhancements to internal controls

Regardless of whether an investigation is conducted in-house or is outsourced to an independent third party, the audit committee must be involved in every step of the process and must have a plan in place *in advance* to "triage" instances of suspected fraud to ensure that it is handled properly and handled by the right individuals. Along these lines, a best practice is to cultivate relationships with external advisors *before their services may be*

<sup>3</sup> Note: Many of the protocols outlined can and should be established *before* fraud occurs and should be considered as part of the audit committee's creation of an anti-fraud environment.

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needed. Audit committees need to be prepared to spend time and effort throughout the process, as these investigations often take on a life of their own. At the end of this experience, ensure that there is proper reflection on what went wrong and that adjustments are made to policies, procedures and controls and that education is provided throughout the organization to help prevent future recurrence.

For further guidance on conducting investigations, refer to the BDO Consulting's "Investigative Tips for the Non-Investigator" publication available at: <http://www.bdoconsulting.com/resources/thought-leaders/investigative%20tips.pdf>

### SUMMARY

Facing allegations of fraud within an organization can be a frustrating and challenging time for those charged with governance. Cultivating an ethical culture and having established policies/procedures and identified resources in advance of fraud allegations will allow those with oversight responsibility the wherewithal to react quickly and effectively to combat fraud and minimize the damage to the organization.

### CAQ GUIDANCE: INQUIRING ABOUT FINANCIAL REPORTING FRAUD – A GUIDE FOR AUDIT COMMITTEES<sup>4</sup>

The following is a list of questions prepared as a guide for audit committees excerpted from the Center for Audit Quality's (CAQ's) 2010 report, *Deterring and Detecting Financial Reporting Fraud – A Platform for Action*. The questions were prepared by the CAQ as a starting point in order to "advance the thinking of audit committees around the most likely sources of weakness, with a particular eye for business pressures that may influence accounting judgments or decisions." Audit committees should customize these questions further to apply to their organizations:

1. What are the potential sources of business influence on the accounting staff's judgments or determinations?
2. What pressures for performance may potentially affect financial reporting?
3. What about the way the organization operates causes concern or stress?
4. What areas of the organization's accounting tend to take up the most time?
5. What kind of input into accounting determinations does non-financial management have?
6. What are the areas of accounting about which you are most worried?
7. What are the areas of recurring disagreement or problems?
8. How does the organization use technology to search for an unnatural accounting activity?
9. If a newspaper article were to appear about the organization's accounting, what would it most likely talk about?
10. If someone wanted to adjust the financial results at headquarters, how would they go about it and would anything stop them?

### RECOMMENDED ANTI-FRAUD PROGRAM RESOURCES:

- BDO Consulting's Fraud Prevention Program includes the following elements designed to assist management and audit committees in the prevention, detection and remediation of fraud:
  - Fraud risk assessment
  - Fraud education
  - Ethics awareness and education
  - Background investigations
  - Mechanisms for reporting and investigating fraud
  - Board and audit committee oversight

The CAQ's anti-fraud initiative site is available at: <http://www.thecaq.org/Anti-FraudInitiative/index.htm>. As part of this initiative, consider the CAQ's 2010 report "*Deterring and Detecting Financial Reporting Fraud – A Platform for Action*," which focuses on financial reporting fraud at publicly traded organizations of all sizes and is available at: <http://www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf>.

Association of Certified Fraud Examiners' (ACFE) Fraud Resources available at: <http://www.acfe.com/fraud-resources.aspx>

The AICPA [Anti-Fraud and Corporate Responsibility Center](http://www.aicpa.org) provides various tools and information to professionals in combatting fraud available within: <http://www.aicpa.org>

AICPA Fraud and Forensics publications – while aimed at CPAs, these resources may provide additional guidance useful to management and audit committees and are available at: <http://www.aicpa.org/Publications/Fraud/Pages/Fraud.aspx>

<sup>4</sup> Refer to the CAQ's report on "Deterring and Detecting Financial Reporting Fraud – A Call to Action" available at: <http://www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf>.

## ► FOREIGN CORRUPT PRACTICES ACT

The Foreign Corrupt Practices Act (FCPA) of 1977, as amended, has been the recent focus of U.S. Department of Justice (DOJ) and SEC Enforcement and has resulted in significant risk and penalty/violation costs to companies, not to mention the exposure of directors to personal liability. The FCPA generally prohibits the practice of paying or offering to pay (directly or indirectly) money or anything of value to a foreign official to obtain or retain business. Violations under the FCPA can be broad-reaching and may result in significant fines and penalties with respect to anti-bribery provisions as well as to requirements for the maintenance of accurate books and records and the implementation of internal controls designed to prevent corrupt payments. For example, violations can result from:<sup>1</sup>

- Improper payments made by U.S. companies and citizens that take place either within the U.S. **OR** wholly outside of the U.S.
- “Payments” made in cash or anything of value (e.g., discounts, gifts, use of materials, facilities and equipment, entertainment, benefits, etc.)
- Application of the FCPA’s anti-bribery provisions not only to issuers but to “domestic concerns” (i.e., any corporation, partnership, association, joint-stock company, business trust, unincorporated organization or sole proprietorship with a principal place of business in the U.S. or organized under U.S. law) as well
- Making improper payments to obtain government licenses, registrations, special tax or custom treatment which allow a company to do business in a foreign country (i.e., broad application – not just limited to those activities that directly influence the acquisition or retention of government contracts)
- Inappropriate activities conducted by third parties acting on behalf of the company that the company may be deemed to have (or deemed as should have had) knowledge of
- False characterization of improper payments on a company’s books and records – this includes books or records ultimately consolidated for financial reporting purposes

*Note: The DOJ has predicated jurisdiction and, thus, FCPA may apply to **non-U.S. companies or concerns**, including foreign corporations and foreign nationals, who commit any act in furtherance of a prohibited payment while in the territory of the U.S.*

Best practices include the establishment of an FCPA compliance program which includes:

- Understanding and complying with applicable anti-corruption laws and regulations
- Performing due diligence on business relationships (individuals and entities)
- Communicating a consistent “top-down, zero-tolerance” message on creating and maintaining a corruption-free business environment throughout the organization
- Creating a comprehensive training program on anti-corruption policies and procedures to include:
  - regular reporting by management to the audit committee about the company’s compliance program
  - documented assessment of an organization’s compliance program to demonstrate that the audit committee is fulfilling its fiduciary responsibility
  - monitoring and regular updates to the program, as necessary
- Responding to allegations of corrupt activities and investigating them in a timely and comprehensive manner


<sup>1</sup> Refer to the Foreign Corrupt Practices Act (FCPA) – Enforcement document “*The FCPA Explained*” available at <http://www.fcpenforcement.com/explained/explained.asp>.

## ▶ ENDNOTES

1. Refer to COSO "Fraudulent Financial Reporting: 1998-2007 – An Analysis of U.S. Public Companies" at: <http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>.
2. Source: Executive summary of the COSO framework, which may be accessed within the COSO website at: <http://www.coso.org/guidance.htm>.
3. Refer to the AICPA's *Audit Committee Toolkit: Not-for-Profit Organizations, 2nd Edition* available for purchase at: <http://www.aicpa.org/Pages/Default.aspx>
4. Refer to the NACD's Directors Registry accessible via: <http://www.nacdonline.org/>.
5. The AICPA's Audit Committee Effectiveness website has numerous resources available for purchase, including its Audit Committee Toolkit for not-for-profit organizations.
6. Refer to the U.S. Government Accountability Office (GAO) *Government Auditing Standards (GAS)* (the Yellow Book), December 2011 Revision. The 2011 revision of GAS will be effective for financial audits and attestation engagements for periods ending on or after December 15, 2012 and for performance audits beginning on or after December 15, 2011. Earlier implementation is not permitted. See <http://www.gao.gov/yellowbook>.
7. The "Report of the NACD Blue Ribbon Commission on The Audit Committee" is referred to throughout this publication and may be purchased on the NACD's website at: [www.nacdonline.org/](http://www.nacdonline.org/).
8. This publication may be downloaded from the AICPA's website at: [http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/DownloadableDocuments/achilles\\_heel.pdf](http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/DownloadableDocuments/achilles_heel.pdf).
9. Refer to the AICPA Auditing Standards (SAS) Codification – Post Clarity AU-C Section 240 "Consideration of Fraud in a Financial Statement Audit," which is available on the AICPA website.
10. Refer to "The Fraud Diamond: Considering the Four Elements of Fraud," an article by David Wolfe and Dana Hermanson published in the CPA Journal (December 2004) and available at: <http://www.nysscpa.org/cpajournal/2004/1204/essentials/p38.htm>.
11. For further information on BDOC's Fraud Prevention Program or BDOC's Investigations & Compliance and Risk Advisory Practices visit: <http://www.bdoconsulting.com/services/consultingservices.aspx>.
12. Refer to further guidance contained within the AICPA's "Management Override of Internal Controls: The Achilles Heel of Fraud Prevention" available at: [http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/DownloadableDocuments/achilles\\_heel.pdf](http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/DownloadableDocuments/achilles_heel.pdf).
13. Refer to COSO "Fraudulent Financial Reporting: 1998-2007 – An Analysis of U.S. Public Companies" at: <http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>.
14. Refer to AICPA's *Audit Committee Toolkit: Not-for-Profit Organizations, 2nd Edition* available for purchase at: <http://www.aicpa.org/Pages/Default.aspx>.
15. Note: AICPA SAS 115, as it pertains to nonpublic organizations, aligns the definitions of significant deficiencies and material weaknesses with those included in PCAOB AS 5. SAS 115 also requires the auditors to communicate in writing to the audit committee or those charged with governance of nonpublic organizations SDs and MWs identified during the course of the audit. Refer to the earlier section on required communications on pages 14-15.
16. The AICPA's Audit Committee Effectiveness website has numerous resources available for purchase, including its Audit Committee Toolkit for nonprofit organizations.
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