



OTHER QUESTIONS

an Audit Committee Should Ask

▶ OTHER QUESTIONS AN AUDIT COMMITTEE SHOULD ASK

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

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

Sensitive areas

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

Accounting and financial reporting

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

▶ OTHER QUESTIONS AN AUDIT COMMITTEE SHOULD ASK continued

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

Program activities

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

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

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

Investment management

- What was the return on investments for the year?
 - Does that include [realized/unrealized] capital gains/losses?
 - If not, what would it be if such gains/losses **were** included?
 - How does that compare to the _____ market index?
 - Why was it so [low/high]? ("high" implies organization may be assuming an inappropriate degree of risk)
- How does the organization protect itself against:
 - Adverse effects of stock market fluctuations?
 - Loss of assets from failure of the [bank(s)/investment custodians] with whom it deals?
- Do we invest in "derivative" instruments? How do we monitor our exposure to market risks?
- Why does the organization own any municipal bonds, since it pays no taxes anyway?

▶ OTHER QUESTIONS AN AUDIT COMMITTEE SHOULD ASK continued

Tax and regulatory matters

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

The nonprofit environment

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

External auditors' relationship with the organization

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

▶ OTHER QUESTIONS AN AUDIT COMMITTEE SHOULD ASK continued

Audit procedures

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

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

Other topic

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



The online guide, *Effective Audit Committee for Nonprofit Organizations*, incorporates specific recommendations, guidelines and rules of governmental and private sector bodies concerned with such matters. The purpose of this online tool and its supplemental materials is to provide an overview of the common functions and responsibilities of an audit committee in order to help nonprofit organizations: (1) form and maintain an effective audit committee, and (2) set an appropriate agenda for its ongoing activities. We hope this document and the accompanying site offer comprehensive guidance to nonprofit organizations as they establish and maintain audit committees that will, ultimately, ensure the financial wellbeing and future success of the organization.

The guide, *Effective Audit Committee for Nonprofit Organizations*, can be viewed in its entirety in PDF form by visiting <http://www.bdo.com/download/2127> or on the microsite Nonprofitblog.bdo.com/index.php/auditcommitteeguide/.

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