2005

AICPA audit committee toolkit: Not-for-profit organizations; Audit committee toolkit

American Institute of Certified Public Accountants. Audit Committee Effectiveness Center

CNA Financial Corporation

AICPA

American Institute of Certified Public Accountants

in cooperation with

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The AICPA

Audit Committee TOOLKIT: Not-for-Profit Organizations

Audit Committee Effectiveness Center

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Audit Committee TOOLKIT: Not-for-Profit Organizations

Presented by the AICPA's
Audit Committee Effectiveness Center
in cooperation with CNA

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NOTICE TO READERS

The AICPA Audit Committee Toolkit: Not-for-Profit Organizations material is designed to provide illustrative information with respect to the subject matter covered. It does not establish standards or preferred practices. *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* material has not been considered or acted upon by any senior technical committee or the AICPA Board of Directors and does not represent an official opinion or position of the AICPA or the sponsors of the toolkit. It is provided with the understanding that the author, publisher, and sponsors are not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought. The author, publisher, and sponsors make no representations, warranties or guarantees as to, and assume no responsibility for the content or application of the material contained herein, and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material.

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Audit Committee Effectiveness Center

September 2005

In January 2004 the AICPA launched its Audit Committee Effectiveness Center to provide resources in the public interest to those who work with, and serve on, audit committees of boards of directors. Since that time, the two main features of the Center: *The AICPA Audit Committee Toolkit* and the *Audit Committee Matching System* have helped thousands of organizations effectively carry out their corporate governance responsibilities.

We are pleased to introduce *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations*, which has been developed by CPAs working in and with not-for-profit organizations, and is tailored to meet the unique needs of the organizations that they serve.

The foundational component of *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* is the Audit Committee Charter Matrix. This Matrix and the accompanying checklists, interview guides, questionnaires and other resources are intended to be used as active tools to help the audit committee do the job they need to do.

All of the tools are also available as free downloads in MS Word from the Center Web site at www.aicpa.org/audcommctr, which will allow you to tailor and customize each of them to your organization's specific requirements.

We also encourage you to make use of the *Audit Committee Matching System*, which is a means to link CPAs that are willing to serve as members of boards of directors and audit committees with the organizations that need the CPA skill set in these roles.

Another feature of the Center is the E-Alert option. By registering for the e-mail alerts, you will be kept informed of new tools as they are released, updates to existing tools, and other developments that relate to audit committee responsibilities.

We are grateful to CNA for their sponsorship and continued support of the Center.

If you have questions, comments, ideas for additional tools or other feedback please e-mail our staff at acec@aicpa.org.

Sincerely,

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We would like to recognize Paul Sullivan, Task Force Chair, and Kenneth Witt, AICPA staff liaison, for their leadership of this project, and also thank Leonard C. Sonnenberg for the contribution of his expertise to the Peer Review Tool.

Finally, to our AICPA staff colleagues: Joel Tanenbaum, Karen Coutinho, Michael Doyle, Hal Clark, Emanuela Limandri, and a host of others, we thank you for your contribution to making this Toolkit and the Audit Committee Effectiveness Center Web site available in support of our members, the organizations that they serve, and the public interest.

The AICPA Audit Committee Toolkit: Not-for-Profit Organizations
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Audit Committee Charter Matrix

PURPOSE OF THIS TOOL: Preparing an audit committee charter is often referred to as a best practice and is required for many public companies. It is encouraged for most organizations and required by some states for not-for-profit organizations. However, the charter is often prepared and forgotten except for its annual review. This tool is designed to help audit committees make the charter a living document and use it to manage the agenda.

This tool is meant as a sample of what might be considered to be a best practice. Users of the tool should put their own charter in the first column and use this example as a guide for defining the steps to accomplish each objective, the associated performance measure, and the scheduling.

This tool is intended to serve not-for-profit organizations of all sizes and organizational structures. For instance, some small not-for-profit organizations cannot justify the expense of an internal auditor, while others have very large internal audit departments headed by a senior executive. It is becoming more common in larger organizations to refer to the person heading the internal audit function as the chief audit executive (CAE). As used in this tool, the terms *chief audit executive* and *CAE* refer to the person responsible for the internal audit function, irrespective of their title or organizational role. Similarly, relatively few not-for-profit organizations employ in-house legal counsel. Instead, most not-for-profit organizations rely on the professional services of outside attorneys engaged on a retainer basis or rely on volunteers' services. The guidance provided in this tool is applicable whether in-house resources are employed, an outsource arrangement exists, or volunteers provide services.

Audit Committee Charter Matrix for the Year Ending: ___________

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
1. The chair of the audit committee shall be a member of the board of directors, in good standing, and all members shall be independent in order to serve on this committee. Although not all audit committee members need be members of the board of directors, a majority of the audit committee members should be members of the board of directors.	Test for independence, based on the policies established by the organization. Minimal independence standards would prohibit employees or those with direct financial interests in entities serving the organization from serving on the audit committee. Additionally, an organization's independent auditors should not serve on the audit committee or on the board of directors.	Indicate in the audit committee minutes whenever a new member is appointed.	Affirm annually or whenever a change in status by any audit committee member occurs.	
2. The audit committee should have access to *financial expertise*, whether in the form of a single individual serving on the committee, or collectively among committee members. If the financial expertise is provided by one individual, it is desirable that he or she be a member of the board of directors. When no single member of the board has the requisite skills, other arrangements should be made to ensure that the audit committee has the financial expertise to carry out its duties. (See the tool "Audit Committee Financial Expertise Considerations," in this toolkit.)	Ascertain that the audit committee has the requisite financial expertise as defined by the organization.	Indicate in audit committee meeting minutes how financial expertise is available to the audit committee.	Affirm annually and when there is a change in status.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
3. Review the committee's charter annually, reassess the adequacy of this charter, and recommend any proposed changes to the board of directors. Consider changes that are necessary as a result of new laws or regulations.	Review the charter each year. Assess the appropriateness of each point in the charter in light of the previous year's experience. Assess the completeness of the charter in light of new best practices and new legal or regulatory requirements.	Report to the board on the appropriateness of the audit committee charter and any revisions recommended.	Review annually, unless changes are needed during the course of the year.	
4. The audit committee will meet as needed to address matters on its agenda, but not less frequently than twice each year. The audit committee may ask members of management or others to attend the meeting and provide pertinent information as necessary.	In-person meetings should be held at least once each year. All members are expected to attend each meeting in person, via telephone conference, or videoconference. Telephone conference meetings may be held more frequently. The agendas for meetings should be prepared and provided to members in advance, along with appropriate briefing materials.	Prepare minutes that document decisions made and action steps following meetings and review for approval. Meeting minutes should be filed with the board of directors.	Minutes should be distributed as soon as possible but no later than before the next meeting.	
5. Conduct executive sessions with the outside auditors, executive director, and chief financial officer (CFO). If the organization has a chief audit executive (CAE), general counsel, or outside counsel, executive sessions should be conducted with each of these individuals as well. Circumstances may dictate that additional executive sessions may be needed with the director of financial reporting, controller, or others as desired by the Committee. (See the tool "Conducting an Audit Committee Executive Session: Guidelines and Questions," in this toolkit.)	Establish these sessions in conjunction with regularly scheduled meetings or as necessary.	Develop action steps to be taken, if appropriate.	Review as necessary, but not less frequently than regularly scheduled meetings.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
6. The audit committee shall be authorized to hire independent auditors, counsel, or other consultants as necessary. (This may take place any time during the year.) (See the tool "Points to Consider When Engaging External Resources," in this toolkit.) (See the tool "Sample Request for Proposal Letter for CPA Services," in this toolkit.)	Establish a policy for the audit committee to preapprove engaging independent auditors and other experts. Discuss whether a budget should be established for this purpose. Requests for proposals (RFPs) should be used if time permits.	Prepare an engagement letter for each engagement. Report submitted by external accountant, counsel, or consultant.	Continually review the policy and compliance with it as needed.	
7. Review and approve the appointment, replacement, reassignment, or dismissal of the CAE. (See the tool "Guidelines for Hiring the Chief Audit Executive (CAE)," in this toolkit.)	Meet in executive session at each meeting with the CAE. Hold special meetings as may be necessary to address appointment, reassignment, or dismissal of the CAE. The audit committee chair should be available if any unforeseen issues arise between meetings relating to the CAE. Meet at least once annually with other members of executive management and the independent auditors to discuss the performance of the CAE. Discuss job satisfaction and other employment issues with the CAE.	Report to the full board on the performance of the CAE, including the effectiveness of the internal audit function.	Conduct ongoing reviews, as changes can be made at any time during the year.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
8. Appoint the independent auditors to be engaged by the organization, establish the audit fees of the independent auditors, and preapprove any nonaudit services provided by the independent auditors, including tax services, before the services are rendered. Review with management the significance of bidding out audit services. (See the tools "Sample Request for Proposal Letter for CPA Services" and "Peer Review of CPA Firms: An Overview," in this toolkit.)	At least once each year, discuss each of these items with management, the CAE, and the board of directors. Review total audit fee in relation to any nonaudit services being provided by the independent auditors. Review and evaluate the professional relationship with the auditors, including continuity of partner, manager, and staff; and level of service provided by auditors. Review the scope of *all* services provided by the audit firm throughout the organization.	Document these discussions in the audit committee meeting minutes. Report on findings and provide recommendations to the board as considered necessary.	Review soon after the audit has been approved by the board, so the recommendation for the appointment of the outside auditor in the next fiscal year can be documented in the board minutes.	
9. Review with management the policies and procedures with respect to officers, key employees (executive director, CFO, chief operating officer), disqualified persons as defined by the IRS (under Internal Revenue Code Section 4958), expense accounts, and perks, including excess benefit transactions; consider the results of any review of these areas by the internal auditor or the independent auditors.	Ensure written policies and procedures exist. Discuss with the CAE, or equivalent, the need for testing by either the internal auditors, independent auditors, or other parties.	Report issues, if any, to the board.	Review policies and procedures annually. Review any significant findings as they arise.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
10. Inquire of management, the CAE, and the independent auditors about significant risks or exposures facing the organization; assess the steps management has taken or proposes to take to minimize such risks to the organization; and periodically review compliance with such steps.	Document the material risks that the organization faces. Update as events occur. Review with management and the CAE on a periodic basis.	Submit a risk report to the board and the independent auditors including mitigation strategies and quantifiable risks and insurance to cover such risks, e.g., loss of business.	Review at least once each year, and more frequently if necessary.	
11. Review with the independent auditors, CFO, controller, and CAE the audit scope and plan of the internal auditors, if applicable, and the independent auditors. Address the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.	Meet with external audit partner, CFO, controller, and CAE to discuss scope of the previous year's audit, and lessons learned. Later, discuss planned scope for audit of current year and the standard of work to be followed. In addition, discuss the timing of progress reports, to be provided by the independent auditors, and the communications process to be followed in the event of deviations from the plan.	Document the meeting in the audit committee meeting minutes.	On an annual basis, review the scope of the previous year's audit, and the interrelationship between the internal and independent auditors with respect to the scope of the independent auditors' work. At another of the meetings each year, review the plans of Internal Audit for audits in the current year, if applicable.	
12. Consider reviewing with management and the CAE: • Significant findings on internal audits during the year and management's responses thereto • Whether Internal Audit encountered any difficulties in the course of its audits, such as any restrictions on the scope of its work or access to required information	Review reports of all internal audits issued since the previous meeting and planned for the upcoming year along with the status of each planned audit. Review and discuss the findings for each audit completed since the prior meeting, and management's response to the report. Discuss internal audit department budget and staffing with the CAE.	Report on the status of all internal audits planned for the next quarter and/or year. Internal Audit should provide a summary of findings for completed audits, including management's plan to address findings and weaknesses identified.	Review at each meeting.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
• Any changes required in the scope of its internal audit • The Internal Audit department's budget and staffing • The Internal Audit department's charter • Internal Audit's compliance with the Institute of Internal Auditors' (IIA's) Standards for the Professional Practice of Internal Auditing (Standards), if applicable. Internal Audit should meet separately with the independent auditors.	Discuss Internal Audit's compliance with IIA Standards, if applicable, including the requirement for a peer review once every five years. If the organization receives federal funds, Internal Audit is required to have a peer review once every three years if the independent auditors plan to rely on their work to reduce the external audit scope. Review the internal audit charter periodically and update, if necessary.			
13. Inquire of the executive director and CFO regarding the sources of support and revenue of the organization from a subjective as well as an objective standpoint.	Discuss sources of support and revenue with the executive director, CFO, and other executives. Identify any issues addressed, and their resolution.	Include an agenda for executive sessions. (See the tool "Conducting an Audit Committee Executive Session: Guidelines and Questions," in this toolkit.)	Review, as necessary, but at least annually.	
14. Review with the independent auditors and the CAE: • The adequacy of the organization's internal controls, including computerized information system controls and security • Any related significant findings and recommendations of the independent auditors and internal audit services, together with management's responses thereto	Review the reports of the internal audit team for all audits completed since the prior audit committee meeting. Review key internal controls with the CAE, and understand how these controls will be tested during the year. Review these plans with the independent auditors to understand their scope with respect to key controls.	Report to the board on issues relating to internal controls, with emphasis on management's ability to override controls and the monitoring and testing relating to this capacity.	Submit a comprehensive report to the board at a specified meeting each year. Update on anything new, or any changes to the internal control system, at every meeting.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
(See the tools "Internal Control: A Tool for the Audit Committee," and "Fraud and the Responsibilities of the Audit Committee: An Overview" in this toolkit.)	Review with the CAE the plans for audits of other elements of the control environment. Determine that all internal control weaknesses are quantified, reviewed, and addressed.			
15. Review with management and the independent auditors the effect of any regulatory and accounting initiatives, as well as other unique transactions and financial relationships, if any. (See the tool "Unique Transactions and Financial Relationships," in this toolkit.)	Independently, through professional reading and continuing education, keep up-to-date on new developments related to the not-for-profit industry, the organization's specific sector, and the environment in which the organization operates, including any regulatory requirements it may be subject to. Discuss with management and the independent auditors in meetings.	Record discussion and any action steps in audit committee meeting minutes.	Review as necessary.	
16. Review with management, and the CAE, any interim financial reports issued since the last meeting.	Discuss the financial statements with emphasis on changes in reporting, new and unusual transactions, and financial trends.	Record discussion and any action steps in audit committee meeting minutes.	Review as necessary.	
17. Review with each public accounting firm that performs an audit: • All critical accounting policies and practices used by the organization.	Discuss each matter, and related matters that may come to the attention of the audit committee and/or the independent auditors through this process. Create an action plan and follow-up plan as necessary.	Submit reports and documentation of discussions and resolution of disagreements.	Review, at least annually, and/or in conjunction with the year-end audit.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
• All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management of the organization, the ramifications of each alternative, and the treatment preferred by the organization. (See the tool "Issues Report From Management," in this toolkit.)				
18. Review all material written communications between the independent auditors and management, such as any management letter or schedule of unadjusted differences.	Discuss each item with the independent auditors and management (including the CAE) and conclude on the appropriateness of the proposed resolution.	Submit reports and documentation of discussions, resolution of issues, and the action plan for any items requiring follow-up and monitoring.	Review, at the completion of the external audit.	
19. Review with management and the independent auditors: • The organization's annual financial statements and related footnotes • The independent auditors' audit of the financial statements and their report thereon • The independent auditors' judgments about the quality, not just the acceptability, of the organization's accounting principles as applied in its financial reporting • Any significant changes required in the independent auditors' audit plan	Discuss each matter, and others that may come to the attention of the audit committee through this process, with management (including the CAE) and the independent auditors. Review with management the course of action to be taken for any action requiring follow-up. Monitor any follow-up action that requires continued audit committee intervention.	Submit reports and documentation of discussions, resolution of disagreements, or action plan for any item requiring follow-up.	Review at the completion of the annual external audit.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
• Any serious difficulties or disputes with management encountered during the audit • Matters required to be discussed by Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees* (AICPA, Professional Standards, vol. 1, AU sec. 380), as amended, related to the conduct of the audit. (See the tool "Discussions With the Independent Auditor: What to Expect," in this toolkit.)				
20. Review with the general counsel and the CAE, legal and regulatory matters that, in the opinion of management, may have a material impact on the financial statements, related organization compliance policies, and programs and reports received from regulators.	Discuss whether the organization is in compliance with laws and regulations that govern the environment(s) in which it operates, as well as other applicable laws and regulations.	Report to the board that the review has taken place and any matters that need to be brought to its attention.	Review at least annually.	
21. Periodically review the organization's code of conduct/ethics to ensure that it is adequate and up-to-date.	Review results with the CAE and general counsel. Consider any adjustments that may be necessary to the organization's code of conduct/ethics.	Report to the board that the review of the code of conduct/ethics was done.	Review at least annually. Review any significant findings as they arise.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
Review with the CAE and the organization's general counsel the results of their review of the monitoring of compliance with the organization's code of conduct/ethics. (See the tool "Independence and Related Topics: Conflicts of Interest, Related Parties, Inurement, and Other Issues," in this toolkit.)	Consider steps that may need to be taken to ensure that compliance is at the highest possible level.	Recommend changes to the code of conduct/ethics to the board as needed.		
22. Review the procedures for the receipt, retention, and treatment of complaints received by the organization regarding accounting, internal accounting controls, or auditing matters that may be submitted by any party internal or external to the organization. Review any complaints that might have been received, current status, and resolution if one has been reached. (See also the tool "Sample Whistleblower Tracking Report," in this toolkit.)	Review procedures with CAE and the general counsel. Review all complaints that have been received and the status of resolution. Ensure that proper steps are taken to investigate complaints and resolve them in a timely fashion.	Review an original of each complaint received, no matter the media used to submit. Discuss the status or resolution of each complaint. Review a cumulative list of complaints submitted to date to review for patterns or other observations.	Review at least annually.	
23. Review procedures for the confidential, anonymous submission by employees of the organization of concerns regarding questionable accounting or auditing matters. Review any submissions that have been received, the current status, and the resolution, if one has been reached.	Review procedures with the CAE and the general counsel. Review all complaints that have been received and the status of resolution. Ensure that proper steps are taken to investigate complaints and resolve timely.	Review an original of each complaint received no matter the media used to submit. Discuss the status of resolution of each complaint Review a cumulative list of complaints submitted to date to review for patterns or other observations.	Review at least annually.	

Audit Committee Charter	Steps to Accomplish the Objective (Checklist)	Deliverable	When to Achieve (Frequency Due Date)	Date Completed
(See also the tool "Sample Whistleblower Tracking Report:," in this toolkit.)				
24. The audit committee will perform such other functions as assigned by the organization's charter or bylaws, or the board of directors.	Monitor developments in the regulatory and legislative and legal environment and respond to any new requirements as needed.		Review new business at all meetings.	
25. The audit committee will evaluate the independent auditors and internal audit function, if applicable. (See the tools "Evaluating the Internal Audit Team: Guidelines and Questions" and "Evaluating the Independent Auditors: Questions to Consider," in this toolkit.)	Use information from executive sessions conducted throughout the year. Use a formal assessment tool for each group.	Submit recommendations for change in process and procedures. For independent auditors, request proposals if changes are being considered.	Review after completion of the annual audit.	
26. The audit committee will review its effectiveness.	The audit committee will review its accomplishments and make recommendations for improving its effectiveness.	Discuss recommendations with board of directors.	Review annually.	
27. Create an agenda for the ensuing year or review and approve the agenda submitted by the CAE.	Complete the "Audit Committee Charter Matrix." (Use this tool as a sample, and tailor it to your organization.)		Review before the upcoming year.	
28. Oversee the preparation of, or prepare, an audit committee annual report.	Review and discuss the report with CAE and auditors.	Annual report finalized and approved. Present to board.	Review annually upon completion of audited financial statements	

Audit Committee Financial Expertise Considerations

PURPOSE OF THIS TOOL: The following information illustrates how the audit committee might approach assuring it has access to requisite financial expertise.

Audit Committee Financial Expertise

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

- An understanding of generally accepted accounting principles (GAAP), generally accepted auditing standards (GAAS), and financial statements.
- The ability to assess the general application of such principles and standards 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 can reasonably be expected to be raised by the organization's financial statements, or experience actively supervising (that is, direct involvement with) one or more persons engaged in such activities.
- An understanding of internal controls and procedures for financial reporting.
- An understanding of audit committee functions.
- A general understanding of nonprofit financial issues and specific knowledge of the not-for-profit sector (for example, health care or education) in which the organization participates.

The following questions should be used to assess whether an individual audit committee member, or the committee as a whole, possesses the above attributes.

- Have one or more individuals completed a program of learning in accounting or auditing?
- Do one or more individuals have experience as a chief or principal financial officer (for example, finance director or business manager), principal accounting officer, controller, public accountant, or auditor?
- Do one or more individuals have experience in position(s) that involve the performance of similar functions?
- Have one or more individuals gained experience by actively supervising a person(s) performing one or more of these functions?
- Do one or more individuals have experience overseeing or assessing the performance of companies, not-for-profit organizations, or public accountants with respect to the preparation, auditing, or evaluation of financial statements?

- Do one or more individuals have other relevant financial experience (for example, service on boards of banking or investment institutions or experience as a banker, investment adviser)?

- Do one or more individuals have experience serving on audit committees of other not-for-profit organizations?

Alternative Approaches

If no individual member of the audit committee possesses the attributes required for financial expertise, and the committee members collectively do not possess such attributes, several options might be considered:

- Establish a relationship with a peer or otherwise comparable organization to have the chief financial officer for one organization provide financial expertise to the other. Such arrangements can be reciprocal or involve multiple organizations.

- Establish an outsource relationship in which a financial professional is engaged and compensated to provide financial expertise as a consultant to the audit committee. Such an individual must otherwise be independent with respect to the organization (that is, must have no other financial arrangements with the organization).

- Pursue a training program for audit committee members to develop the financial expertise. Such training can include participation in professional development programs offered by the AICPA, associations serving the not-for-profit industry, or the specific sector in which the organization participates, or the conduct of in-house training programs.

Resources

Various organizations provide information to support audit committees in carrying out their responsibilities. In addition to this toolkit, the AICPA maintains an Audit Committee Effectiveness Center. Independent Sector has devoted significant attention to issues related to financial expertise, as have sector organizations such as the National Association of College and University Business Officers. Many public accounting firms provide information on these subjects as well. Finally, although its provisions are not directly applicable to not-for-profit organizations, the “SEC Rule on Audit Committee Financial Experts” contains information that may be of interest. See the tool, “Resources for Audit Committees” in this toolkit.

Sample Request for Proposal Letter for CPA Services

PURPOSE OF THIS TOOL: This tool contains sample language that may be used by an organization requesting a proposal letter from qualified CPA firms when seeking a new service provider. As such, the sample letter may be subject to audit committee review or discussion, if an audit committee exists.

[*Organization Letterhead*]

[*Date*]

[*Managing Partner*]
[*CPA Firm*]
[*Street Address*]
[*City, State, Zip*]

Dear Sir or Madam:

Our organization is accepting proposals from CPA firms to provide audit (and tax) services for our organization in the future. We invite your firm to submit a proposal to us by June 30, 20XX, for consideration. A description of our organization, the services needed, and other pertinent information follows:

Background of ABC Organization

ABC Organization is a 501(c)(6) trade association, with a related 501(c)(3) foundation, representing manufacturers of widgets. Annual revenues are between $10 million and $12 million per year, and the organization employs 35 people in one location. The organization is membership-based and has approximately 20,000 members worldwide. The organization has a June 30 fiscal year end, with a requirement to file an audited financial statement with the bank and general membership by September 30 of each year.

Services to Be Performed

Your proposal is expected to cover the following services:

1. Annual audit to be completed in compliance with the above filing requirement and meetings with audit committee and or board of directors, as necessary.

2. Tax filings for the organization and related foundation.

3. Quarterly reviews of internally prepared financial statements.

Key Personnel

Following are key contacts for information you may seek in preparing your proposal:

Mr. Green	CEO	(123) 456-7891
Ms. Brown	CFO	(123) 456-7892
Mr. White	Controller	(123) 456-7893
Ms. Blue	Accounting Manager	(123) 456-7894

Requests for additional information, visits to our site, review of prior financial statements and tax returns, and/or appointments with the executive director or chief financial officer should be coordinated through our controller. You may reach him at the number listed above. Please return the completed proposal to my attention at the above address.

Relationship With Prior CPA Service Provider

These services have been provided by XYZ, CPAs. However, that firm is no longer able to provide the services our organization requires. In preparing your proposal, be advised that management will give permission to contact the prior auditors.

[You may use this section to disclose whether the decision to change auditors is a function of changes in your organization, changes in the audit firm, or the result of a periodic review of your satisfaction with the services provided. Other aspects of your relationship with the prior auditor that you are willing to disclose at this stage in the proposal process may also be described here. CPA firms may request additional information, which you may choose to disclose only if the CPA firm signs a nondisclosure agreement.]

Other Information

[Use this space to discuss other information that a CPA firm may need to make an informed proposal on the accounting and/or auditing work that you require. As mentioned above, you should only disclose information here that you are comfortable disclosing; additional information may be available to the CPA firms interested in making a serious proposal only after signing a nondisclosure agreement.]

Your Response to This Request for Proposal

In responding to this request, we request the following information:

1. Detail your firm's experience in providing auditing and tax services to companies in the not-for-profit sector, as well as associations of a comparable size to ABC Organization, including those with international memberships.
2. Provide information on whether you provide services to any related industry associations or groups.

3. Discuss the firm's independence with respect to ABC Organization.
4. Discuss commitments you will make to staff continuity, including your staff turnover experience in the last three years.
5. Identify the five largest clients your firm (or office) has lost in the past three years and the reasons. Also discuss, in instances where loss of the client was due to an unresolved auditing or accounting matter, the process of attempting to resolve the issue(s).
6. Identify the partner, manager, and in-charge accountant who will be assigned to our job if you are successful in your bid, and provide biographies. Indicate any complaints against them that have been leveled by the state board of accountancy or other regulatory authority, if any. Indicate any corrective actions that have been taken by the firm with respect to these people.
7. Describe how your firm will approach the audit of the organization, including the use of any association or affiliate member firm personnel and the areas that will receive primary emphasis. Also discuss the firm's use of technology in the audit. And finally, discuss the communication process used by the firm to discuss issues with the management and audit committees of the board.
8. Set forth your fee proposal for the 20XX audit, with whatever guarantees can be given regarding increases in future years. Provide your proposed fee for the required quarterly review work and for tax preparation.
9. Furnish standard billing rates for classes of professional personnel for each of the last three years.
10. Provide the names and contact information for other, similarly sized clients of the partner and manager that will be assigned to our organization for reference purposes.
11. Describe how and why your firm is different from other firms being considered, and why our selection of your firm as our independent accountants is the best decision we could make.
12. Include a copy of your firm's most recent peer review report, the related letter of comments, and the firm's response to the letter of comments.

Evaluation of Proposals

ABC Organization will evaluate proposals on a qualitative basis. This includes our review of the firm's peer review report and related materials, interviews with senior engagement personnel to be assigned to our organization, results of discussions with other clients, and the firm's completeness and timeliness in its response to us.

Please submit your response to this request for proposal by June 30, 20XX. We would also appreciate a response if you decline to submit a proposal.

Sincerely,

Ms. Brown, CPA
Chief Financial Officer

Attachments:
Most recent financial statements and Form 990.

Independence and Related Topics: Conflict of Interest, Related Parties, Inurement, and Other Issues[1]

PURPOSE OF THIS TOOL: The purpose of this tool is to provide audit committee and board members with an overview of issues of independence and related topics. These topics must be considered in connection with audit committee membership, board membership, and relationships with external auditors and other parties.

Independence implies one's ability to act with integrity and exercise objectivity and professional skepticism. Therefore, independence in not-for-profit governance is critical to promote ethical behavior and reliable financial reporting. With direct contacts to the management team and the auditing firm, the audit committee is quite possibly in the best position to monitor an organization's compliance with independence standards.

There are many groups that define and require independence from the auditor, the board, and management (see table). The AICPA's independence standards apply to CPAs in all situations requiring independence. In addition, Government Accountability Office (GAO) standards, which are generally more restrictive, apply to engagements involving federal entities and those organizations receiving federal funds. The GAO standards have been voluntarily adopted by many state and local governments and other entities both domestically and internationally. The IRS and most states also have prohibitions against self-dealing and conflicts of interest that have specific provisions and implications for not-for-profit organizations.

In addition, there are practices self-imposed by the board of directors. Many not-for-profit organizations include definitions of *independence*, *ethics*, and *integrity* in their policies and procedures. Others require that the board, staff, or both sign annual Statements of Independence or Conflict of Interest. It is recommended that senior management define, communicate, and exhibit these qualities to set a high standard throughout the organization. A sample conflict of interest policy for a not-for-profit organization is provided as a part of this tool.

AICPA: Auditor Independence

Independence shall be considered impaired by a variety of factors. Generally, CPAs are not independent if they are in a position to influence, make management decisions, provide accounting services, or have financial interests in an entity. A CPA is required to document any possible situations that might impair his or her independence on an engagement, inform his or her CPA firm, and inform the potential client if any such situations may exist.

[1] AICPA Plain English Guide to Independence, updated 1/1/2004
www.aicpa.org/members/div/ethics/notice_rev_int101-3.htm
www.aicpa.org/download/ethics/2004_02AICPA-GAO_rules_comparison.pdf
IRS Form 990 Instructions

Auditor independence requirements will be determined by state boards of accountancy; the GAO, if law, regulation, agreement, policy, or contract requires the member's report to be filed under GAO regulations; and any organization that issues or enforces standards of independence that would apply to the member's engagement. Such organizations may have independence requirements or rulings that differ from (for example, may be more restrictive than) those of the AICPA.

GAO Yellow Book: Auditor Independence

In 2003, the GAO enacted significant changes to the auditor independence requirements under *Government Auditing Standards*. Commonly referred to as the Yellow Book, this guide covers federal entities and those organizations receiving federal funds. Various laws require compliance with the comptroller general's auditing standards in connection with audits of federal entities and funds. Furthermore, many states, local governments, and other entities, both domestically and internationally, have voluntarily adopted these standards.

Although the standard deals with a range of auditor independence issues, the most significant change relates to the rules associated with nonaudit, or consulting, services. Auditors have the capability of performing a range of services for their clients. However, in some circumstances, it is not appropriate for them to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, their client, or both will have to make a choice about which of these services they will provide.

The focus of the changes to the auditor independence standard is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities. The standard includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The new independence standard for nonaudit services is based on two overarching principles:

1. Auditors should not perform management functions or make management decisions.
2. Auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

For nonaudit services that do not violate these above principles, certain supplemental safeguards have to be met, for example: (1) personnel who perform nonaudit services are precluded from performing any related audit work, (2) the auditor's work cannot be reduced beyond the level that would be appropriate if the nonaudit work was performed by another unrelated party; and (3) certain documentation and quality assurance requirements must be met.

The standard includes an express prohibition regarding auditors providing certain bookkeeping and recordkeeping services, and limits payroll processing and certain other services, all of which are presently permitted under AICPA auditing standards. At the same time, the standard recognizes that auditors can provide routine advice and answer technical questions without violating these two principles or having to comply with the supplemental safeguards. The standard also provides examples of how certain services are treated under the rules.

IRS: Inurement, Disqualified Persons, Excess Benefit, Excise Tax, Revocation

The IRS has a different set of rules and definitions to promote independence from not-for-profit boards and staff. A fundamental requirement for tax-exempt organizations under Internal Revenue Code (IRC) Section 501(c)3, 6, 7, 9, 10, 13, or 19 is that they must be organized and operated in a way that no part of their net earnings *inure* (accrue) to the benefit of any private shareholder or individual.

Inurement. Organizations have lost their exempt status because of private inurement from unreasonable compensation; unreasonable fringe benefits; improper (generally personal) use of an organization's assets; forgiveness of debts owed by insiders; personal expenses being paid by the entity; low-interest or unsecured loans to insiders; unreasonable housing allowances; and other-than-arm's-length fair-market-value purchases, sales, or property rental between the organization and insiders.

An organization is not prohibited from transacting business with members of its board of directors or paying competitive salaries. Certain guidelines and procedures must exist, however, to ensure that transactions do not unreasonably benefit the insider.

Disqualified Persons. In any transaction, a person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction. Persons who hold certain powers, responsibilities, or interests are among those who are in a position to exercise substantial influence over the affairs of the organization. This would include, for example, voting members of the governing body, and persons holding the power of:

- Presidents, executive directors, or chief operating officers
- Treasurers and chief financial officers

A disqualified person also includes certain family members of a disqualified person, and 35 percent-controlled entities of a disqualified person.

Excess Benefit. An excess benefit transaction is a transaction in which an economic benefit is provided by an applicable tax-exempt organization, directly or indirectly, to or for the use of any disqualified person, and the value of such economic benefit provided by the organization exceeds the value of the consideration (including the performance of services) received for providing such benefit.

Excise Tax Under Section 4958—Intermediate Sanctions. An excise tax equal to 25 percent of the excess benefit is imposed on each excess benefit transaction between an applicable tax-exempt organization and a disqualified person. The disqualified person who benefited from the transaction is liable for the tax. If the 25 percent tax is imposed and the excess benefit transaction is not corrected within the taxable period, an additional excise tax of 200 percent of the excess benefit is imposed.

Revocation. The IRS has indicated that the following four factors will be considered in determining whether to revoke an applicable tax-exempt organization's exemption status when an excess benefit transaction has occurred: repeated excess benefit transactions, size and scope of excess benefit transactions, whether organization implemented safeguards to prevent future recurrences, and whether there was compliance with applicable laws.

Summary of Significant Independence and Conflict of Interest Standards and Requirements

AICPA	• Standards Document: AICPA *Code of Professional Conduct*, Section 100, "Independence, Integrity, and Objectivity." • Sets independence standards that CPAs must adhere to with regards to the type of work performed. • Applies to CPAs in all situations involving an attest client. • Attest: Services requiring independence and assurances from the CPA such as audits, reviews, and agreed-upon procedures.
Government Accountability Office (GAO; formerly General Accounting Office)	• Standards Document: *Government Auditing Standards* (also known as GAGAS or Yellow Book) • Sets independence standards for federal entities and those organizations receiving federal funds. Various laws require compliance with the Comptroller General's auditing standards in connection with audits of federal entities and funds. Furthermore, many states, local governments, and other entities, both domestically and internationally, have voluntarily adopted these standards. • GAO rules are generally more restrictive than AICPA's.
Internal Revenue Service (IRS)	• Standards Document: Internal Revenue Code Section 501c—Defines inurement, disqualified persons, excess benefits. See also Form 990 Instruction booklet. • Section 4958 Intermediate Sanctions: Violations can result in excise taxes on amount of excess benefits and, in some cases, revocation of exempt status.
State Legislation	• Most states include prohibitions against self-dealing or conflict of interest transactions by management and officers.

Conflict of Interest Policy*

***Note:** This example of a Conflict of Interest policy, with key definitions included, was adapted with permission from the Minnesota Charities Review Council.

[*Organization Name*]

Policy on Conflicts of Interest
and Disclosure of Certain Interests

This conflict of interest policy is designed to help directors, officers, and employees of the [*Organization Name*] identify situations that present potential conflicts of interest and to provide [*Organization Name*] with a procedure that, if observed, will allow a transaction to be treated as valid and binding even though a director, officer, or employee has or may have a conflict of interest with respect to the transaction. In the event there is an inconsistency between the requirements and procedures prescribed herein and those in federal or state law, the law shall control. All capitalized terms are defined in Part 2 of this policy.

1. Conflict of Interest Defined. For purposes of this policy, the following circumstances shall be deemed to create Conflicts of Interest:

   A. Outside Interests.

      (i) A Contract or Transaction between [*Organization Name*] and a Responsible Person or Family Member.

      (ii) A Contract or Transaction between [*Organization Name*] and an entity in which a Responsible Person or Family Member has a Material Financial Interest or of which such person is a director, officer, agent, partner, associate, trustee, personal representative, receiver, guardian, custodian, conservator, or other legal representative.

   B. Outside Activities.

      (i) A Responsible Person competing with [*Organization Name*] in the rendering of services or in any other Contract or Transaction with a third party.

      (ii) A Responsible Person's having a Material Financial Interest in; or serving as a director, officer, employee, agent, partner, associate, trustee, personal representative, receiver, guardian, custodian, conservator, or other legal representative of, or consultant to; an entity or individual that competes with [*Organization Name*] in the provision of services or in any other Contract or Transaction with a third party.

   C. Gifts, Gratuities and Entertainment. A Responsible Person accepting gifts, entertainment, or other favors from any individual or entity that:

      (i) does or is seeking to do business with, or is a competitor of [*Organization Name*]; or

(ii) has received, is receiving, or is seeking to receive a loan or grant, or to secure other financial commitments from [*Organization Name*];

(iii) is a charitable organization;

under circumstances where it might be inferred that such action was intended to influence or possibly would influence the Responsible Person in the performance of his or her duties. This does not preclude the acceptance of items of nominal or insignificant value or entertainment of nominal or insignificant value that are not related to any particular transaction or activity of [*Organization Name*].

2. <u>Definitions.</u>

A. A *Conflict of Interest* is any circumstance described in Part 1 of this Policy.

B. A *Responsible Person* is any person serving as an officer, employee, or member of the board of directors of [*Organization Name*].

C. A *Family Member* is a spouse, domestic partner, parent, child, or spouse of a child, brother, sister, or spouse of a brother or sister, of a Responsible Person.

D. A *Material Financial Interest* in an entity is a financial interest of any kind that, in view of all the circumstances, is substantial enough that it would, or reasonably could, affect a Responsible Person's or Family Member's judgment with respect to transactions to which the entity is a party. This includes all forms of compensation. (The board may wish to establish an amount that it would consider to be a "material financial interest.")

E. A *Contract or Transaction* is any agreement or relationship involving the sale or purchase of goods, services, or rights of any kind, the providing or receipt of a loan or grant, the establishment of any other type of pecuniary relationship, or review of a charitable organization by [*Organization Name*]. The making of a gift to [*Organization Name*] is not a Contract or Transaction.

3. <u>Procedures.</u>

A. Before board or committee action on a Contract or Transaction involving a Conflict of Interest, a director or committee member having a Conflict of Interest and who is in attendance at the meeting shall disclose all facts material to the Conflict of Interest. Such disclosure shall be reflected in the minutes of the meeting.

B. A director or committee member who plans not to attend a meeting at which he or she has reason to believe that the board or committee will act on a matter in which the person has a Conflict of Interest shall disclose to the chair of the meeting all facts material to the Conflict of Interest. The chair shall report the disclosure at the meeting and the disclosure shall be reflected in the minutes of the meeting.

C. A person who has a Conflict of Interest shall not participate in or be permitted to hear the board's or committee's discussion of the matter except to disclose material facts and to respond to questions. Such person shall not attempt to exert his or her personal influence with respect to the matter, either at or outside the meeting.

D. A person who has a Conflict of Interest with respect to a Contract or Transaction that will be voted on at a meeting shall not be counted in determining the presence of a quorum for purposes of the vote. The person having a conflict of interest may not vote on the Contract or Transaction and shall not be present in the meeting room when the vote is taken, unless the vote is by secret ballot. Such person's ineligibility to vote shall be reflected in the minutes of the meeting. For purposes of this paragraph, a member of the board of directors of [*Organization Name*] has a Conflict of Interest when he or she stands for election as an officer or for re-election as a member of the board of directors.

E. Responsible Persons who are not members of the board of directors of [*Organization Name*], or who have a Conflict of Interest with respect to a Contract or Transaction that is not the subject of board or committee action, shall disclose to the Chair or the Chair's designee any Conflict of Interest that such Responsible Person has with respect to a Contract or Transaction. Such disclosure shall be made as soon as the Conflict of Interest is known to the Responsible Person. The Responsible Person shall refrain from any action that may affect [*Organization Name*]'s participation in such Contract or Transaction.

   In the event it is not entirely clear that a Conflict of Interest exists, the individual with the potential conflict shall disclose the circumstances to the Chair or the Chair's designee, who shall determine whether there exists a Conflict of Interest that is subject to this policy.

4. <u>Confidentiality.</u> Each Responsible Person shall exercise care not to disclose confidential information acquired in connection with such status or information the disclosure of which might be adverse to the interests of [*Organization Name*]. Furthermore, a Responsible Person shall not disclose or use information relating to the business of [*Organization Name*] for the personal profit or advantage of the Responsible Person or a Family Member.

5. <u>Review of Policy.</u>

   A. Each new Responsible Person shall be required to review a copy of this Policy and to acknowledge in writing that he or she has done so.

   B. Each Responsible Person shall annually complete a disclosure form identifying any relationships, positions, or circumstances in which the Responsible Person is involved that he or she believes could contribute to a Conflict of Interest arising. Such relationships, positions, or circumstances might include service as a director of or consultant to a not-for-profit organization, or ownership of a business that might provide goods or services to [*Organization Name*]. Any such information regarding business interests of a Responsible Person or a Family Member shall be treated as confidential and shall generally be made available only to the Chair, the Executive Director, and any committee appointed to address Conflicts of Interest, except to the extent additional disclosure is necessary in connection with the implementation of this Policy.

   C. This policy shall be reviewed annually by each member of the board of directors. Any changes to the policy shall be communicated immediately to all Responsible Persons.

[*Organization Name*]

Conflict of Interest Information Form

Name: ______________________________________ Date: ______________________________

Please describe below any relationships, positions, or circumstances in which you are involved that you believe could contribute to a Conflict of Interest (as defined in [*Organization Name*]'s Policy on Conflicts of Interest) arising.

*I hereby certify that the information set forth above is true and complete to the best of my knowledge. I have reviewed, and agree to abide by, the Policy of Conflict of Interest of [*Organization Name*] that is currently in effect.*

Signature: ___________________________________ Date: ______________________________

Peer Review of CPA Firms: An Overview

PURPOSE OF THIS TOOL: This tool is prepared to inform audit committee members about the practice-monitoring programs over the accounting and auditing practices of the substantial majority of CPA firms. This tool is intended to help audit committee members understand the obligations and oversight of CPA firms, and thereby gauge the suitability of the CPA firm for the not-for-profit entity.

Peer review requirements for CPA firms have changed considerably over the years. Currently, most CPA firms undergo a review of their accounting and auditing practice at least once every three years. However, the requirements vary, and not all firms have peer reviews. The audit committee should be aware of when peer reviews are required and what assurance is provided by having a peer review.

Peer Review of a CPA Firm

Peer reviews are required of all CPA firms that are members of the AICPA. However, some CPA firms are not members, thereby avoiding a peer review, which may be a consideration for the audit committee. Some state boards of accountancy require peer reviews for all licensed firms. For not-for-profit organizations subject to *OMB Circular A-133* (Single Audit), that is, those expending $500,000 of federal awards, the auditing firm is required to have a peer review every three years and submit a copy of the peer review report letter to the not-for-profit organization (NPO).

A peer review of a CPA firm can be used by an audit committee as a tool to assess whether the CPA firm it hires or is considering hiring:

1. Has a system of quality control for its accounting and auditing practice that has been designed to meet the requirements of the AICPA's Statements on Quality Control Standards (SQCSs).
2. Is complying with that system of quality control during the peer review year to provide the firm with reasonable assurance of complying with professional standards.

The AICPA's standards regarding quality control provide requirements in the areas of auditor independence, integrity, and objectivity; audit personnel management; acceptance and continuance of audit clients and engagements; audit engagement performance; and firm quality control monitoring. Professional standards include generally accepted auditing standards (GAAS), generally accepted accounting principles (GAAP), generally accepted government auditing standards (GAGAS), and the standards on auditor independence.

To conduct its peer review, a CPA firm will engage another CPA firm, a CPA firm group, or a state peer review committee to perform the review. However, in selecting its peer reviewer, the reviewing CPA firm must be independent of the CPA firm being reviewed and must be qualified to perform the review, including matching industry experience. The peer review committee (the body responsible for evaluating and accepting peer reviews) monitors firm independence and approves the peer review team before the peer review taking place.

Types of Peer Reviews

There are three different levels of peer reviews, under the AICPA Peer Review Program:

1. A *system* peer review is an on-site review required for firms performing audits and/or examinations of prospective financial statements.
2. An *engagement* peer review is performed (off-site) when the CPA firm's highest level of service is a review of financial statements or compilation of financial statements with disclosures.
3. A *report* peer review is performed for firms performing only compilations without disclosures.

Accordingly, for an audit engagement the audit committee should ascertain that the CPA or firm has had the appropriate system-level peer review.

Peer Review Reports

For system peer reviews, there are three types of peer review reports:

1. An *unmodified report* means that the reviewed firm's system of quality control has been designed to meet the requirements of the quality control standards for an accounting and auditing practice and the system was being complied with during the peer review year to provide the firm with reasonable assurance of conforming with professional standards.
2. A *modified report* means that the design of the firm's system of quality control created a condition in which the firm did not have reasonable assurance of conforming with professional standards in certain instances, or that the firm's degree of compliance with its quality control policies and procedures did provide it with reasonable assurance of conforming with professional standards, except for certain instances.
3. An *adverse report* means that there are significant deficiencies in the design of the firm's system of quality control, pervasive instances of noncompliance with the system as a whole, or both, resulting in material failures to adhere to professional standards on engagements.

Modified reports, and usually unmodified reports, are accompanied by a letter of comments issued by the peer reviewer. A letter of comments describes matters that the peer reviewer believes resulted in conditions in which there was more than a remote possibility that the firm would not comply with professional standards and sets forth recommendations regarding those matters. A letter of comments is not prepared when an adverse report is issued because all deficiencies, comments, and recommendations are contained in the report itself.

Effective January 1, 2005, new peer review requirements specify that the peer review report must identify any specialized industries—for example, SEC, Single Audit, or GASB—and the peer review report must specify deficiencies, if any, by industry. In addition, the reviewed firm must submit a representation letter to the peer reviewer.

The reviewed firm is required to respond in writing (called the letter of response) to the peer reviewer's comments on matters in the peer review report and/or in the letter of comments. The response describes the actions taken or planned with respect to each matter in the report and/or the letter.

It is recommended that the NPO audit committee request a copy of the auditor's latest peer review report and letter of comments, if any, and letter of response thereto, and discuss them with the auditor. If a report is modified or adverse, the audit committee should consider the reasons as part of its assessment of whether it should engage or continue to engage the auditor.

Common Misconceptions of Peer Review

1. *Fiction:* A peer review evaluates every engagement audited by a CPA firm. *Fact:* A peer review is performed using a risk-based approach. A peer reviewer must review a sufficient sample of a cross-section of engagements to obtain reasonable assurance that the reviewed firm is complying with its quality control policies and procedures. Therefore, it is possible that the review would not disclose all weaknesses in the system of quality control or all instances of lack of compliance with it.
2. *Fiction:* An unmodified report provides assurance with respect to every engagement conducted by the firm. *Fact:* Every engagement conducted by a firm is not included in the scope of a peer review, nor is every aspect of each engagement reviewed. The peer review includes reviewing all key areas of the engagements selected.
3. *Fiction:* If a firm receives a letter of comments, its system of quality control is inadequate. *Fact:* The criterion for including an item in the letter of comments is whether the item resulted in a condition being created in which there was more than a remote possibility that the firm would not comply with professional standards on accounting and auditing engagements. Because this is a very low threshold, most peer reviews result in the issuance of a letter of comments. Peer reviews are considered to be a constructive exercise toward improvement of professional practices.

Questions for the Auditor Regarding Peer Review

The following questions should be asked by the audit committee of its current or prospective auditors to gain a better understanding of the firm's peer review experience.

Question	Yes	No	Comments
1. Is the CPA or firm subject to peer review? If not, please explain.	☐	☐	
2. Has a peer review been performed in the last three years? If not, please explain.	☐	☐	
3. Was a system type of peer review performed?	☐	☐	
4. Did the peer review result in an unmodified report? If not, obtain an explanation of findings and inquire about the status of any follow-up action required by the peer review committee.	☐	☐	
5. Has the firm corrected deficiencies noted in the peer review report and/or the letter of comments? If not, please explain.	☐	☐	
6. Explain what the comments and recommendations in the letter of comments mean.	☐	☐	
7. Did the peer review committee request any follow-up actions? If so, have these actions been carried out?	☐	☐	
8. Was our organization selected for review during the peer review? (When the firm is the current auditor) If so, were any negative responses noted?	☐	☐	
9. Was the engagement partner (or auditor in charge) selected for review during the peer review? If so, were any negative responses noted on audits performed by them?	☐	☐	
10. Does the firm perform Single Audits? If so, were they included in the last review? If not, why not?	☐	☐	

Evaluating the Auditor's Engagement Letter—Questions to Consider

PURPOSE OF THIS TOOL: The board of directors or appointed committee such as the audit committee having the responsibility to hire, fire, and evaluate the independent auditors should discuss a series of questions about the audit engagement letter (service agreement) with the independent auditor in discharging this responsibility.

If this is the initial audit of the organization by the audit firm, the engagement letter should be reviewed to ensure that the terms of the letter are consistent with those that were stated in the proposal received by the organization in response to its request for proposal.

The financial management of the organization should be consulted regarding its agreement with the details of the audit engagement, including timing of the work and the level of assistance to be provided by the organization's staff.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are a starting point to evaluating the engagement letter with the independent auditors. Audit committee members should answer the following questions with consultation of the auditor and financial management as needed.

Evaluating the Auditor's Engagement Letter	Yes	No	Not sure	Comments
1. Does the engagement letter address the scope of work to be performed? • Audit of financial statements • Supplemental information • Compliance reports • GAGAS (Generally Accepted Government Auditing Standards)—Yellow Book • OMB requirements—Single Audit OMB Circular A-133 • Tax filings • Other requirements	☐	☐	☐	

Evaluating the Auditor's Engagement Letter	Yes	No	Not sure	Comments
2. Does the engagement letter include a timetable for the audit work including dates for: • Interim fieldwork, if applicable • Provision of year-end trial balance • Completion of client-prepared schedules • Beginning of year-end fieldwork • End of year-end fieldwork • Delivery of draft of financial statements • Delivery of final financial statements • Delivery of management letter, if applicable • Required communications letter (Statement on Auditing Standards No. 61, *Communication With Audit Committees*) • Meetings with audit committee	☐	☐	☐	
3. Does the letter discuss third-party reliance on the auditor's report?	☐	☐	☐	
4. Does the letter identify the persons or entities that will use the audit report and for what purpose?	☐	☐	☐	
5. Does the letter include estimates of the professional fees to be charged for the engagement and make provision for the handling of out-of-pocket expenses?	☐	☐	☐	
6. Does the letter provide for an agreed-upon process for changes in the scope of work?	☐	☐	☐	
7. Does the letter indicate the payment terms for the fees and costs and whether there are any finance charges for late payment?	☐	☐	☐	
8. Are mediation or arbitration terms discussed should a dispute or claim arise in connection with the performance or breech of the engagement agreement?	☐	☐	☐	

Evaluating the Auditor's Engagement Letter	Yes	No	Not sure	Comments
9. Does the letter contain a severability clause to address the possibility that a portion of the letter may be determined to be invalid?	☐	☐	☐	
10. Does the engagement letter require a written acceptance by the organization?	☐	☐	☐	
11. Does the letter include discussion of assistance that is expected to be provided during the audit by the organization's personnel?	☐	☐	☐	
12. Does the letter address how adjustments below the auditor's materiality threshold will be handled? (e.g., Does it address how they will be communicated to management for possible recording in the subsequent year's financial statements?)	☐	☐	☐	
13. Does the letter address the use of e-mail communications and related disclaimers regarding privacy?	☐	☐	☐	
14. Does the letter address the provision of a safe environment by the organization for the audit staff?	☐	☐	☐	
15. Does the letter address the auditor's record retention policy?	☐	☐	☐	
16. Does the letter address how the auditor will respond to circumstances that create a potential or actual conflict of interest?	☐	☐	☐	
17. Does the letter address how the auditor will respond to outside inquires related to the audit engagement?	☐	☐	☐	
18. Does the letter discuss the auditor's privacy policy regarding the organization's financial information?	☐	☐	☐	
19. Does the letter include a schedule of information to be provided by the organization, such as permanent file documents and schedules prepared by the organization's staff in connection with the audit engagement?	☐	☐	☐	

Evaluating the Auditor's Engagement Letter	Yes	No	Not sure	Comments
20. Does the letter indicate that nonattest services are excluded from this engagement and are subject to a separate written understanding before any additional services are commenced?	☐	☐	☐	
Other Comments, Additional Questions				

Guidelines for Hiring the Chief Audit Executive (CAE)

PURPOSE OF THIS TOOL: An internal audit function is a key mechanism in the internal control structure for many organizations. It is recognized that most not-for-profit organizations (NPOs) cannot justify the expense of an internal auditor, while some have very large internal audit departments headed by a senior executive. It is becoming more common in larger organizations to refer to the person heading the internal audit function as the chief audit executive (CAE). As used in this tool, the terms *chief audit executive* and *CAE* refer to the person responsible for the audit function, irrespective of their title or organizational role. Care must be taken in hiring the right CAE, one that matches the organization's needs with the necessary technical expertise that meets other requirements (NPO experience, temperament, integrity, management and human relationship skills, and others).

Role of the Chief Audit Executive

A critical activity of the audit committee is to be involved in the hiring of the CAE of the organization. The CAE will have a high degree of interaction with the audit committee, so the audit committee should be comfortable working with this person. In many organizations, the CAE will report functionally to the audit committee and administratively to a senior executive of the organization.

CAE Qualifications

In general, candidates for a CAE position should have distinguished themselves professionally by earning a CPA and/or certified internal auditor (CIA) credential, and should have significant experience in a management role and strong technical skills in accounting and auditing. In addition, because of the breadth of experience it offers, the audit committee should seek candidates that have experience in public accounting (or its equivalent) and possibly an advanced business degree, such as a masters of business administration.

Additionally, the AICPA's competency self-assessment tool (CAT) may be a useful exercise for candidates to complete, provided they agree to share results with the audit committee. The CAT is available at www.cpa2biz.com/CPEConferences/CAT.htm.

INSTRUCTIONS FOR USING THIS TOOL: The audit committee should consider asking the following questions of candidates that have passed the initial employment screening by the organization's human resource department, internal executive search committee, or an outside recruiting firm. This tool is meant to prepare the audit committee for the kinds of questions that should be asked of candidates for this important position. Note that some sample questions may not be appropriate for your organization or the candidate.

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
1. What do you consider to be internal audit's role within the organization?	
2. What do you see as the biggest challenges for an internal audit team in the short run (3 to 6 months), medium term (6 to12 months) and over the next 2 to 3 years?	
3. What experience do you have in the NPO sector, and how do you plan to keep abreast of the significant developments relevant to internal audit in the NPO sector?	
4. If applicable, what is your experience in addressing different business practices in different countries?	
5. Have you ever been offered a gratuity or a payment that could be construed as a bribe? What were the circumstances, and how did you handle the situation?	
6. Have you worked with audit committees in the past? What processes have you put in place to keep the audit committee fully and appropriately informed? In the course of a year, what is the typical number of meetings/communications between the CAE and the audit committee (chair)?	
7. Give some examples of situations you have faced that required special meetings with the audit committee in executive session as a result of disagreements with management. How were these situations resolved with management? Have there been situations in which management has tried to squash your recommendations or discredit your findings, and how did you respond to this? In retrospect, would you now handle these situations differently?	
8. Have you worked with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control Framework? How has the framework influenced your process in evaluating the adequacy of internal controls? How is this framework used to design your internal audits?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
9. In previous organizations at which you were employed, what type of technology platform was used? Have you been involved in a technology system implementation? What role did you play in the process and how did you make sure that the proper controls were in place when the system went live?	
10. Have you used technology in conducting internal audits, and how has it enhanced your conduct of the internal audit? How would you recognize a problem that might exist either in the internal audit data or in the organization's records? What would you do about it?	
11. Do you use a formal project planning process that is applied consistently for all internal audits? If so, what benefits have you derived in meeting your team's goals and objectives? What is your average report cycle time from the end of fieldwork?	
12. Have you ever conducted a formal risk assessment and, if so, how have you incorporated it into setting up an audit plan?	
13. What roles do the organization's strategic and technology plans play in the development of an audit plan?	
14. Have you gone out to subsidiaries or affiliate locations to ensure that they have significant input into audit objectives and scopes? How is this achieved? How have you resolved differences of opinion in this area without compromising the goals you have established for an audit?	
15. What role have you played in assisting subsidiary or affiliate locations in implementation of recommendations?	
16. When you or your team conducts an internal audit, do you have a service orientation to your audit process? Do you work to improve the effectiveness and efficiency of the operations and controls in each audit area? How would you make your recommendations to management? What process would you use to resolve differences of opinion?	
17. Would you use a process for conducting a "customer satisfaction" survey after an internal audit is completed? How would you integrate this feedback into future audits?	
18. How would you ensure that the personnel in internal audit have the necessary skills to ensure an adequate understanding of the organization's accounting and other business practices?	

Chief Audit Executive—Sample Candidate Interview Questions	Interviewer Notes
19. How many people have you managed, either as direct reports or within an organization that you might have overseen? How would you describe your management style?	
20. Have you ever participated in a 360-degree assessment process? (A 360-degree evaluation is one that obtains anonymous feedback from a group of individuals representing various perspectives.) If so, what did you learn about yourself that surprised you? How did the results of the assessment change your behavior?	
Other Notes and Questions	
1. If applicable, has your internal audit department ever been through a Yellow Book peer review? What were the results of that review?	

Points to Consider When Engaging External Resources

PURPOSE OF THIS TOOL: While not-for-profit organizations (NPOs) are not subject to the requirements of the Sarbanes-Oxley Act, the audit committees of many NPOs may deem it necessary to engage outside advisers in the course of carrying out their duties. This tool is intended to assist audit committee members in understanding the process of engaging independent counsel and other advisers if needed.

When selecting independent counsel or other advisers (expert/adviser) for an engagement within the organization, the audit committee should not only consider the education, training, and experience of the specialists and staff assistants actually performing the work, but it should determine that the service provider (1) maintains integrity and objectivity; (2) is free of conflicts of interest with respect to the members of the audit committee and the organization, (3) has the expertise and resources necessary to do the work it is under consideration to do, and (4) has a reputation for reliability, among other considerations.

The source of funding for payments to the outside advisers should be considered before initiating the process of engaging external resources. Many NPOs receive funding support from governmental and other regulated agencies, and funding agreements with these agencies may require the NPO to follow statutory or contractual procedures when engaging external resources. Such procedures may include specific procurement requirements for advertising, securing bids, and bid acceptance.

Although the nature of every engagement will be different, the initial steps the audit committee (or its designee) should undertake when engaging external resources include the following:

1. Determine that the expert/adviser has the competence and experience to perform the requested service. Check references with other clients of the service provider.
2. Consider and discuss whether the expert/adviser has a conflict of interest with respect to the NPO. Such a conflict might arise if the expert/adviser has a relationship with the external auditor, or if they provide service to organizations with similar missions, programs, donors, or other constituent groups. Depending on the nature of the service to be offered, a conflict could arise if the expert/adviser has a relationship with a member of the board of directors, or a member of the organization’s management. Be aware of other potential conflicts of interest that may distract the expert/adviser or undermine the work to be done.
3. Determine if the expert/adviser has sufficient resources to perform the work in the time frame specified by the audit committee.
4. Evaluate the scope of work to be performed and other issues, including the proposed plan for payment of fees and expenses.

5. Make sure all parties (including management and the expert/adviser) understand that the audit committee is the owner of the service relationship. Make sure that management understands that the expert/adviser is working on behalf of the audit committee and the audit committee expects management to be fully cooperative and forthcoming with respect to any information that may be requested.

6. Determine the criteria that will be used to measure the expert's/adviser's work and document those criteria in an agreement with the service provider. As with any relationship, communication and managing expectations is important.

Internal Control: A Tool for the Audit Committee

PURPOSE OF THIS TOOL: Internal control over financial reporting has always been a major area in the governance of an organization, and this importance has been magnified in recent years. This tool is intended to give audit committees basic information about internal control to understand what it is, what it is not, how it can be used most effectively in the organization, and the requirements of management with respect to the system of internal control over financial reporting. Note that the primary responsibility of the audit committee with respect to internal control is the system of internal control over financial reporting.

Basics of Internal Control

In 1992, the Committee of Sponsoring Organizations (COSO)[1] of the National Commission on Fraudulent Financial Reporting (also known as the Treadway Commission) published a document called *Internal Control—Integrated Framework*,[2] which defined *internal control* as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in three categories:

1. Effectiveness and efficiency of operations.
2. Reliability of financial reporting.
3. Compliance with applicable laws and regulations.

Internal control can be judged as effective in each of these categories if the board of directors and management have reasonable assurance that:

1. They understand the extent to which the entity's operations objectives are being achieved.
2. Published financial statements are being prepared reliably.
3. Applicable laws and regulations are being complied with.

The COSO Framework consists of five interrelated components as follows:

1. *Control environment.* Sometimes referred to as the "tone at the top" of the organization, meaning the integrity, ethical values, and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility and organizes and

[1] The Committee of Sponsoring Organizations consists of the American Institute of CPAs (AICPA), the Institute of Management Accountants (IMA), the Institute of Internal Auditors (IIA), Financial Executives International (FEI), and the American Accounting Association (AAA).
[2] The COSO publication *Internal Control—Integrated Framework* (Product Code Number 990012), may be purchased through the AICPA store at www.cpa2biz.com. The proceeds from the sale of the Framework are used to support the continuing work of COSO.

develops its people; and the attention and direction provided by the board of directors. It is the foundation for all other components of internal control, providing discipline and structure.

2. *Risk assessment.* The identification and analysis of relevant risks to achieve the objectives that form the basis to determine how risks should be managed. This component should address the risks, both internal and external, that must be assessed. Before conducting a risk assessment, objectives must be set and linked at different levels.

3. *Control activities.* Policies and procedures that help ensure that management directives are carried out. Control activities occur throughout the organization at all levels in all functions. These include activities such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.

4. *Information and communication.* Addresses the need in the organization to identify, capture, and communicate information to the right people to enable them to carry out their responsibilities. Information systems within the organization are key to this element of internal control. Internal information, as well as external events, activities, and conditions must be communicated to enable management to make informed business decisions and for external reporting purposes.

5. *Monitoring.* The internal control system must be monitored by management and others in the organization. This is the framework element that is associated with the internal audit function in the organization, as well as other means of monitoring such as general management activities and supervisory activities. It is important that internal control deficiencies be reported upstream, and that serious deficiencies be reported to top management and the board of directors.

These five components are linked together, thus forming an integrated system that can react dynamically to changing conditions. The internal control system is intertwined with the organization's operating activities, and is most effective when controls are built into the organization's infrastructure, becoming part of the very essence of the organization.

Key Terms in Internal Control

A few common internal control terms are described as follows:

Reportable condition. Has the same meaning as the term *significant deficiency.* These two terms are used to define a significant deficiency in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize, and report financial data consistent with the assertions of management in the company's financial statements. An aggregation of significant deficiencies could constitute a material weakness.

Material weakness. Defined in the auditing literature as a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned duties.

Compensating controls. Some organizations, by virtue of their size, are not able to implement basic controls such as segregation of duties. In these cases, it is important that management institute compensating controls to cover for the lack of a basic control, or if a basic control is not able to function for some period of time.

What Internal Control Cannot Do

As important as an internal control structure is to an organization, an effective system is not a guarantee that the organization will be successful. An effective internal control structure will keep the right people informed about the organization's progress (or lack of progress) in achieving its objectives, but it cannot turn a poor manager into a good one. Internal control cannot ensure success, or even survival.

Internal control is not an absolute assurance to management and the board about the organization's achievement of its objectives. It can only provide reasonable assurance, due to limitations inherent in all internal control systems. For example, breakdowns in the internal control structure can occur due to simple error or mistake, as well as faulty judgments that could be made at any level of management. In addition, controls can be circumvented by collusion or by management override. Finally, the design of the internal control system is a function of the resources available, meaning that there must be a cost-benefit analysis in the design of the system.

Roles and Responsibilities

Everyone in the organization has some role to play in the organization's internal control system.

Chief executive officer (CEO). The CEO has ultimate responsibility and "ownership" of the internal control system. The individual in this role sets the tone at the top that affects the integrity and ethics and other factors that create the positive control environment needed for the internal control system to thrive. Aside from setting the tone at the top, much of the day-to-day operation of the control system is delegated to other senior managers in the company, under the leadership of the CEO.

Chief financial officer (CFO). Much of the internal control structure flows through the accounting and finance area of the organization under the leadership of the CFO. In particular, controls over financial reporting fall within the domain of the chief financial officer. The audit committee should use interactions with the CFO, and others, as a basis for their comfort level on the internal control over financial reporting.

This is not intended to suggest that the CFO must provide the audit committee with a level of assurance regarding the system of internal control over financial reporting. Rather, through interactions with the CFO and others, the audit committee should get a "gut feeling" about the completeness, accuracy, validity, and maintenance of the system of internal control over financial reporting.

Controller/director of accounting or finance. Much of the basics of the control system come under the domain of this position. It is key that the controller understands the need for the internal control system, is committed to the system, and communicates the importance of the system to all people in the accounting organization. Further, the controller must demonstrate respect for the system though his or her actions.

Internal audit. A main role for the internal audit team is to evaluate the effectiveness of the internal control system and contribute to its ongoing effectiveness. With the internal audit team reporting directly to the audit committee of the board of directors and/or the most senior levels of management, it is often this function that plays a significant role in monitoring the internal control system. It is important to note that many not-for-profits are not large enough to employ an internal audit team. Each organization should assess the need for this team, and employ one as necessary.

Board of director/audit committee. A strong, active board is necessary. This is particularly important when the organization is controlled by an executive or management team with tight reins over the organization and the people within the organization. The board should recognize that its scope of oversight of the internal control system applies to all the three major areas of control: over operations, over compliance with laws and regulations, and over financial reporting. The audit committee is the board's first line of defense with respect to the system of internal control over financial reporting.

All other personnel. The internal control system is only as effective as the employees throughout the organization that must comply with it. Employees throughout the organization should understand their role in internal control and the importance of supporting the system through their own actions and encouraging respect for the system by their colleagues throughout the organization.

Compensating Controls

It is important to realize that both the design and compliance with the internal control system is important. The audit committee should be "tuned-in" to the tone-at-the-top of the organization as a first indicator of the functioning of the internal control system.

In addition, audit committees should realize that the system of internal control should be scaled to the organization. Some organizations will be so small, for example, that they will not be able to have appropriate segregation of duties. The message here is that the lack of segregation of duties is not automatically a material weakness, or even a reportable condition, depending on the compensating controls that are in place.

For example, suppose an organization's accounting department is so small that it is not possible to segregate duties between the person who does the accounts payable and the person who reconciles the bank statements. In this case, it is one and the same person, so the implication is that there are no checks and balances on the accounts payable person, who could be writing checks to a personal account, then passing on them during the bank reconciliation process (that is, there is no one to raise the red flag that personal checks are being written on the company account).

Compensating controls could make up for this apparent breach in the internal control system. Here are some examples of compensating controls in this situation:

1. All checks are hand signed by an officer of the company, rather than using a signature plate that is in the control of the person that prepared the checks.
2. The bank reconciliation may be reviewed by the person's manager.
3. A periodic report of all checks that are cleared at the bank could be prepared by the bank and forwarded to an officer of the company for review.

Audit committees should be aware of situations like this and be prepared to ask questions and evaluate the answers when an obvious breach in internal control is surfaced.

Management Override of Controls

Another area that an audit committee needs to focus on is the ability of management to override internal controls over financial reporting to perpetrate a fraud. Examples of techniques used by management in overriding internal controls over the financial reporting function include:

- Back dating or forward dating documents to a different period.
- Making adjusting entries during the financial reporting closing process.
- Reclassifying items improperly between the statement of activity and the statement of financial condition.

Some of these override techniques were used in some of the recent scandals and have gained substantial notoriety.

An audit committee has the responsibility to help prevent or deter a management override of controls. It is important for the audit committee to understand that there is a system to uncover an override, as well as follow-up to determine its appropriateness. Questions about management override, and the controls over management override, as well as audit steps to detect if a management override has occurred, should be addressed to the CEO, CFO, and independent auditor during the respective executive sessions with the audit committee as noted elsewhere in this toolkit.

Conclusion

This tool was intended to provide a summary of what is meant by *internal control*. The concepts are not complex, but sometimes the application of internal control can be a challenge in an organization, depending on its size and culture. However, it is vitally important to design the system of internal control to achieve the objectives of (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) compliance with applicable laws and regulations.

Simply stated a strong system of internal control (both in its design and compliance) is good business.

Internal Control—A Tool for the Audit Committee

The following tool, “Internal Control—A Tool for the Audit Committee,” contains questions modeled on those found in the COSO Report, *Internal Control—Integrated Framework*.

Internal Control—A Tool for the Audit Committee

INSTRUCTIONS FOR USING THIS TOOL: This tool is created around the five interrelated components of an internal control structure. Within each component is a series of questions that the audit committee should focus on to assure itself that controls are in place and functioning. These questions should be discussed in an open forum with the individuals who have a basis for responding to the questions. The audit committee should ask for detailed answers and examples from the management team, including key members of the financial management team, internal auditors, and independent auditors to assure itself that the system is operating as management represents. Evaluation of the internal control structure is not a one-time, but rather a continuous, event for the audit committee—the audit committee should always have its eyes and ears open for potential weaknesses in internal control and should continuously probe the responsible parties regarding the operation of the system. These questions are written in a manner such that a "no response" indicates a weakness that must be addressed.

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Integrity and Ethical Values				
1. Does the organization have a comprehensive code of conduct, and/or other policies addressing acceptable business practice, conflicts of interest, and expected standards of ethical and moral behavior?	☐	☐	☐	
2. Is the code distributed to all employees?	☐	☐	☐	
3. Are all employees required to annually acknowledge that they have read, understood, and complied with the code?	☐	☐	☐	
4. Does management demonstrate through actions its own commitment to the code of conduct?	☐	☐	☐	
5. Are dealings with clients and other constituents, customers, suppliers, employees, and other parties based on honesty and fair business practices?	☐	☐	☐	
6. Does management take appropriate action in response to violations of the code of conduct?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Integrity and Ethical Values (cont.)				
7. Is management explicitly prohibited from overriding established controls? What controls are in place to provide reasonable assurance that controls are not overridden by management? Are deviations from this policy investigated and documented? Are violations (if any) and the results of investigations brought to the attention of the audit committee?	☐	☐	☐	
8. Is the organization proactive in reducing fraud opportunities by (1) identifying and measuring fraud risks, (2) taking steps to mitigate identified risks, (3) identifying a position within the organization to "own" the fraud prevention program, and (4) implementing and monitoring appropriate preventative and detective internal controls and other deterrent measures?	☐	☐	☐	
9. Does the company use an anonymous ethics and fraud hotline and, if so, are procedures in place to investigate and report results to the audit committee? (See also the tool "Sample Whistleblower Tracking Report," in this toolkit.)	☐	☐	☐	
Commitment to Competence				
1. Are the level of competence and the requisite knowledge and skills defined for each job in the accounting and internal audit organizations?	☐	☐	☐	
2. Does management make an effort to determine whether the accounting and internal audit organizations have adequate knowledge and skills to do their jobs?	☐	☐	☐	
Board of Directors and/or Audit Committee				
1. Are the audit committee's responsibilities defined in a charter? If so, is the charter updated annually and approved by the board of directors? (See also the tool "Audit Committee Charter Matrix," in this toolkit.)	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Board of Directors and/or Audit Committee (cont.)				
2. Are audit committee members independent of the company and of management? Do audit committee members have the knowledge, industry experience, and financial expertise to serve effectively in their role?	☐	☐	☐	
3. Are a sufficient number of meetings held, and are the meetings of sufficient length and depth to cover the agenda and provide healthy discussion of issues?	☐	☐	☐	
4. Does the audit committee constructively challenge management's planned decisions, particularly in the area of financial reporting, and probe the evaluation of past results?	☐	☐	☐	
5. Are regular meetings held between the audit committee and the CFO, the CAE (internal audit), other key members of the financial management and reporting team, and the independent auditors? Are executive sessions conducted on a regular basis? (See also the tool "Conducting an Audit Committee Executive Session: Guidelines and Questions," in this toolkit.)	☐	☐	☐	
6. Does the audit committee approve internal audit's annual audit plan?	☐	☐	☐	
7. Does the audit committee receive key information from management in sufficient time in advance of meetings to prepare for discussions at the meetings?	☐	☐	☐	
8. Does a process exist for informing audit committee members about significant issues on a timely basis and in a manner conducive to the audit committee having a full understanding of the issues and their implications? (See also the tool "Issues Report from Management," in this toolkit.)	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Board of Directors and/or Audit Committee (cont.)				
9. Is the audit committee informed about personnel turnover in key functions including the audit team (both internal and the independent auditors), senior executives, and key personnel in the financial accounting and reporting teams? Are unusual employee turnover situations observed for patterns or other indicators of problems?	☐	☐	☐	
Management's Philosophy and Operating Style				
1. Is the accounting function viewed as a team of competent professionals bringing information, order, and controls to decision-making?	☐	☐	☐	
2. Is the selection of accounting principles made in the long-term best interest of the organization (as opposed to short-term maximization of income)?	☐	☐	☐	
3. Are assets, including intellectual assets, protected from unauthorized access and use?	☐	☐	☐	
4. Do managers respond appropriately to unfavorable signals and reports?	☐	☐	☐	
5. Are estimates and budgets reasonable and achievable?	☐	☐	☐	
Organizational Structure				
1. Is the organizational structure within the accounting function and the internal audit function appropriate for the size of the organization?	☐	☐	☐	
2. Are key managers in the accounting and internal audit functions given adequate definition of their responsibilities?	☐	☐	☐	
3. Do sufficient numbers of employees exist, particularly at the management levels in the accounting and internal audit functions, to allow those individuals to effectively carry out their responsibilities?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Assignment of Authority and Responsibility				
1. Is the authority delegated appropriate for the responsibilities assigned?	☐	☐	☐	
2. Are job descriptions in place for management and supervisory personnel in the accounting and internal audit functions?	☐	☐	☐	
3. Do senior managers get involved as needed to provide direction, address issues, correct problems, and/or implement improvements?	☐	☐	☐	
Human Resources Policies and Practices				
1. Are policies and procedures in place for hiring, training, promoting, and compensating employees in the accounting and internal audit functions?	☐	☐	☐	
2. Do employees understand that sub-standard performance will result in remedial action?	☐	☐	☐	
3. Is remedial or corrective action taken in response to departures from approved policies?	☐	☐	☐	
4. Do employees understand the performance criteria necessary for promotions and salary increases?	☐	☐	☐	
Risk Assessment				
1. Does the organization consider risks from external sources such as creditor demands, economic conditions, regulation, or labor relations?	☐	☐	☐	
2. Does the organization consider risks from internal sources such as key employees (retention and succession planning), financing and the availability of funding for key programs, competitive compensation and benefits, information systems security, and backup systems?	☐	☐	☐	
3. Is the risk of a misstatement of the financial statements considered, and are steps taken to mitigate that risk?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Risk Assessment (cont.)				
4. If applicable, are the risks associated with foreign/off-shore operations considered, including their impact on the financial reporting process?	☐	☐	☐	
Control Activities				
1. Does the organization have a process in place to ensure that controls as described in its policy and procedures manuals are applied as they are meant to be applied? Do the policy and procedures manuals document all important policies and procedures? Are these policies and procedures reviewed and updated on a regular basis? If so, by whom?	☐	☐	☐	
2. Do supervisory personnel review the functioning of controls? If so, how is that review conducted and what happens to the results? Is appropriate and timely follow-up action taken on exceptions?	☐	☐	☐	
Information and Communication				
1. Is a process in place to collect information from external sources, such as industry, economic, and regulatory information, that could have an impact on the organization and/or the financial reporting process?	☐	☐	☐	
2. Are milestones to achieve financial reporting objectives monitored to ensure that timing deadlines are met?	☐	☐	☐	
3. Is necessary operational and financial information communicated to the right people in the organization on a timely basis and in a format that facilitates its use, including new or changed policies and procedures?	☐	☐	☐	
4. Is a process in place to respond to new information needs in the organization on a timely basis?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Information and Communication (cont.)				
5. Is there a process in place to collect and document errors or complaints to analyze, determine cause, and eliminate a problem from recurring in future?	☐	☐	☐	
6. Is a process established and communicated to officers, employees, and others, about how to communicate suspected instances of wrongdoing by the organization or employees of the organization? Further, does a process exist to ensure that anyone making such a report is protected from retaliation for making one? (See also the tool entitled "Sample Whistleblower Tracking Report," in this toolkit.)	☐	☐	☐	
Monitoring				
1. Do officers and employees understand their obligation to communicate observed weaknesses in design or compliance with the internal control structure of the organization to the appropriate supervisory or management personnel?	☐	☐	☐	
2. Are interactions with external stakeholders periodically evaluated to determine if they are indicative of a weakness in the internal controls structure? (For example, consider the frequency of complaints about incorrect invoices, statements, and acknowledgments.)	☐	☐	☐	
3. Is there follow-up on recommendations from the internal and external auditors for improvements to the internal control system?	☐	☐	☐	
4. Are personnel required to sign off, indicating their performance of critical control activities such as performing reconciliations?	☐	☐	☐	

Control Environment—Tone at the Top	Yes	No	Not Sure	Comments
Monitoring (cont.)				
5. Does the internal audit team have the right number of competent and experienced staff? Do they have access to the board of directors and audit committee? Is the reporting structure in place to ensure their objectivity and independence? Is the work of the internal audit team appropriate to the organization's needs, and prioritized with the audit committee's direction?				

Fraud and the Responsibilities of the Audit Committee: An Overview

PURPOSE OF THIS TOOL: An audit committee should take an active role in the prevention and deterrence of fraud, as well as an effective ethics and compliance program. The audit committee should constantly challenge management and the auditors to ensure that the entity has appropriate antifraud programs and controls in place to identify potential fraud and ensuring that investigations are undertaken if fraud is detected. The audit committee should take an interest in ensuring that appropriate action is taken against known perpetrators of fraud.

This tool is intended to make audit committee members aware of their responsibilities as they undertake this important role. This tool highlights areas of activity that may require additional scrutiny by the audit committee.

Definition and Categories of Fraud

An understanding of fraud is essential for the audit committee to carry out its responsibilities. The term *fraud* is defined in *Black's Law Dictionary* (Sixth Edition, 1990) as:

> An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right. A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury... A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated.

The audit committee also needs to be aware that fraud affecting the organization often falls within one of three categories:

- *Management fraud*, which involves senior management's intentional misrepresentation of financial statements, or theft or improper use of company resources.
- *Employee fraud*, which involves nonsenior employee theft or improper use of company resources.
- *External fraud*, which involves theft or improper use of resources by people who are neither management, nor employees of the firm.

This categorization of fraud is useful, but not absolute. Middle management employees may intentionally misrepresent financial statement transactions, for example, to improve their apparent performance, or outside individuals may collude with company management or employees.

Roles of the Audit Committee in the Prevention, Deterrence, Investigation, and Discovery or Detection of Fraud

The members of the audit committee should understand their role of ensuring that the organization has antifraud programs and controls in place to help prevent fraud, and aid in its discovery if it does occur, to properly fulfill their fiduciary duties of:

1. Monitoring the financial reporting process.
2. Overseeing the internal control system.
3. Overseeing the internal audit and independent public accounting functions.
4. Reporting findings to the board of directors.

Guidance to boards of directors/trustees, audit committees, and management to help prevent, deter, and detect fraud is contained in the AICPA's Antifraud & Corporate Responsibility Resource Center available at www.aicpa.org/antifraud/homepage.htm. The information contained in the center can be viewed from different user perspectives for a personalized focus on the issues.

Not-for-profit organizations (NPOs) can use the specific requirements for audit committees as outlined in the Sarbanes-Oxley Act and the Securities Exchange Commission (SEC) rules as a guide. The requirements can be obtained from the AICPA Web site at www.aicpa.org/sarbanes/index.asp.

The audit committee should ensure that the organization has implemented an effective ethics and compliance program, and that it is periodically tested. Since the occurrence of significant frauds can frequently be attributed to an override of internal controls, the audit committee plays an important role to ensure that internal controls address the appropriate risk areas and are functioning as designed.

Internal auditors and external auditors can serve a vital role in aiding in fraud prevention and deterrence. Internal audit staff and external auditors that are experienced and trained in fraud prevention and deterrence can help to provide assurance that (1) risks are effectively identified and monitored, (2) organizational processes are effectively controlled and tested periodically, and (3) appropriate follow-up action is taken to address control weaknesses. The audit committee needs to ensure that internal and external auditors are carrying out their responsibilities in connection with potential fraud.

Expertise of Forensic Accounting Consultants

In some situations, it may be necessary for an organization to look beyond the independent audit team for expertise in the fraud area. In such cases, CPA forensic accounting consultants can provide additional assurance or advanced expertise, since they have special training and experience in fraud prevention, deterrence, investigation, and detection. Forensic accounting consultants may also provide fresh insights into the organization's operations, control systems, and risks. The work of forensic accounting consultants may also provide comfort for the organization's executive director and chief financial officer. Forensic accounting consultants, however, cannot act as an insurer to prevent or detect fraud.

When Fraud Is Discovered

Fraud can be discovered through many sources, namely, internal or external auditors, forensic accounting consultants, employees, vendors, and others. Establishing a confidential hotline can also be an important source of information leading to fraud discovery, as part of an organization's overall ethics, compliance, and fraud prevention program. Although a confidential hotline is something that could be accomplished internally, there are a variety of outside service providers that can be engaged to provide this service for the organization.

If fraud or improprieties are asserted or discovered, the audit committee—through the external auditors, internal auditors, or forensic accounting consultants, as appropriate—should investigate, and, if necessary, retain legal counsel to assert claims on the organization's behalf. Forensic accounting consultants, in particular, may be needed to provide the depth of skills necessary to conduct a fraud investigation, and if it is desirable to get an independent assessment.

If fraud is discovered, or there is a reasonable basis to believe that fraud may have occurred, the audit committee is responsible for ensuring that an investigation is undertaken. Criteria should be in place describing the audit committee's level of involvement, based on the severity of the offense. Most audit committees will also want to obtain information about all violations of the law and the organization's policies.

Forensic accounting consultants can also frequently provide audit committees with other related advisory services, namely, (1) evaluations of controls designs and operating effectiveness through compliance verification, (2) creation of special investigations units (SIUs), (3) incident management committees, (4) disclosure risk controls, (5) ethics hotlines, (6) code of conduct, and other antifraud measures.

The audit committee can engage the audit firm to carry out a forensic or fraud investigation. If CPA forensic accountants are engaged by the organization's general counsel, rather than the audit committee, they may potentially attain attorney-client privilege status, not otherwise available under normal circumstances.

Whistleblowers

Not-for-profit organizations must 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 (see Sarbanes-Oxley Act of 2002, Title III, Section 301.) See also the "Sample Whistleblower Tracking Report" in this toolkit.

Conclusion

The public is demanding greater vigilance from all parties involved in organizational governance, thus increasing the need to fight fraud. Audit committees are required to play a pivotal role in the prevention and deterrence of fraud, and to take appropriate action in the discovery of fraud. Independent public accountants, hired by audit committees, and internal auditors will continue to play an important part in the process. CPA forensic accounting consultants have emerged, however, as vital, newly recognized allies. Qualified forensic accounting consultants have the education, training, and experience to provide additional assistance to audit committees so they may better carry out their fiduciary responsibilities in the fight against fraud.

Sample Whistleblower Tracking Report

PURPOSE OF THIS TOOL: A key defense against fraud occurring in an organization is the availability of a means for employees and other constituents to anonymously report suspected wrongdoing (whistleblowing). Respondents to a 2004 survey by the Association of Certified Fraud Examiners (ACFE) revealed that various forms of fraud are detected 40 percent of the time by tips, the leading method for detecting fraud.[1] Also, ACFE recommends opening the system to suppliers, customers, and others, which can increase the number of reports by approximately 50 percent.[2]

While whistleblower programs are not required of not-for-profit organizations, many agree that it is a prudent practice to follow. In addition, some states have adopted whistleblower provisions, and federal law prohibits retaliation against anyone "blowing the whistle" with respect to a violation of a federal law or regulation.

If a not-for-profit organization chooses to institute a whistleblower program this tool could be used by the audit committee and management to implement an appropriate policy and process, to review any complaints received regarding internal accounting controls or auditing matters, and to track complaints received to an appropriate resolution.

Sample Whistleblower Policy

State regulatory requirements for establishing whistleblower reporting programs and for the protection of employees from retaliatory actions should be considered in developing and implementing whistleblower policies such as the example that follows.

ABC Organization Whistleblower Policy

General

The ABC Organization Code of Conduct (hereinafter referred to as the Code) requires directors, other volunteers, and employees to observe high standards of business and personal ethics in the conduct of their duties and responsibilities. Employees and representatives of the organization must practice honesty and integrity in fulfilling their responsibilities and comply with all applicable laws and regulations.

[1] Association of Certified Fraud Examiners, 2004 Report to the Nation on Occupational Fraud and Abuse, Austin, TX: ACFE, 2004, p 18.
[2] Association of Certified Fraud Examiners, 2004 Report to the Nation on Occupational Fraud and Abuse, Austin, TX: ACFE, 2004, p. 19.

The objectives of the ABC Organization Whistleblower Policy are to establish policies and procedures for:

- The submission of concerns regarding questionable accounting or auditing matters by employees, directors, officers, and other stakeholders of the organization, on a confidential and anonymous basis.
- The receipt, retention, and treatment of complaints received by the organization regarding accounting, internal controls, or auditing matters.
- The protection of directors, volunteers and employees reporting concerns from retaliatory actions.

Reporting Responsibility

Each director, volunteer, and employee of ABC Organization has an obligation to report in accordance with this Whistleblower Policy (a) questionable or improper accounting or auditing matters, and (b) violations and suspected violations of ABC Organization's Code (hereinafter collectively referred to as Concerns).

Authority of Audit Committee

All reported Concerns will be forwarded to the Audit Committee in accordance with the procedures set forth herein. The Audit Committee shall be responsible for investigating, and making appropriate recommendations to the Board of Directors, with respect to all reported Concerns.

No Retaliation

This Whistleblower Policy is intended to encourage and enable directors, volunteers, and employees to raise Concerns within the Organization for investigation and appropriate action. With this goal in mind, no director, volunteer, or employee who, in good faith, reports a Concern shall be subject to retaliation or, in the case of an employee, adverse employment consequences. Moreover, a volunteer or employee who retaliates against someone who has reported a Concern in good faith is subject to discipline up to and including dismissal from the volunteer position or termination of employment.

Reporting Concerns

Employees

Employees should first discuss their Concern with their immediate supervisor. If, after speaking with his or her supervisor, the individual continues to have reasonable grounds to believe the Concern is valid, the individual should report the Concern to the Director of Human Resources. In addition, if the individual is uncomfortable speaking with his or her supervisor, or the supervisor is a subject of the Concern, the individual should report his or her Concern directly to the Director of Human Resources.

If the Concern was reported verbally to the Director of Human Resources, the reporting individual, with assistance from the Director of Human Resources, shall reduce the Concern to writing. The Director of Human Resources is required to promptly report the Concern to the Chair of the Audit Committee, who has specific and exclusive responsibility to investigate all Concerns. If the Director of Human Resources, for any reason, does not promptly forward the Concern to the Audit Committee, the reporting individual should directly report the Concern to the Chair of the Audit Committee. Contact information for the Chair of the Audit Committee may be obtained through the Human Resources

Department. Concerns may be also be submitted anonymously. Such anonymous Concerns should be in writing and sent directly to the Chair of the Audit Committee.

Directors and Other Volunteers

Directors and other volunteers should submit Concerns in writing directly to the Chair of the Audit Committee. Contact information for the Chair of the Audit Committee may be obtained from the Chief Financial Officer.

Handling of Reported Violations

The Audit Committee shall address all reported Concerns. The Chair of the Audit Committee shall immediately notify the Audit Committee, the President, the Executive Director, and Chief Operating Officer of any such report. The Chair of the Audit Committee will notify the sender and acknowledge receipt of the Concern within five business days, if possible. It will not be possible to acknowledge receipt of anonymously submitted Concerns.

All reports will be promptly investigated by the Audit Committee, and appropriate corrective action will be recommended to the Board of Directors, if warranted by the investigation. In addition, action taken must include a conclusion and/or follow-up with the complainant for complete closure of the Concern.

The Audit Committee has the authority to retain outside legal counsel, accountants, private investigators, or any other resource deemed necessary to conduct a full and complete investigation of the allegations.

Acting in Good Faith

Anyone reporting a Concern must act in good faith and have reasonable grounds for believing the information disclosed indicates an improper accounting or auditing practice, or a violation of the Codes. The act of making allegations that prove to be unsubstantiated, and that prove to have been made maliciously, recklessly, or with the foreknowledge that the allegations are false, will be viewed as a serious disciplinary offense and may result in discipline, up to and including dismissal from the volunteer position or termination of employment. Such conduct may also give rise to other actions, including civil lawsuits.

Confidentiality

Reports of Concerns, and investigations pertaining thereto, shall be kept confidential to the extent possible, consistent with the need to conduct an adequate investigation.

Disclosure of reports of Concerns to individuals not involved in the investigation will be viewed as a serious disciplinary offense and may result in discipline, up to and including termination of employment. Such conduct may also give rise to other actions, including civil lawsuits.

INSTRUCTIONS FOR USING THIS TOOL: Before using this tool, the audit committee should review any applicable state or local laws or regulations, and the appropriate rules promulgated by other relevant regulatory bodies, if any.

Sample Whistleblower Tracking Report

Date Submitted	Tracking Number	Description of Concern	Submitted By Employee (E) Constituent (C) Vendor (V) Stakeholder (S) Other (O)	Current Status: R – Resolved UI – Under Investigation D – Dismissed W – Withdrawn P – Pending/ No Action	Actions Taken	
					Date	Comments

Conducting an Audit Committee Executive Session: Guidelines and Questions

PURPOSE OF THIS TOOL: Although it is generally accepted that audit committees should hold executive sessions with various members of the executive management, leaders of the financial management team, the leader of the internal audit team, and the independent auditor, audit committee members may not realize the type of questions and the extent of the questions they should ask. This tool is intended to help the audit committee ask the right *first* questions, bearing in mind that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up question. See the "Other Questions for Management" section of this tool for possible follow-up questions audit committee members can ask key members of the financial management team to improve their understanding of the day-to-day operating environment and management teams' decision-making processes and interactions.

What Is an Executive Session?

The purpose of an executive session is to ask questions of various members of the management team and the external auditors in a safe environment. During an executive session meeting, minutes are (usually) not recorded, and when meeting with members of the financial management team, anyone who is not a member of the audit committee is excluded from the meeting. Executive sessions should occur at every meeting of the audit committee, though not every individual needs be in an executive session at every meeting. For example, it may be appropriate for the chief audit executive (CAE), or equivalent, and the independent auditor to have an executive session at every meeting, but the director of financial reporting might be in executive session with the audit committee only at the meeting before the audit is accepted. The length of these sessions obviously varies depending on the issues that need to be discussed by the committee.

It is recommended that executive sessions be conducted with key members of the financial management team and external auditors on a one-on-one basis. It is important that, when meeting with the controller, for example, the chief financial officer (CFO) not be in the room. Executive sessions should be a matter of routine at every audit committee meeting, and not be done only on an exception basis. The audit committee should avoid situations of asking in an open session whether an individual has anything to discuss in an executive session—that question alone could put the individual in an awkward position with others in the organization.

Asking open-ended questions in an executive session could be a major source of information for the audit committee. This tool includes examples of the kinds of questions the audit committee should ask. These are meant to be sample questions to help start a conversation and create dialogue between the individual and the audit committee. *These sample questions are not intended to be a checklist.* Audit committee members need to have sufficient financial expertise to understand the answers to the questions and to use these answers to develop appropriate follow-up questions. Since it will not be unusual to ask similar questions of key executives, the independent auditor, and/or the internal auditor, a comparison of their respective responses could be a good source of insight. Depending on the answers, follow-up action may also be necessary, and the audit committee must be prepared to take that action. The most important thing to do when conducting an executive session is to *listen to the answers that are given and follow up on anything that is not clear!*

Note that the questions for the executive session are such that the participants may not feel free to answer honestly in the open environment of an executive session. Nevertheless, there may be other information that the audit committee wants to know. Following the suggested executive session questions is an associated section of follow-up questions, "Other Questions for Management." An executive session may not be required for these questions, which nevertheless may elicit information the audit committee wants.

Audit committee members should also consider the history of the organization, the environment in which it operates, the current economic climate, the competitive environment, and other factors, when asking questions in executive session. Finally, each executive session should be concluded with a reminder to the member of management, that audit committee members are accessible even outside the meeting, and that they should feel free to reach out to the audit committee member at other times if the need arises.

It is important to note that not every organization will have different individuals in each position, as assumed in the following questions. Nevertheless, the audit committee should be aware of the functions that are part of dual roles, and adjust the questions accordingly. For example, in a small organization, the CFO and controller might share the duties of the director of financial reporting.

The audit committee should explore how a function or role is accomplished, and compose questions accordingly. Also, the audit committee should consider and take into account other roles in the organization. It may be that other people within an organization should also be asked to meet with the audit committee in executive session.

INSTRUCTIONS FOR USING THIS TOOL: This tool is intended to help audit committees ask the right *first* questions, bearing in mind that the audit committee should have the necessary expertise to evaluate the answers and the insight to identify the appropriate follow-up question. Audit committee members may want to use the questions in the "Other Questions for Management" section in conjunction with this one to formulate and ask the appropriate follow-up question. As a reminder, not every organization will have different individuals in each position, as assumed in the following questions. Nevertheless, the audit committee should be aware of the functions that are part of such dual roles, and adjust the questions accordingly.

Conducting an Executive Session— Sample Questions	Comments
Chief Financial Officer	
1. Do you believe the financial statements and applicable federal and state filings fairly present the organization's financial position and activities?	
2. Do you believe the disclosures are adequate and are understandable by the average reader?	
3. Are you satisfied that an appropriate audit was performed by the independent auditors?	
4. Are you aware of any situations of revenue or expense manipulation in the organization?	
5. Are you aware of any kind of fraud in the organization? Do you know of any situations in which fraud could occur?	
6. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, generally accepted accounting principles (GAAP), federal regulations (if the organization receives federal funding), professional, or accepted business practices?	
7. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to demonstrate its commitment to the highest ethical standards?	
8. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	
9. Do you feel comfortable raising issues without fear of retribution?	

Conducting an Executive Session— Sample Questions	Comments
Chief Financial Officer (cont.)	
10. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	
Executive Director	
1. Do you believe the financial statements, IRS Form 990, and Form 990T, fairly present the organization's financial position?	
2. Do you believe the disclosures are adequate and are understandable by the average reader?	
3. Are you satisfied that an appropriate audit was performed by the independent auditors?	
4. Are you aware of any situations of revenue or expense manipulation in the organization?	
5. Are you aware of any disagreements between management of the organization and the independent auditors? If any, please provide details of the disagreement.	
6. Are you aware of any disagreements between management and the internal auditors? If any, please provide details of the disagreement.	
7. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, federal regulations (if the organization receives federal funding), professional practice, or the mores of business?	
8. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	
9. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	
10. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	

Conducting an Executive Session— Sample Questions	Comments
Chief Audit Executive (leader of Internal Audit Team)	
1. Overall, is management cooperating with the internal audit team? Does management have a positive attitude in responding to findings and recommendations, or is it insecure and defensive of findings?	
2. Has management set an appropriate "tone at the top" with respect to the importance of and compliance with the internal control system around financial reporting?	
3. Are you aware of any current or past occurrence of any type of fraud in the organization? Do you know of any situations where fraud could occur?	
4. Are you aware of any situations of revenue or expense manipulation in the organization? Has the organization taken any tax positions that could be construed as aggressive?	
5. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	
6. Do you have the freedom to conduct audits as necessary throughout the organization?	
7. Were you restricted or denied access to requested information?	
8. Have you been pressured to change findings, or minimize the language in those findings so as to not reflect badly on another member of management? Are findings and recommendations given the level of discussion needed to properly satisfy any issues raised, to your satisfaction?	
9. Do you feel comfortable raising issues without fear of retribution?	
10. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, federal regulations (if the organization receives federal funding), professional practice, or the mores of business?	

Conducting an Executive Session— Sample Questions	Comments
Chief Audit Executive (leader of Internal Audit Team) (cont.)	
11. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	
Controller	
1. Do you believe the financial statements and IRS Form 990 fairly present the organization's financial position?	
2. Do you believe the disclosures are adequate and are understandable to the average reader?	
3. If you were the CFO, how would you change the financial statements and accompanying footnotes?	
4. Are you aware of any current or past occurrence of any type of fraud in the organization? Do you know of any situations in which fraud could occur?	
5. Are you aware of any situations of revenue or expense manipulation in the organization? Has the organization taken any tax positions that could be construed as aggressive?	
6. Are you satisfied that an appropriate audit was performed by the independent auditors?	
7. Are you aware of any disagreements between management of the organization and the independent auditors?	
8. Has management set an appropriate "tone at the top" with respect to the importance of and compliance with the internal control system around financial reporting?	
9. Do you feel comfortable raising issues without fear of retribution?	
10. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet failed to go the extra mile to demonstrate its commitment to the highest ethical standards?	

Conducting an Executive Session— Sample Questions	Comments
Controller (cont.)	
11. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, federal regulations (if the organization receives federal funding), professional practice, or the mores of business?	
12. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	
13. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	
Director of Financial Reporting	
1. Do you believe the financial statements and IRS Form 990 fairly present the organization's financial position?	
2. Are there any issues since our last meeting that you wish to discuss with the audit committee?	
3. Are you aware of any current or past occurrences of any type of fraud in the organization? Do you know of any situations in which fraud could occur?	
4. Are you aware of any situations of revenue or expense manipulation in the organization?	
5. Do you believe the financial statements and related disclosures adequately convey the financial situation in the organization to an average reader?	
6. Now that you have the opportunity, is there anything you want to tell the audit committee? Is there anything else that we need to know?	
7. Are you aware of any disagreements between management of the organization and the independent auditors?	
8. Do you feel comfortable raising issues without fear of retribution?	

Conducting an Executive Session— Sample Questions	Comments
Director of Financial Reporting (cont.)	
9. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, federal regulations (if the organization receives federal funding), professional practice, or the mores of business?	
10. Is there anything going on in the organization with which you are uncomfortable?	
11. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	
General Counsel	
1. Are you aware of any issues that could cause embarrassment to the organization?	
2. Have you ever been told anything in confidence or otherwise that would embarrass the organization if it were known publicly?	
3. Are you aware of any situations of revenue or expense manipulation in the organization?	
4. Are there any items that have significant financial statement impact that you have discussed with the executive director, CFO or other officers, or outside counsel, that the audit committee is not already aware of?	
5. Are you aware of any disagreements between management of the organization and the independent auditors?	
6. Do you feel comfortable raising issues without fear of retribution?	
7. Is there any activity at the executive level of management that you consider to be a violation of laws, regulations, GAAP, federal regulations (if the organization receives federal funding), professional practice, or the mores of business?	
8. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet did not go the extra mile to demonstrate its commitment to the highest ethical standards?	

Conducting an Executive Session— Sample Questions	Comments
8. Have you encountered any situations in which the organization complied with legal minimums of behavior, yet did not go the extra mile to demonstrate its commitment to the highest ethical standards?	
General Counsel (cont.)	
9. Is there any activity in the organization that you are uncomfortable with, consider unusual or warrants further investigation?	
10. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	
Chief Information Officer	
1. Is there any activity in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?	
2. Do you feel comfortable raising issues without fear of retribution?	
3. Has management set an appropriate “tone at the top” with respect to the importance of and compliance with the internal control system around financial reporting?	
4. Are there any items that have financial statement impact that you have discussed with the executive director, CFO or other officers, or outside counsel, that the audit committee is not already aware of?	
5. Are there any questions we have *not* asked that should have been asked? If so, what are those questions?	

Conducting an Executive Session—Sample Questions
Independent Auditors
Note that there are certain communications that are required between the independent auditors and the audit committee. A separate tool, "Discussions With the Independent Auditors: What to Expect," has been prepared for the audit committee to ensure completeness of the committee's required communication with the independent auditors. These suggested questions are meant to be in addition to the required communications.
1. Explain the process your firm goes through to ensure that all of your engagement personnel are independent and objective with respect to our audit. Particularly, with respect to nonaudit services, how do those services affect the work that you do or the manner in which the engagement team or others are compensated? Are you aware of any anticipated event that could possibly impair the independence, in fact or in appearance, of the firm and any member of the engagement team?
Comments:
2. Has management, legal counsel, or others made you aware of anything that could be considered a violation of laws, regulations, GAAP, federal regulations (if the organization receives federal funding), professional practice, or the ethics of business?
Comments:
3. Are there any areas of the financial statements and the notes that you believe could be more explicit or transparent, or provide more clarity to help a user better understand our financial statements?
Comments:

Conducting an Executive Session—Sample Questions
Independent Auditors (cont.)
4. Have you expressed any concerns or comments to management with respect to how our financial statement presentation could be improved?
Comments:
5. Which accounting policies or significant business transactions do you think a reader will have trouble understanding based on our disclosure? What additional information could (should) we provide?
Comments:
6. Based on your auditing procedures, do you have any concerns about how management may be recording revenues and expenses? Have you noticed any biases as a result of your audit tests with respect to estimates?
Comments:
7. Are there areas in which you and management have disagreed?
Comments:
8. Discuss your impressions of the performance of the chief audit executive in terms of the completeness, accuracy, and faithfulness of the financial reporting process.
Comments:

Conducting an Executive Session—Sample Questions
Independent Auditors (cont.)
9. Has the firm been engaged to provide any services besides the independent audit and preparation of the IRS Form 990 or Form 990T of which the audit committee is not already aware?
Comments:
10. How can management improve in terms of setting an appropriate "tone at the top"?
Comments:
11. Describe the ideas you have discussed with management for improving the internal control system over financial reporting.
Comments:
12. Describe for us any situation in which you believe management has attempted to circumvent the spirit of GAAP, but has yet complied with GAAP.
Comments:
13. Is there anything going on in the organization that you are uncomfortable with or consider unusual, or that warrants further investigation?
Comments:

Conducting an Executive Session—Sample Questions
Independent Auditors (cont.)
14. Are there any questions we have *not* asked that you wish to share with the audit committee?
Comments:

Other Questions for Management

PURPOSE OF THIS SECTION: It is important for the audit committee to have a solid familiarity with the management team, since the committee relies heavily on them. In some large organizations, there is an expectation that members of the board will interact with members of management one-on-one on a regular basis. However, such interaction is not always possible. This section lists other questions that the audit committee may wish to address to key members of the financial management team. These questions need not be asked in an executive session, but can be addressed more informally as opportunities arise.

Other Questions for Management	Comments
Chief Financial Officer	
1. Describe your working relationship with the executive director.	
2. If you were the partner-in-charge of the audit, what would you do differently?	
3. Are you aware of any disagreements between management of the organization and the independent auditors?	
4. How frequently do you meet with the lead audit partner? Describe your relationship with him or her.	
5. Are you aware of any disagreements between management and the internal auditors?	
6. Describe your relationship with the chief audit executive (CAE). Discuss your impressions of his or her performance.	
7. How do you interface with the internal audit function?	
8. Have the independent auditors been engaged for any services other than the annual audit and preparation of the IRS Form 990 of which the audit committee is not already aware?	
9. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	
10. Which systems are the most difficult to work with?	

Other Questions for Management	Comments
Chief Financial Officer (cont.)	
11. Are there any new systems or functionality that you would like to purchase but have delayed due to cost considerations?	
12. What procedures or oversight do you apply to manual journal entries that are proposed during the book-closing process?	
13. Do the accounting and finance departments of the organization have adequate personnel, both in numbers and quality, to meet all their obligations?	
14. What are the most difficult challenges facing the accounting and finance organization today?	
15. Which departments might benefit the most from additional human resources?	
16. What are the personnel turnover rates in the accounting and finance departments for the last year?	
17. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to address those risks?	
18. What are the biggest risks facing the organization over the long term? What measures do you believe the organization should take to address those risks?	
Executive Director	
1. Discuss your impressions of the performance of the chief audit executive (CAE), chief financial officer (CFO), and controller.	
2. Have the independent auditors been engaged for any services other than the annual audit and preparation of the IRS Form 990 of which the audit committee is not already aware?	
3. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to address those risks?	
4. What are the biggest risks facing the organization over the long term? What measures do you believe the organization should take to address those risks?	

Other Questions for Management	Comments
Chief Audit Executive (leader of Internal Audit function)	
1. What procedures do you apply to the review of manual journal entries made during the book-closing process, and to other entries that could be termed as a management override of the internal control system around financial reporting?	
2. If you were the executive director, how would you do things differently in the internal audit department?	
3. Do you believe you have adequate resources available to you to fulfill the charge of the department? If not, what additional resources are needed?	
4. Did you encounter any disagreements or difficulties between the internal audit team and the independent auditors in connection with the recently completed audit of the organization's financial statements? How will you approach the financial statement audit differently next year?	
5. What critical risks are being monitored by the internal audit team on a periodic or regular basis? How do you address the continuous auditing of these critical risks, and is automation and integrated system reporting assisting you in this effort?	
6. Are you aware of any other disagreements between management of the organization and the independent auditors?	
7. Are there any disagreements between the internal audit team and management?	
8. Have the independent auditors been engaged for any services other than the annual audit and preparation of the IRS Form 990 of which the audit committee is not already aware?	
9. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	

Other Questions for Management	Comments
Chief Audit Executive (leader of Internal Audit function) (cont.)	
10. Do you monitor payments to the independent audit firm to ensure that the auditor is only providing services that are related to the audit, or other services that have been preapproved by the audit committee (e.g., preparation of the IRS Form 990 and/or Form 990T)?	
11. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to address those risks?	
12. What are the biggest risks facing the organization over the long term? What measures do you believe the organization should take to address those risks?	
Controller	
1. Have the independent auditors been engaged for any services other than the annual audit and preparation of the IRS Form 990 and/or Form 990T of which the audit committee is not already aware?	
2. If you were the partner-in-charge of the audit, what would you do differently?	
3. Discuss your impressions of the performance of the chief audit executive.	
4. Are the computer systems upon which you rely integrated, or does it require manual intervention to integrate your systems?	
5. What procedures do you apply to review manual journal entries proposed during the book-closing process, or to other entries that could be termed as a management override of the internal control system around financial reporting?	
6. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to address those risks?	
7. What are the biggest risks facing the organization over the long term? What measures do you believe the organization should take to address those risks?	

Other Questions for Management	Comments
Director of Financial Reporting	
1. How could the financial statements and related disclosures be improved?	
2. Are the computer systems upon which you rely integrated, or is manual intervention required to integrate your systems?	
General Counsel	
1. Discuss your impressions of the performance of the chief audit executive.	
2. Have the independent auditors been engaged for any services other than the annual audit and preparation of the IRS Form 990 of which the audit committee is not already aware?	
3. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to address those risks?	
4. What are the biggest risks facing the organization over the long term? What measures do you believe the organization should take to address those risks?	
Chief Information Officer	
1. Are you satisfied with the integrity of the information running through the systems in the organization? How could technology improve the integrity of the information?	
2. What exposure is associated with the organization's firewalls?	
3. If you had an unlimited budget, how would you spend money to improve the organization's information architecture?	
4. What do you consider your critical risk areas?	
5. Describe your relationship with the CFO and other key people in the accounting and finance departments.	
6. Are manual journal entries identified and approved? Are they brought to the attention of the CAE, or other officer(s) that did not have a hand in creating the journal entries?	

Other Questions for Management	Comments
Chief Information Officer (cont.)	
7. Is documentation updated every time there is a change to the internal controls process?	
8. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to address those risks?	
9. What are the biggest risks facing the organization over the long term? What measures do you believe the organization should take to address those risks?	
Independent Auditors	
1. What role, if any, did your firm have in management's documentation and assessment of the organization's internal control structure?	
2. What audit procedures do you apply to manual journal entries that are proposed during the book-closing process, or to other journal entries that could be termed as a management override of the internal control system around financial reporting?	
3. Was any audit work not performed due to any limitations placed on you by management (e.g., any areas scoped out by management, or any restriction on fees that limited the scope of your work)?	
4. What, if any, changes do you believe need to be made in these areas?	
5. What are the biggest risks facing the organization in the next year? What steps do you think the organization should take to address those risks?	
6. What are the biggest risks facing the organization over the long term?	
7. What measures do you believe the organization should take to address those risks?	

Notes	

Issues Report From Management

PURPOSE OF THIS TOOL: This tool is to be used by audit committees in considering significant issues, estimates, and judgments that may have a material impact on the organization's financial statements, among other concerns. Management should be encouraged to use this tool as a means to document any significant issues, judgments, and estimates for discussion with the audit committee. Each matter should be prepared as a separate issues report. Statements should be clear and concise. Some issues may carry over to subsequent meetings, in which case, any updated information should be included in bold.

Defining Significant Issues, Estimates, and Judgments

As a first step to any discussion of this nature among the audit committee members, it is important for the audit committee to define its threshold for a significant issue, judgment, and estimate. The following are some points that the audit committee should consider in its quest to define a significant issue, estimate, or judgment.

A significant issue, estimate, or judgment is one that:

1. Creates controversy among members of the management team, or between management and the internal or independent auditors.
2. Has or could have a material impact on the financial statements.
3. Is or could be a matter of public interest or exposure.
4. May be reported in an external release of financial information and management is unclear or undecided on its presentation. (This may include the Annual Report, federal and state filings, and any bond filings.)
5. Applies a new accounting standard. (*Note:* the application of a new accounting standard may or may not be considered a significant issue, estimate, or judgment for the organization. However, for the record, the audit committee may ask management to use this format as a means to brief the audit committee on the application of the new standard.)
6. Relates to the application of an accounting standard in a way that is not consistent with general practice.
7. Relates to key controls over financial information that are being designed or redesigned, have failed, or otherwise are being addressed by the organization.

The audit committee needs to be proactive and consistent in its inquiries regarding significant issues, estimates, and judgments. At each meeting, the audit committee should inquire about current and/or unresolved issues or problems that have arisen in the financial, compliance, or operational control environment. Management's response should be documented in the meeting minutes.

Management's report to the audit committee concerning significant issues, estimates, and judgments should contain the following elements for a proper basis of discussion by the audit committee:

1. *Definition of the significant issue, estimate, or judgment.* In this section of the issues report, management should define or summarize the issue as concisely and clearly as possible.
2. *Management's position.* This section should address management's position on the issue. If there is disagreement among members of management, those disagreements should be identified here as explicitly as possible, with brief explanations of why each member of the management team has taken his or her respective position.
3. *Relevant literature.* Any professional literature or regulatory requirements addressing this issue should be cited here. If there is no professional literature available, it would be appropriate to define industry practice in this space. If this is a developing area, and there is no accepted industry practice or other sources to support or refute these positions, this fact should be reported. If there is a choice on the accounting treatment, that should be disclosed here along with a discussion on how the choices of treatment were compared and the basis for the final choice made.
4. *Risks.* Management should identify various risks and/or opportunities associated with this proposal.
5. *Federal or state agency or other regulatory disclosure.* Management must inform the audit committee of how it intends to address this issue in required filings.
6. *Auditor's position.* Has management consulted with the independent auditors on this issue? Do they agree with management's position? Have they addressed the audit issues that might be associated with it? If so, use this section of the issues report to discuss their position. If not, use this section to explicitly state that the auditors have not been consulted.
7. *Other information relating to this issue, estimate, or judgment.* Management should use this section of the issues report to highlight other related and relevant information that is not already included in the previous sections.

Discussions With the Independent Auditors: What to Expect

PURPOSE OF THIS TOOL: Auditing standards issued by the AICPA require that the auditor communicate, either orally or in writing, certain information to an audit committee of the board, or another designated party that performs oversight of the financial reporting process.

Communications with the audit committees have engendered more public scrutiny in light of what is considered to be best practices for governance. Independent auditors, in the wake of well-documented audit failures, are required to increase their documentation and communication efforts as they relate to their interactions with the audit committee. The following sections list matters that must be communicated. This list is not meant to indicate that this is all that the auditor is communicating to the audit committee.

Auditor's Responsibility Under Generally Accepted Auditing Standards

It is important for audit committees to understand what an audit is and what it is not. Usually, audit committees are most concerned about the system of internal control and that the organization's financial statements are free of material misstatement. The auditor should make sure the audit committee understands the level of responsibility that the auditor assumes for the system of internal control and the financial statements under generally accepted auditing standards (GAAS). It is also important that the auditor make sure that the audit committee understands that an audit is designed to obtain reasonable rather than absolute assurance about the financial statements.

Significant Accounting Policies

The auditor should determine that the audit committee is informed about all significant accounting policies and how they are applied in the organization. To make sure, the audit committee should expect that the auditors will communicate the following:

1. All significant accounting policies, including those that applied for the first time during the year.
2. How those accounting policies are applied in the organization.
3. Methods the organization used to account for significant unusual transactions.
4. The effect of significant accounting policies in controversial or emerging areas for which there is lack of authoritative guidance or consensus (for example, revenue recognition, off-balance-sheet financing).

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of the financial statements prepared by management. These estimates are based on management's judgments (which are normally based on management's knowledge and experience about past and current events), and assumptions about future events.

The auditor should address the following issues with the audit committee:

1. The process used by management in formulating particularly sensitive accounting estimates.
2. The basis for the auditor's conclusion about the reasonableness of those estimates.

Audit Adjustments

The auditor should inform the audit committee about all audit adjustments arising from the audit that could, in the auditor's judgment, have a significant effect on the organization's financial reporting process. The audit team will keep track of those proposed adjustments for later discussion with management. Management will evaluate those proposed adjustments and decide whether the adjustment should be booked to the account balances as proposed. The auditor may find it necessary to qualify the audit report if management does not record the adjustments that the auditor deems necessary to record.

As part of its communications, the auditor should:

1. Inform the audit committee about adjustments arising from the audit that could either individually or in the aggregate have a significant effect on the organization's financial reporting process.
2. Address whether the adjustments were recorded.
3. Determine whether the adjustments may not have been detected except through the auditing procedures performed (meaning that the organization's own internal control system did not detect the need for the adjustment).
4. Explain about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the most recent period presented in the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

Auditor's Judgments About the Quality of the Organization's Accounting Principles

Note: This communication is required for audits of public companies. It is not required for organizations that are not public companies, but could be considered a best practice.

Although objective criteria for evaluating the quality of an organization's accounting practices have not been established, the auditor's judgments about the quality, not just the acceptability of the organization's accounting principles as applied in its financial statements, including disclosures, should be discussed. The discussion should be open and frank, and tailored to the organization's specific circumstances. It should include the following topics:

1. Consistency of the organization's accounting principles and their application
2. Clarity of the financial statements and related disclosures
3. Completeness of the financial statements and related disclosures

4. Any items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements, examples of which follow:

   a. Selection of new accounting policies or changes to current ones

   b. Estimates, judgments, and uncertainties

   c. Unusual transactions

   d. Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded

5. A discussion of accounting practices that are not specifically addressed in the accounting literature, for example, those that may be unique to the not-for-profit industry.

Other Information Contained in Audited Financial Statements

Although the notes to the financial statements are an integral part of the financial statements and therefore are included in the scope of the auditing procedures, other information prepared by management that may accompany financial statements is not necessarily included in the scope of the auditing procedures.

The auditor should discuss the responsibility, if any, that he or she has for other information in documents containing audited financial statements, any procedures performed, and the results.

Disagreements With Management

Disagreements may arise between the auditor and management over the application of accounting principles to specific transactions and events, as well as the basis for management's judgments about accounting estimates, or even the scope of the audit or disclosures to be made in the financial statements or footnotes. Differences of opinion based on incomplete facts or preliminary information that are later resolved are not considered disagreements for this purpose.

When meeting with the audit committee, the auditors should discuss any disagreements with management, whether or not resolved, about matters that individually or in the aggregate could be significant to the organization's financial statements or the auditor's report.

Consultation With Other Accountants

Sometimes, management of the organization may consult with other accountants about accounting and auditing matters. If the auditor is aware that such consultation has occurred, the auditor should discuss with the audit committee their views about the significant matters that were the subject of the consultation. The audit committee may wish to ask management whether they have consulted with other accountants about accounting and auditing matters.

Major Issues Discussed With Management Prior to Retention

The auditor should discuss with the audit committee any major issues that were discussed with management in connection with the initial or recurring retention of the auditor. This includes any discussions regarding the application of accounting principles or auditing standards.

Difficulties Encountered in Performing the Audit

The auditor should inform the audit committee about any serious difficulties encountered in working with management during the audit. Examples include, but are not limited to:

1. Unreasonable delays by management in allowing the commencement of the audit
2. Unreasonable delays by management in providing needed information to the auditor
3. Unreasonable timetable set by management for the conduct of the audit
4. Unavailability of client personnel
5. Failure of client personnel to complete client-prepared schedules on a timely basis

Illegal Acts

The auditor has the responsibility to assure himself or herself that the audit committee is adequately informed about illegal acts that come to the auditor's attention (this communication need not include matters that are clearly inconsequential). The communication should describe (1) the act, (2) the circumstances of its occurrence, and (3) the effect on the financial statements.

What is an illegal act for purposes of this communication? Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), defines it as violations of laws or government regulations attributable to the entity, or acts by management or employees on behalf of the entity. Illegal acts do not include personal misconduct by the entity's personnel unrelated to their business activities.

Internal Control Matters

See also the tool, "Internal Control: A Tool for the Audit Committee," elsewhere in this toolkit.

SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325) as amended, requires the auditor to communicate matters relating to the organization's internal control that are observed by the auditor in the conduct of a financial statement audit. These matters should be discussed with the audit committee because they represent significant deficiencies in the design or operation of the internal control system, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

Fraud

See also the tool, "Fraud and the Responsibilities of the Audit Committee: An Overview," elsewhere in this toolkit.

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), requires that the independent auditor bring any evidence of fraud to the attention of the appropriate level of management (generally seen as one level higher than the level at which a suspected fraud may have occurred), even in the case of an inconsequential fraud, such as a minor defalcation by an employee or volunteer. The independent auditor should reach an understanding with the audit committee regarding when an inconsequential fraud (nature and scope) conducted by a low-level employee should be brought to the audit committee's attention.

Fraud involving senior management, and any fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements must be reported to the audit committee by the independent auditors.

Evaluating the Independent Auditors: Questions to Consider

PURPOSE OF THIS TOOL: The audit committee or the board of directors should have the responsibility to hire, fire, and evaluate the independent auditors. In discharging these responsibilities, the audit committee should answer a series of questions about its relationship with the independent auditors and should ask key executives in the organization for their comments as well.

In considering information gathered through the process of evaluating the independent auditors, it is important that the audit committee give consideration to the source of the information. For example, if the chief financial officer (CFO) or controller comments that he or she believes the auditors went too far in certain areas, that would probably carry less weight in audit committee deliberations than if the CFO or controller comments that certain areas were not tested adequately. As with all deliberative processes, the audit committee should consider the different perspectives and motivations of those having input into the deliberations.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are only a starting point to evaluating the performance and effectiveness of the independent auditors. Audit committee members should ask follow-up questions as appropriate and required.

Evaluation of the Independent Auditors	Yes	No	Not sure	Comments
Questions for Audit Committee Members				
1. Did the auditors meet with the audit committee when requested?	☐	☐	☐	
2. Did the auditors address issues of "tone at the top" and antifraud programs and controls in place in the organization?	☐	☐	☐	
3. Did the auditors inform the audit committee of any risks of which the committee was not previously aware?	☐	☐	☐	
4. Did the auditors adequately discuss issues of the quality of financial reporting, including the applicability of new and significant accounting principles?	☐	☐	☐	
5. Did the auditors communicate issues freely with the audit committee, or did they seem protective of management?	☐	☐	☐	
6. Does it appear that management exercises undue influence on the independent auditors?	☐	☐	☐	
7. Does it appear that the independent auditors are reluctant or hesitant to raise issues that would reflect negatively on management?	☐	☐	☐	
8. Is the audit committee satisfied with the planning and conduct of the audit, including the financial statements and internal control over financial reporting (as applicable)?	☐	☐	☐	

Evaluation of the Independent Auditors	Yes	No	Not sure	Comments
Questions for Audit Committee Members (cont.)				
9. Is the audit committee satisfied that the independent auditors remain independent and objective both in fact and appearance? • Review all audit-related and nonaudit services conducted by the independent auditors in the prior year. • Review whether the firm, the office or the partner is dependent on the organization for a material percentage of its fee income. • Review whether former members of the audit team are now employed by the organization. If any of these conditions exist, the audit committee should consider whether they impair the independence with respect to the organization. (See tool "Independence and Related Topics: Conflict of Interest, Related Parties, Inurement, and Other Issues.")	☐	☐	☐	
10. *a.* How is the concurring partner (if applicable) compensated?	☐	☐	☐	
b. Is the concurring partner "protected" in the event a tough call needs to be made?	☐	☐	☐	
11. Is the audit committee satisfied with its relationship with the auditors? In making this determination, the audit committee should consider (*a*) whether the partner-in-charge of the audit participated in audit committee meetings, (*b*) whether the auditors were frank and complete in the required discussions with the audit committee, (*c*) whether the auditors were frank and complete during executive sessions with the audit committee, (*d*) whether the auditors are on-time in their delivery of services to the organization.	☐	☐	☐	

Evaluation of the Independent Auditors	Yes	No	Not sure	Comments
Questions for Audit Committee Members (cont.)				
12. Was the audit fee fair and reasonable in relation to what the audit committee knows about fees charged to other nonprofit organizations, and in line with fee benchmarking data the audit committee might have available to it?	☐	☐	☐	
13. Did the independent auditors provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting?	☐	☐	☐	
14. Did the independent auditors demonstrate an ongoing understanding of the uniqueness of nonprofit organizations, especially those operating in the sector of this organization?	☐	☐	☐	
Following are some questions the audit committee should ask different individuals in the organization to assist in evaluating the performance of the independent auditors.				
Executive Director				
1. From your perspective in working with the independent auditors, are you satisfied with the scope, nature, extent, and timing of testing performed by the independent auditors?	☐	☐	☐	
2. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work?	☐	☐	☐	
3. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s), and fieldwork leaders?	☐	☐	☐	
4. Did the independent auditors provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting?	☐	☐	☐	

Evaluation of the Independent Auditors	Yes	No	Not sure	Comments
Executive Director (cont.)				
5. *a.* If the choice were yours, would you hire the firm to conduct next year's audit?	☐	☐	☐	
b. If yes, are there any changes you would make?	☐	☐	☐	
6. Are you satisfied with the quality and quantity of information provided by the independent auditors relative to the general progress of the audit?	☐	☐	☐	
7. Were identified problems or potential issues brought to your attention in sufficient time to be addressed without delaying or extending the completion of the audit?	☐	☐	☐	
Chief Audit Executive				
1. From your perspective in working with the independent auditors, are you satisfied with the scope, nature, extent, and timing of testing performed by the independent auditors?	☐	☐	☐	
2. Did the independent auditors work with you to ensure the coordination of audit efforts to assure the completeness of coverage, reduction of redundant efforts, and the effective use of audit resources?	☐	☐	☐	
3. *a.* Are you satisfied with the knowledge, skills, and abilities of the staff assigned to do the audit work?	☐	☐	☐	
b. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s) and fieldwork leaders?	☐	☐	☐	
4. *a.* Did the independent auditors work with the internal auditors according to the plan?	☐	☐	☐	
b. Was cooperative work conducted in the spirit of professionalism and mutual respect?	☐	☐	☐	

Evaluation of the Independent Auditors	Yes	No	Not sure	Comments
Chief Audit Executive (cont.)				
c. Are you satisfied with the quality and quantity of information provided by the independent auditors relative to internal audit's performance related to the audit?	☐	☐	☐	
5. Are you satisfied that the independent auditors remain independent of the organization in spite of any audit-related, or nonaudit services the auditors provide to the organization?	☐	☐	☐	
6. *a.* Are you aware of any other information that might impair the independence of the independent audit firm?	☐	☐	☐	
b. Are you aware of any individuals on the audit team that might not be independent with respect to the organization for whatever reason?	☐	☐	☐	
7. *a.* If the choice were yours, would you hire the firm to conduct next year's audit?	☐	☐	☐	
b. If yes, are there any changes you would make?	☐	☐	☐	
CFO (or Finance Director)				
1. From your perspective in working with the independent auditors, are you satisfied with the scope, nature, extent, and timing of testing performed by the independent auditors?	☐	☐	☐	
2. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work?	☐	☐	☐	
3. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s), and fieldwork leaders?	☐	☐	☐	
4. Did the independent auditors provide constructive observations, implications, and recommendations in areas needing improvement, particularly with respect to the organization's internal control system over financial reporting?	☐	☐	☐	

Evaluation of the Independent Auditors	Yes	No	Not sure	Comments
CFO (or Finance Director) (cont.)				
5. *a.* If the choice were yours, would you hire the firm to conduct next year's audit?	☐	☐	☐	
b. If yes, are there any changes you would make?	☐	☐	☐	
6. Are you satisfied with the quality and quantity of information provided by the independent auditors relative to the general progress of the audit?	☐	☐	☐	
7. Were identified problems or potential issues brought to your attention in sufficient time to be addressed without delaying or extending the completion of the audit?	☐	☐	☐	
Controller (or Chief Accounting Professional)				
1. From your perspective in working with the independent auditors, are you satisfied with the scope, nature, extent, and timing of testing performed by the independent auditors?	☐	☐	☐	
2. Are you satisfied with the knowledge, skills, and abilities of the staff assigned to the audit work?	☐	☐	☐	
3. Are you satisfied with the engagement leadership assigned, including the partner(s), manager(s), and fieldwork leaders?	☐	☐	☐	
4. *a.* If the choice were yours, would you hire the firm to conduct next year's audit?	☐	☐	☐	
b. If yes, are there any changes you would make?	☐	☐	☐	
5. Are you satisfied with the quality and quantity of information provided by the independent auditors relative to the general progress of the audit?	☐	☐	☐	
6. Were identified problems or potential issues brought to your attention in sufficient time to be addressed without delaying or extending the completion of the audit?	☐	☐	☐	

Evaluation of the Independent Auditors	Yes	No	Not sure	Comments
Other Comments, Further Questions				

Evaluating the Internal Audit Team: Guidelines and Questions

PURPOSE OF THIS TOOL: The sample questions included in this tool are only a starting point to assist the audit committee in evaluating the performance and effectiveness of the internal audit team. Follow-up questions should be considered as appropriate. Please also note that many not-for-profit organizations are not large enough to necessitate the formation of an internal audit team. Each organization's audit committee should evaluate the need for such a team before implementing one.

Audit Committee or Board Relationship With Internal Audit Team

It is in the best interest of all concerned for the audit committee or board of directors and the internal audit team to maintain a strong positive relationship. The audit committee should view the internal audit team as their eyes and ears about what is going on within the organization. The audit committee should promote a relationship of healthy professional skepticism between the chief audit executive and the chief financial officer (CFO), though it is these two individuals that will likely spend the most time working with the audit committee.

The audit committee chair and the leader of the internal audit team (the chief audit executive, or CAE) should have frequent contact between meetings of the audit committee. In fact, the CAE should have a "solid-line" reporting relationship to the audit committee (with a "dotted-line" reporting relationship to a senior executive in the organization for administrative purposes), and the audit committee should be consulted before the CAE can be hired, fired, or reassigned.

At every audit committee meeting the committee should hold an executive session with the CAE to ask specific questions (see the tool, "Conducting an Audit Committee Executive Session: Guidelines and Questions" elsewhere in this toolkit). It is best for the audit committee to ask specific, yet open-ended questions, and to probe deeper with the CAE on answers that might be puzzling or incomplete. The CAE should be forthcoming with information including the results of audits conducted, as well as the audit currently underway. The internal audit team must recognize that it is an agent of the audit committee and not management.

The CAE should be the keeper of the audit committee charter and should consult with the committee chair and the CFO in developing meeting agendas.

Periodically, the CAE should review with the audit committee the staffing needs of the internal audit team, and the competencies of the individuals filling those positions. As a best practice, the internal audit team should not be the victim of a downsizing; in fact, it is at precisely this time that the internal audit team should be doing extra monitoring regarding the safeguarding of assets, the integrity of the internal control system, and related matters.

Discussions between the CAE and the audit committee should also address the competencies of the financial management team. The internal audit team is in the best position to determine whether the financial management team is able to address complex accounting issues on its own, or whether it relies too heavily on the independent auditors or other consultants for evaluation and decision-making.

The audit committee should also promote a positive working relationship between the CAE and the independent auditors. If possible, the independent auditors should rely on the work of the internal auditor to supplement or limit their own testing. Generally accepted auditing standards (GAAS) require that the independent audit firm maintain control of the work being performed on its behalf, and to reperform some of the testing to reach its own conclusion about the work of the internal auditor.

Finally, the audit committee should periodically assess the performance of the CAE and the internal audit team to ensure that they are the appropriate agent of the audit committee in the organization. The following tool includes some sample questions that the audit committee should ask itself in evaluating the effectiveness of the internal audit team.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are only a starting point to evaluating the performance and effectiveness of the internal audit team. Audit committee members should ask follow-up questions where appropriate.

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
1. Does the department appear to be using its time and resources effectively and efficiently?	☐	☐	☐	
2. Are the department's size and structure adequate to meet its established objectives?	☐	☐	☐	
3. Is the experience level of the internal auditors adequate?	☐	☐	☐	
4. Does the department appear to be objective, and what procedures are performed to ensure objectivity?	☐	☐	☐	
5. Is the technical knowledge of the department members sufficient to ensure that duties are performed appropriately?	☐	☐	☐	
6. Does the department have an appropriate continuing education program?	☐	☐	☐	
7. Are there department members with sufficient information systems auditing expertise to address the level of technology used by the organization?	☐	☐	☐	
8. Is the department's work planned appropriately?	☐	☐	☐	
9. Does planning include written audit plans and programs?	☐	☐	☐	
10. What types of reports are issued by the internal audit department and to whom?				
Notes:				
11. Are the internal audit reports issued on a timely basis?	☐	☐	☐	

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
12. Do the internal audit reports include sufficient detail for effective action by management and/or the audit committee?	☐	☐	☐	
13. Does management respond in an appropriate and timely fashion to significant recommendations and comments made by the internal auditors?	☐	☐	☐	
14. Do internal audit procedures encompass operational as well as financial areas?	☐	☐	☐	
15. To what extent does the internal audit team perform certain preparatory audit procedures, including internal control grids, for the independent auditors that would alleviate management from this task?				
16. To what extent does the internal audit team "dialog" with the organization's independent auditors, including review of management letter comments and regulatory audit reports, e.g., OMB Circular A-133?				
17. To what extent is the internal audit team involved with management and the independent auditors to plan the scope of the external audit, with reference to internal audit areas reviewed by the team since the last external audit?				
18. Was the department's involvement in the annual audit effective?	☐	☐	☐	
19. What could be done in the future to maximize the department's effectiveness and efficiency?				
Notes:				
20. To what extent is outsourcing used in the internal audit function, what areas are outsourced, and to whom are they outsourced?				
Notes:				

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
21. Does the internal audit team have a periodic "peer review" performed and, if so, what were the results of the latest review?	☐	☐	☐	
Notes:				
22. What criteria are used to establish and prioritize the annual and long-range internal audit plan?				
Notes:				
23. Is the department's work concentrated in areas of high risk, judgment, and sensitivity?	☐	☐	☐	
24. To what extent does the internal audit team keep itself informed about, and involved in, professional activities?				
Notes:				
25. What are the internal auditors' views regarding controls, the risk of fraud, and compliance matters?				
Notes:				
26. Has the charter of the internal audit department been evaluated to determine that it is still appropriate?	☐	☐	☐	
27. To what extent is the internal audit team itself informed about the not-for-profit environment by membership and/or leadership in industry-wide monitoring and/or watchdog groups?				
Notes:				

Evaluation of Internal Audit Team	Yes	No	Not Sure	Comments
28. To what extent does the internal audit team react to news and information about industry-wide events and possible areas of exposure posed by other not-for-profit organizations?				
Notes:				
29. To what extent is the internal audit team involved with the "exit conferences" between management and regulatory and/or compliance auditors?				
Notes:				
30. To what extent does the internal audit team "sign off" on resolutions of management comments by outside independent auditors?				
Notes:				

Other Questions or Comments	

Conducting an Audit Committee Self-Evaluation: Guidelines and Questions

PURPOSE OF THIS TOOL: Audit committees should conduct a self-evaluation on an annual basis. This can be accomplished in a number of different evaluation formats and scenarios (through the use of outside evaluators, a 360-degree evaluation format, and other methods). The sample questions included in this tool are suggestions and intended to provide a starting point to evaluating the performance and effectiveness of the audit committee. Follow-up questions are encouraged, and the committee should plan for further action as appropriate.

An audit committee should conduct a comprehensive self-evaluation on an annual basis. The self-evaluation can take different forms, involve a number of participants, and use diverse techniques. Most important, however, the self-evaluation should adopt a straightforward approach that will aid the audit committee in assessing its strengths and weaknesses and lay a foundation for future improvement. Some guidelines in designing the format for self-evaluation would include the following areas of consideration.

1. *Introspection.* Be introspective. Evaluate the audit committee's performance by asking specific questions about the impact it has had on the organization, and most importantly, its financial reporting process, the annual audit, the relationship with the independent auditor, and members of management. Include the chair of the board in this evaluation session and ask for his or her input as well.

2. *Comprehensive.* Conduct 360-degree evaluations of all audit committee members and the committee chair. A 360-degree evaluation is one that obtains anonymous feedback from a large group of individuals representing various perspectives. In this setting, each committee member would conduct a self-evaluation and be evaluated by the other committee members, the board chair, chief audit executive, chief financial officer, and executive director, and if appropriate, other senior finance/accounting personnel. The board chair and the audit committee chair should consider the result of the evaluations. They should decide whether any members of the committee should be rotated off the committee and/or whether the chair of the committee should be rotated. The members' attendance record and level of participation should be considered during this process.

3. *Competency.* Use tools that are available, including the AICPA Competency Self-Assessment Tool (CAT) to evaluate performance. The CAT is available at www.cpa2biz.com/CPE Conferences/ CAT.htm.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions provided in this tool are only a starting point to evaluating the performance and effectiveness of the audit committee. Before completion, the committee should determine how it can best ensure that responses reflect a forthright exchange of ideas and opinions among audit committee members. The committee should determine how the process should be completed. The following sample questions can be completed anonymously, before attending an evaluation discussion meeting or during a session of the committee. Discuss the following questions and include notes and comments if you feel further action is appropriate.

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
1. Does the audit committee have the appropriate number of members? We would suggest a minimum of three members. The audit committee should not be so large that: • Its ability to operate efficiently and effectively is reduced. • Members' ability to raise issues is hampered. • It is difficult to get a quorum when a time-sensitive issue arises. The audit committee should have a sufficient number of members to ensure needed skill sets and knowledge are represented on the committee. An independent nominating/governance committee or independent directors have responsibility for appointing audit committee members and selecting the chair.	☐	☐	☐	
2. Do all members continue to be independent, as defined by policies applicable to the organization? In addition to meeting the technical definitions of independence, committee members demonstrate their objectivity during meetings, through behaviors such as driving agendas, rigorous probing of issues, consulting with other parties, and hiring experts, as necessary.	☐	☐	☐	

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
3. Are differences of opinion on issues resolved to the satisfaction of the committee?	☐	☐	☐	
4. Do the members challenge the chair as appropriate?	☐	☐	☐	
5. Is the audit committee charter used as a document to guide the committee in its efforts, and to help guide the committee's agenda? Is the audit committee charter matrix used to document compliance with the precepts of the charter?	☐	☐	☐	
6 Are the members financially literate and has the audit committee determined that it has adequate financial expertise in accordance with its charter? Examples of this could be through the following: (a) The committee has a full understanding of the composition of the organization's statement of financial position, including the degree of management judgment inherent in the various accounts. (b) The committee understands which financial ratios and indicators are key to the organization and industry, how the organization's performance compares with its budgetary targets and its peers, and how management plans to address any unfavorable variances. (c) The committee discusses the initial selection of or changes in significant accounting policies used in developing the financial statements, the reason for and impact of any changes in policy, and reasons alternative treatments were not adopted. (d) The committee discusses significant, complex, or unusual transactions with management and the external auditors.	☐	☐	☐	

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
(e) The committee understands which areas represent high risk for material misstatement of the financial statements, and discusses assumptions and approaches used with management and the external auditors. (f) The committee forms its own view of the risk of material misstatement due to fraud, discusses with management and the external auditors their views on the risk of material misstatement due to fraud, and is comfortable that any differences in views can be reconciled. (g) The committee fully understands significant changes in financial statements from prior years and from budget, and is provided with sufficient, reliable evidence to support variances. (h) The committee commits sufficient time to review, discuss, and consider the financial statements. (i) The committee meets with financial management to discuss results reported before finalization.				
7. Does the committee engage outside experts as appropriate?	☐	☐	☐	
8. Are the organization's financial reporting processes stronger as a result of management's interactions with the audit committee? For example: (a) The audit committee understands and agrees with the board on which categories of internal control it oversees. Categories include (from the COSO standards): • Integrity of financial reporting • Compliance with laws and regulations • Operational efficiency and effectiveness	☐	☐	☐	

Audit Committee Self-Evaluation Tool	Yes	No	Not Sure	Comments
The committee and the board concur with any changes to the committee's internal control oversight mandate. (b) The audit committee understands the current high-risk areas—including information technology and computer systems—in the categories of controls it oversees, as well as how management addresses those areas.				
9. Is the committee cognizant of the line between oversight and management, and does it endeavor to respect that line?	☐	☐	☐	
10. Does the committee conduct executive sessions in a manner that offers a "safe haven" to the individual, while at the same time asking tough and necessary questions, evaluating the answers, and pursuing issues that might arise to a satisfactory resolution?	☐	☐	☐	
11. Do audit committee members participate in some form of continuing education to stay abreast of changes in the financial accounting and reporting, regulatory and ethics areas?	☐	☐	☐	
12. Does the committee do its part to ensure the objectivity of the internal audit team?	☐	☐	☐	
13. Does the committee provide constructive feedback to the chief audit executive at least annually?	☐	☐	☐	
Follow-Up Questions				
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	
	☐	☐	☐	

Audit Committee Self-Evaluation Tool	Comments
Other Self-Evaluation Notes	

Single Audits—Circular No. A-133: Audits of States, Local Governments, and Non-Profit Organizations

PURPOSE OF THIS TOOL: Office of Management and Budget (OMB) Circular A-133 was issued pursuant to the Single Audit Act of 1984 and subsequent amendments. It establishes the standards in order to obtain consistency and uniformity among federal agencies for the audit of states, local governments, and not-for-profit organizations expending federal awards.

This tool is intended to aid not-for-profit organizations in complying with the requirements and expectations of the Single Audit Act, as well as to assist with compliance of the provisions of the Act.

The Single Audit Act requires that nonfederal entities that expend $500,000 or more a year in federal awards have a single or program-specific audit in accordance with the provisions of the Act's audit requirements. The determination of when an award is expended should be based on when the award activity occurs. Expenditures include cash transactions, loans, loan guarantees, federally restricted endowment funds, and various other types of noncash assistance, such as interest subsidies. A program-specific audit may be elected only when an auditee expends federal awards under one federal program (excluding research and development, which is considered as one major program) and the federal program's laws, regulations, or grant agreements do not require the auditee to have a financial statement audit.

Requirements and Responsibilities

Recipients of federal awards are required to:

- Maintain a system of internal control over all federal programs in order to demonstrate compliance with pertinent laws and regulations.
- Identify all grant programs by Catalog of Federal Domestic Assistance (CFDA) number and title, awarding agency, year of award, and any pass-through entities if applicable.
- Ensure that audits mandated under OMB Circular A-133 are performed and filed with appropriate federal entities as required.
- Follow up on any audit findings, questioned costs, or compliance issues. This involves specific responses and, when necessary, taking corrective action that will resolve current and/or previous findings.
- Sign the official data collection and single audit submission form that is prepared in conjunction with the independent auditor. The recipient organization is legally responsible for the accuracy and timely submission of these forms even if the auditor prepares the forms.

Auditors of recipients of federal awards are required to:

- Plan and conduct the audit in accordance with GAAS (generally accepted auditing standards) and GAGAS (generally accepted government auditing standards).
- Determine if the organization-wide and federal awards financial statements are presented fairly in accordance with GAAS and GAGAS.
- Determine if the Schedule of Expenditures of Federal Awards is presented fairly in relation to the organization's financial statements as a whole.
- Perform tests that demonstrate an understanding of the recipient's internal controls in order to support a "low assessed risk" for major programs.
- Determine that the recipient has complied with laws, regulations, and grant agreements through review and testing procedures.
- Follow up on the status of previous audit findings.

Awarding agencies have the following responsibilities in the audit process:

- Ensure that audits are completed and filed on time.
- Provide technical assistance to auditors and recipients who may have audit questions.
- Issue a management decision on financial and compliance audit findings within six months after an audit report has been submitted.
- Ensure that recipients follow up on audit findings and develop and implement a corrective action plan if necessary.

Reporting

The auditor's report may be in the form of either combined or separate reports. The auditor's report will state that the audit was conducted in accordance with OMB Circular A-133 and include the following:

- An opinion (or disclaimer of opinion) about whether the financial statements and schedules of expenditures are fairly presented in accordance with GAAP.
- Report on the status of internal controls relative to the financial statements and major programs.
- Compliance report that describes the degree to which the recipient has complied with laws, regulations, and the terms and conditions of the federal assistance awards.
- Schedule of findings and questioned costs.
- List of major programs using the required risk-based methodology.
- Determination concerning federal programs as to whether the recipient of the federal award is a "high risk" or "low risk."

Conclusion

The specific requirements and responsibilities of federal agencies and nonfederal recipients are detailed in OMB Circular A-133 (see the Circular available at www.whitehouse.gov/omb/circulars/a133/a133.html). Federal agencies are required to apply the provisions of Circular A-133 to all nonfederal entities that receive and expend federal awards either directly from federal awarding agencies or as subrecipients who receive federal awards from a pass-through entity.

Unique Transactions and Financial Relationships

PURPOSE OF THIS TOOL: Some transactions and financial relationships put an organization at increased financial risk. Generally accepted accounting principles (GAAP) provide guidance about how an organization should account for and report these transactions and relationships as a means to fully inform the entity's constituents. It is important that the audit committee understand the nature and the reason for these transactions and relationships, and ensure that management adequately discloses them in its financial statements. This tool is intended to assist audit committee members in gaining an understanding of these unique transactions and relationships so they may assess the appropriateness of management's accounting treatment for them and whether it meets the objectives of financial reporting.

Some transactions and financial arrangements put an organization at increased financial risk. The audit committee should be aware of these transactions, relationships, and circumstances that may require recognition in the organization's financial statements and should ensure that those transactions and events have been accounted for properly. Some of the more common of these transactions and relationships that the audit committee should be aware of are:

1. Tax-exempt financing
2. Investments in derivative financial instruments
3. Securities lending transactions
4. Relationships with legally separate entities
5. Joint ventures with other governments or organizations

The following information provides background about these types of transactions and relationships.

Tax-Exempt Financing

Many NPOs enjoy the benefit of tax-advantaged borrowing through the use of tax-exempt bonds. In the typical tax-exempt bond transaction, a conduit governmental agency issues bonds carrying interest rates below those of taxable bonds on behalf of the not-for-profit organization (NPO). Upon issuance, the bonds are purchased by an underwriter and sold to institutional investors, the general public, or both. The conduit agency simultaneously lends the proceeds to the NPO at repayment terms specified in the loan agreement and the bond indenture. Some tax-exempt bonds are issued with credit enhancement, giving the investors in such bonds assurance regarding their creditworthiness. NPOs use credit enhancement to lower the overall cost of borrowing. Such enhancement may be employed in the form of bond insurance or a letter of credit from a highly rated financial institution. In such cases the provider of credit enhancement usually requires certain fees, financial covenants, collateral, or any combination of such, from the NPO in return for providing the enhancement.

To assure success, the typical tax-exempt bond transaction involves the services of many experts. For example, the NPO should employ the services of competent borrower's counsel having an excellent track record in transactions similar to the proposed deal. The NPO will also need a highly experienced underwriter to help structure the deal, guide the process, and eventually sell the bonds. Often, an NPO borrower will engage a financial consultant to assist in developing financial proformas. In consultation with the conduit governmental issuer, the NPO will select the bond counsel, whose role is to protect the interests of bondholders and certify the bonds as tax exempt. If credit enhancement is part of the plan, the NPO will select an appropriate provider and negotiate the best possible credit deal. In addition, the conduit issuer and the credit enhancement provider will be represented by legal counsel. The fees for all these professionals are normally paid by the NPO borrower and become part of the bond issuance costs.

Bond issuance costs generally should not exceed 2 percent of the total face amount issued. Additionally, the repayment term for tax-exempt bonds usually cannot exceed the average estimated economic life of the project costs funded by such bonds and proceeds from the tax-exempt financing generally cannot be used to fund costs for which specific resources have been dedicated, such as restricted contributions received from institutional and individual donors.

Many regulatory issues are operative in issuing tax-exempt bonds. Audit committees of NPO tax-exempt bond borrowers should obtain assurance from management, competent advisers, or both that all applicable laws and regulations have been observed. Specific consideration should be given to:

1. State laws governing issuance and the use of tax-exempt bond proceeds—Although tax-exempt borrowing is allowed by federal law (under certain circumstances), each state must enact enabling legislation to designate conduit issuers and regulate the use of tax-exempt bond proceeds. For example, some states may restrict the use of tax-exempt bond proceeds to housing programs.

2. IRS regulations concerning:

   a. Use of proceeds—IRS regulations include specific qualified uses for tax-exempt bond proceeds. Generally, proceeds must be used primarily for capital projects, with certain exceptions. No more than 2 percent of proceeds may be used to finance issuance costs.

   b. Qualifying borrowers and issuers—Issuance of tax-exempt bonds and use of the proceeds therefrom is restricted to certain types of entities. The IRS is the watchdog agency to ensure that the substantial benefits provided by tax-exempt borrowing accrue only to the intended beneficiaries.

   c. Report filing—At issuance, the NPO borrower must file IRS Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues. In addition, throughout the life of the bonds, the NPO borrower must periodically file additional forms with the IRS.

   d. Arbitrage rebate—These regulations are extremely complex, usually requiring the assistance of special experts to ensure compliance. IRS arbitrage rebate regulations ensure that NPO borrowers use bond proceeds in a timely manner in compliance with tax regulations. If an NPO borrower earns a profit from investment of tax-exempt bond proceeds in taxable securities and fails to timely use this profit (arbitrage) to pay project costs, IRS arbitrage rebate regulations require the NPO to return (or rebate) the excess investment earnings to the U.S. Treasury or face severe penalties.

3. SEC regulations concerning public debt offerings—Such regulations include compliance requirements regarding initial offering statements, the types and quality of information provided to the public and the veracity of statements made concerning the bonds. Additionally, under SEC Rule 15c2-12, issuers of fixed-rate tax-exempt debt are required to make prescribed secondary market disclosures until the bonds are retired.

In short, due to the complexity of tax-exempt bond transactions, it is imperative that NPO audit committees monitor the organization's compliance with laws and regulations, both for the initial offering and on an ongoing basis after the debt has been issued. The audit committee should review the deal points of a proposed tax-exempt bond transaction well before the anticipated issuance date.

Derivatives

An organization's investment polices may allow investments in financial instruments that are not routine or actively traded in the market. Routine or actively traded financial instruments, such as repurchase agreements, government agency debt securities, and money market funds, have some degree of risk. However, derivatives, which are financial instruments or contracts that have unique characteristics underlying their ultimate investment yield, typically have much greater risk.

When an organization holds derivatives, these financial instruments are included in the amount of investments reported in the organization's financial statements, at the instrument's market value, referred to as its fair value. In many cases the derivative may not be actively traded in the market, or its fair value may be based on complicated, unknown events. For this reason, the notes to the financial statements should discuss the following: the organization's objectives for holding or issuing derivatives, the context needed to understand those objectives, and its strategies for achieving those objectives. In addition to many other details, the disclosure should provide information about the organization's policies related to the various types of derivative instruments and a description of the items or transactions for which risks are hedged.

Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, is the source for technical guidance about accounting for derivatives and required reporting disclosures.

Securities Lending Transactions

Sometimes, organizations have large amounts of long-term investments in their portfolios. If an organization wants to earn additional income, it might lend some securities to brokers or financial institutions that need to borrow those securities to cover a short position (that is, they sold a security without owning it) or to avoid a failure to receive a security it purchased for delivery to a buyer. In these transactions, the organization transfers its securities for collateral, which may be cash or other securities, and agrees to return the collateral for its original securities at some time in the future.

When an organization lends its securities, it reports these securities as pledged assets in its financial statements. If the organization receives cash as collateral on the securities lending transactions, makes investments with that cash, or can sell the securities it received as collateral, these amounts are also reported as assets in the financial statements. Of course, because the collateral must be returned in the future, the organization also reports a liability for these transactions in the financial statements. In addition, the notes to the financial statements should disclose:

- The policy for requiring collateral or other security
- The carrying amount and classification of assets not reported separately in the statement of financial position
- The fair value of collateral and the amount sold or repledged as of the statement date in situations in which the transferor has received collateral that it is permitted to sell or repledge.

FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, provides specific guidance on accounting and reporting for securities lending transactions.

Relationship With Legally Separate Entities

Separate entities are created by not-for-profit organizations for a variety of reasons. Some of the more common reasons include greater efficiency in financing and administering debt backed by revenue-generating activities and providing additional services that may not have been envisioned when the organization's charter was written.

Financial reporting standards require an organization to determine when a separate entity should be included as part of the organization's financial reporting entity through consolidation. Although detailed and complex analyses ultimately determine which legally separate entities should be consolidated, entities are generally included if they are controlled by the organization.

AICPA Statement of Position 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, provides specific guidance on financial reporting under such circumstances.

Joint Ventures

A joint venture is a legal entity that results from a contractual arrangement to pool resources and share the costs, risks, and rewards of an activity with other organizations. In a joint venture, each of the participants retains an ongoing financial interest, an ongoing financial responsibility, or both.

Joint ventures typically are accounted for using the equity method of accounting. Under the equity method the organization recognizes its respective share of the joint venture's income or loss and any changes in the value of the joint venture.

Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*, provides specific guidance on financial reporting under such circumstances.

INSTRUCTIONS FOR USING THIS TOOL: The sample questions included in this tool are a starting point for understanding unique transactions and special relationships that may be present in a not-for-profit organization. Audit committee members should answer the following questions in discussion with management and consultation with the independent auditor or other experts as needed.

Audit Committee Questions of Management	Notes
Tax-Exempt Bond Offerings	
1. Please describe the proposed tax-exempt bond transaction deal points, including use of funds, bond structure, interest rate mode, credit enhancement, covenants, collateral, repayment terms, and source of repayment funds, for example.	
2. Describe the process for selection and qualifications of expert advisers engaged to assist with the tax-exempt bond transaction: • Borrower's counsel • Financial consultant • Underwriter • Bond counsel • Credit enhancement provider • Arbitrage rebate compliance consultant • Bond trustee	
3. Describe the procedures management will implement to ensure compliance with state and federal laws and IRS and SEC regulations governing tax-exempt bond transactions. Specifically, how will management protect the organization from the risk of noncompliance default?	
4. Describe management's proposed accounting treatment of issuance costs and review tax-exempt bond footnote disclosure in the financial statements.	
5. Review the initial offering statement. Discuss compliance with SEC regulations including Rule 15c2-12 disclosures, if applicable.	

Audit Committee Questions of Management	Notes
Tax-Exempt Bond Offerings (cont.)	
6. Review IRS Form 8038, Information Return for Tax-Exempt Private Activity Bond Issues. Discuss ongoing compliance with IRS regulations with respect to arbitrage rebate rules.	
7. Describe all debt covenants resulting from the tax-exempt bond transaction and procedures to ensure compliance on an ongoing basis. Review financial statement footnote disclosure of material debt covenants.	
Derivatives	
1. Please describe the organization's policies for investing in derivative financial instruments. Are there any restrictions regarding the type, maturity length, or percentage of total portfolio?	
2. Describe how management has valued its derivatives for financial statement presentation. Discuss the types of risks these investments have and how management has decided to manage those risks.	
Securities Lending	
1. Please describe the organization's policies for entering into securities lending agreements.	
2. Please describe how any securities lending transactions have been accounted for and whether they have been included in the organization's financial statements. Include whether collateral can be used to purchase securities, whether maturities of original and collateral securities match, and the credit risk associated with the securities.	
Legally Separate Entities	
1. Has the organization created, authorized, or become aware of any legally separate organizations that have financial relationships with the organization? If so, please provide details of the arrangement.	

Audit Committee Questions of Management	Notes
Joint Ventures	
1. Has the organization entered into any agreement with another organization to share resources, costs, and risks for providing goods and services or other purposes? If so, please describe the details of the arrangement.	
2. For any such agreements, please describe how the organization accounts for its participation and how the effects of such participation are displayed or disclosed in the organization’s financial statements.	

Resources for Audit Committees

PURPOSE OF THIS TOOL: Audit committees can take advantage of the Internet and find a wealth of resources to assist them in discharging their responsibilities. This Tool provides an overview of organizations and Web sites that contain topical resources for audit committee members to investigate.

Below is a sampling of organizations and Web sites that can assist audit committee members in learning more about their roles, responsibilities, and functions. Some of the organizations listed require membership to access the information. Many public accounting firms and state CPA societies provide information on these subjects as well. As always, monitor your state's nonprofit laws for audit committee requirements. For example, California passed the Nonprofit Integrity Act of 2004 and requires an audit committee separate from the finance committee.

Alliance for Nonprofit Governance www.angonline.org

The Alliance for Nonprofit Governance (ANG) is a coalition of nonprofit technical assistance providers, nonprofit umbrella organizations, funders, public regulators, professional services providers, academics, and others that share an interest in promoting good governance for nonprofit organizations.

American Institute of Certified Public Accountants www.aicpa.org

The American Institute of Certified Public Accountants (AICPA) is the national professional association for all certified public accountants. This includes CPAs working as independent auditors, accountants, or consultants in public practice, business and industry (chief financial officers, controllers, internal auditors, and others), government, not-for-profit organizations, and the academic community.

The AICPA has developed this Audit Committee Toolkit to aid audit committee members in performing their functions. In addition, the AICPA produces publications on accounting and auditing, financial reporting, tax, technology, and many other relevant topics. Some additional online resources useful to audit committees include:

- Audit Committee Effectiveness Center—www.aicpa.org/acec
- Antifraud and Corporate Responsibility Resource Center—www.aicpa.org/antifraud
- Sarbanes-Oxley Implementation Central—www.aicpa.org/sarbanes/index.asp

American Society of Association Executives www.asaenet.org

The American Society of Association Executives (ASAE) is a national organization serving the needs of association professionals through its education and certification programs, publications, research and information, public policy and public relations activities, and member services.

Association of Audit Committee Members, Inc. www.aacmi.org

The Association of Audit Committee Members (AACMI) is a not-for-profit association of audit committee members dedicated to strengthening the audit committee by developing national best practices. They are devoted exclusively to improving audit committee oversight.

Association of Certified Fraud Examiners www.cfenet.com

The Association of Certified Fraud Examiners (ACFE) is a global professional organization dedicated to fighting fraud and white-collar crime. With chapters around the globe, the Association is networked to respond to the needs of anti-fraud professionals everywhere. They offer guidance on fraud prevention, detection, and investigation, as well as internal controls.

Association of Community College Trustees www.acct.org

The Association of Community College Trustees (ACCT) is a not-for-profit educational organization of governing boards, representing more than 6,500 elected and appointed trustees who govern over 1,200 community, technical, and junior colleges in the United States, Canada, and England.

Association of Governing Boards of Universities and Colleges www.agb.org

The Association of Governing Boards of Universities and Colleges (AGB) is a national organization providing university and college presidents, board chairs and individual trustees of both public and private institutions with the resources they need to enhance their effectiveness.

BoardSource www.boardsource.org

BoardSource is a resource for practical information, tools and best practices, training, and leadership development for board members of not-for-profit organizations worldwide. Through their programs and services, BoardSource enables organizations to fulfill their missions by helping build strong and effective nonprofit boards.

Committee of Sponsoring Organizations of the Treadway Commission www.coso.org

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is a voluntary private-sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal controls, and corporate governance. Originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, COSO has released numerous influential publications including *Internal Control—Integrated Framework*.

Conference Board www.conference-board.com

The Conference Board is a global, independent membership organization that creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. They conduct research, convene conferences, make forecasts, assess trends, publish information and analysis, and bring executives together to learn from one another.

Council on Foundations www.cof.org

The Council on Foundations (COF) is a membership organization of more than 2,000 grantmaking foundations and giving programs worldwide. They provide leadership expertise, legal services, and networking opportunities.

Ethics Officers Association www.eoa.org

The Ethics Officers Association (EOA) is the professional association exclusively for managers of ethics, compliance and business conduct programs. The EOA provides ethics officers with training and a variety of conferences and meetings for exchanging best practices in a frank, candid manner.

Ethics Resource Center www.ethics.org

The Ethics Resource Center (ERC) is a nonprofit, nonpartisan educational organization whose vision is a world where individuals and organizations act with integrity. Their mission is to strengthen ethical leadership worldwide by providing leading-edge expertise and services through research, education and partnerships. Especially useful are their resources on business and organizational ethics.

Financial Executives International www.fei.org

The Financial Executives Institute (FEI) is the preeminent professional association for senior level financial executives including Chief Financial Officers, VPs of Finance, Controllers, Treasurers, and Tax Executives. They provide peer networking opportunities, emerging issues alerts, personal and professional development and advocacy services.

Harvard Business School's Corporate Governance, Leadership & Values www.cglv.hbs.edu

Harvard Business School's Corporate Governance, Leadership & Values Web site is a comprehensive overview of research, educational programs, and other activities at Harvard Business School aimed at providing new frameworks for thought and practice in the interrelated areas of corporate governance, leadership, and values. It includes links to the ongoing workshop series; background papers; research programs, such the Corporate Governance Initiative; executive education programs; viewpoints on key issues published in the national press; faculty comments in the media; and an online forum for exchanging views on emerging issues.

Independent Sector www.independentsector.org

The Independent Sector (IS) is committed to strengthening, empowering, and partnering with nonprofit and philanthropic organizations in their work on behalf of the public good.

Institute of Internal Auditors www.theiia.org

The Institute of Internal Auditors (IIA) is an international organization that meets the needs of a worldwide body of internal auditors. IIA focuses on issues in internal auditing, governance and internal control, IT audit, education, and security worldwide. The Institute provides internal audit practitioners, executive management, boards of directors and audit committees with standards, guidance, best practices, training, research, and technological guidance for the profession.

Internal Revenue Service www.irs.ustreas.gov/charities/index.html

The Internal Revenue Service (IRS) has tax information for charities and other not-for-profit organizations.

IT Governance Institute www.itgi.org

Established by the Information Systems Audit and Control Association and Foundation (ISACA) in 1998, the IT Governance Institute (ITGI) exists to assist enterprise leaders in understanding and guiding the role of IT in their organizations. ITGI helps senior executives to ensure that IT goals align with those of the business, deliver value, and perform efficiently, while IT resources are properly allocated and its risks mitigated. Through original research, symposia and electronic resources, ITGI helps ensure that boards and executive management have the tools and information they need to effectively manage the IT function.

National Association of College and University Business Officers www.nacubo.org

The National Association of College and University Business Officers (NACUBO) represents chief administrative and financial officers through a collaboration of knowledge and professional development, advocacy, and community. Their vision is to define excellence in higher education business and financial management.

National Association of Corporate Directors www.nacdonline.org

Founded in 1977, the National Association of Corporate Directors (NACD) is an educational, publishing and consulting organization in board leadership and the only membership association for boards, directors, director-candidates and board advisors. The NACD promotes high professional board standards, creates forums for peer interaction, enhances director effectiveness, asserts the policy interests of directors, conducts research, and educates boards and directors concerning traditional and cutting-edge issues.

National Council of Nonprofit Associations www.ncna.org

The National Council of Nonprofit Associations (NCNA) seeks to guarantee that all not-for-profits have access to knowledge and resources through the national network of state associations and that the not-for-profit sector retains a vibrant and strong voice at the national and state level that speaks to its issues and those of their constituencies.

Nonprofit Coordinating Committee of New York, Inc. www.npccny.org

The Nonprofit Coordinating Committee of New York, Inc. (NPCC) was established to help not-for-profits meet common challenges and problems, to serve as a meeting ground and to strengthen the nonprofit sector as a whole.

Nonprofit Financial Center www.nfconline.org

The Nonprofit Financial Center (NFC) is a not-for-profit organization dedicated to helping nonprofits grow and prosper through practical financial management.

Public Company Accounting Oversight Board www.pcaobus.org

The Public Company Accounting Oversight Board (PCAOB) is a private-sector, not-for-profit corporation, created by the *Sarbanes-Oxley Act of 2002*, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

The Sarbanes-Oxley Act of 2002 www.aicpa.org/info/sarbanes_oxley_summary.htm

President Bush signed the *Sarbanes-Oxley Act*, which regulates the accounting profession and public companies, on July 30, 2002. Although the provisions of Section 301 for a public company audit committee do not apply to the not-for-profit sector, they can be viewed as a best practice.

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