

Best Practices for Audit Committees

By Robert E. Wilson

The Sarbanes Oxley Act applies tough new standards for financial accountability and transparency on boards of corporations that issue public securities. Although the so-called SOX Act doesn't apply to most not-for-profit organizations, many believe it's only a matter of time before states or the Internal Revenue Service adopt similar rules for tax-exempt organizations.

In any event, many hospital and health system boards are using the SOX requirements as a framework to examine and improve their financial oversight, beginning with the board's audit committee.

While no two boards or organizations are exactly alike, these best practices are worth strong consideration:

1. The audit committee should have at least one member who qualifies as a financial expert.

That expertise should include:

- An understanding of financial statements and generally accepted accounting principles.
- An ability to understand how the principles are applied to the health system's financial statements.
- Experience preparing, analyzing or evaluating financial statements.
- An understanding of internal controls and procedures for financial reporting.

Generally, it's good to include at least one certified public accountant on the committee. Business executives

who aren't CPAs may not have the requisite knowledge unless they have been directly responsible for the preparation of financial statements in their companies.

2. The audit committee should pre-approve all services (both audit and non-audit) to be provided by the independent auditing firm.

Pre-approval can be obtained directly from the audit committee, or if procurement takes place in accordance with policies and procedures adopted by the audit committee.

Best Board Practices Checklist

How often should a hospital or health system engage in a competitive process of choosing an audit firm? About every five years is a good rule of thumb, both to verify fair pricing and also to see how other firms would approach the audit process.

It's not necessary to change accounting firms every few years to get an objective assessment, though. If the audit committee does its job in a robust way, it can be sure that management and the audit firm aren't getting too cozy. If the committee thinks that's

happening, a change in the firm or the audit partner assigned to the account may be indicated.

Although many recommend periodic rotation of audit partners, that can be difficult in healthcare because there often isn't a tremendous breadth of people, even in the large audit firms in some locales, who really understand healthcare.

3. The audit committee should foster an environment of open and transparent communication between itself and the independent auditor.

The audit committee should meet with the auditors at least twice each year for at least 45 to 60 minutes. One meeting should discuss the proposed audit plan to address areas of financial reporting and internal control risk, and the second should cover the results of the completed audit.

4. The content of audit committee interaction with the independent auditor should be robust.

In the spirit of candor, the audit committee should seek information such as:

a. **The "quality" of the balance sheet.** Find out the extent to which audited financial statements are af-

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affected by management's accounting estimates and judgments, and where those estimates and judgments fall on a scale from conservative to aggressive.

b. The "quality" of annual earnings. Find out the extent to which the current year's operating earnings reflect error corrections, estimate adjustments, or one-time transactions that may distort actual performance for the year.

c. The nature and magnitude of significant year-end accounting adjustments made just before or during the audit. Large year-end adjustments may indicate that monthly financial information provided to the board is unreliable.

d. The system of internal controls. Most independent financial audits only check on internal control processes to the extent necessary to understand how they are intended to work and to design other complementary audit tests, not to fully verify internal controls.

For example, to see if the process of recording revenues and receivables is following generally accepted accounting principles and the hospital's own policies, an external auditor might take a sample of as few as 20 patients out of thousands during the year to see if all services in the medical record were processed properly.

Such small samples may be sufficient for purposes of the financial statement audit, but they don't answer the question, "Do we always properly bill

for *all* the services we provide, and *only* for the services we provide?" The answer to that question requires a more thorough study, often conducted by an internal auditor. The audit committee needs to know exactly what internal control tests were and were not performed so that it doesn't derive unwarranted assurance from the limited internal control testing performed by the independent auditors.

5. The audit committee should ensure that the independent auditor is able to communicate directly with the audit committee regarding any issue or concern that may arise in the course of his or her work.

The regularly scheduled audit committee meeting should include an executive session without management. The independent auditor should also be able to contact the committee chairman at any time he or she considers it necessary.

6. The audit committee should be satisfied that management has established an effective process for maintaining adequate internal controls and procedures for accurate financial reporting.

If the organization has an internal audit function to help discharge this management responsibility, the internal audit function should report to both the CEO and the board's

audit committee. The committee should review a risk-based, annual internal audit plan and an evaluation of the results.

As with the external auditor, the audit committee should foster an environment of open and frequent communication with the internal auditor, including access to the chairman and the committee at any time.

7. The full board should be informed of and knowledgeable about the audit function.

The audit committee should take a leadership role with management in ensuring that the committee and the entire board have adequate education and orientation relating to risk monitoring, industry financial performance drivers and financial literacy.

8. The audit committee should assess its own performance and continuously improve its processes.

Some ways to do this are benchmarking against other audit committees in similar organizations or asking the outside auditor or an independent consultant to lead a self-assessment discussion with the committee.

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