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Nancy A. Wagner

Herbert A. O'Keefe

William J. Bostwick

Yvonne O. Braune

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The Use Of Audit Committees In Hospitals

By Nancy A. Wagner, Herbert A. O'Keefe,
and William J. Bostwick
Editor: Yvonne O. Braune, City of Tacoma,
Tacoma, WA 98411

The use of corporate audit committees received renewed emphasis recently when the report from the National Commission on Fraudulent Financial Reporting [1987, p. 12] concluded that an audit committee "plays a role critical to the integrity of the company's financial reporting" and recommended "that all public companies be required to have audit committees comprised entirely of independent directors."

Previous studies have examined the use of audit committees in municipal governments [Wagner and O'Keefe, 1985-86] and their use in the corporate sector. (The best-known study of audit committees in the corporate sector is that conducted by R. K. Mautz and F. L. Neumann, *Corporate Audit Committees: Policies and Practices*. Cleveland, Ohio: Ernst & Ernst, 1977.) In addition to municipal governments, there are



many other governmental units and non-business organizations that use audit committees. Included in the latter group are hospitals. This study examines (1) the extent to which audit committees are used by hospitals, (2) the composition and responsibilities of such committees, and (3) the perception of the effectiveness of these committees.

Nature of the Study

A questionnaire was mailed to the chief executive officer or chief financial officer of 199 major not-for-profit hospitals in the southeastern United States. The hospitals surveyed included those with 300 or more beds in the states of Alabama, Arkansas, Florida, Georgia, Kentucky, Louisiana, North Carolina, South Carolina, Tennessee, Virginia, and West Virginia, and responses were received from 114 hospital officers. The questions posed were designed to determine the number of hospitals with provisions for audit committees, the composition and primary responsibilities of the committees, and the perception of their relative success.

Results of the Study

Extent of Audit Committee Use

According to the 114 respondents, 62 hospitals have established audit committees. Nearly half indicated that the committee is of very recent origin: 29 of the committees were formed in 1978 or later, with 25 of these formed in the 1980's.

Several respondents reported that the audit committee function is performed by the Board's finance committee. Some respondents at hospitals with audit committees said that the committee composition is the same as that of the finance committee. If the

respondents indicated that the finance committee functioned as an audit committee, it was counted as an audit committee.

Composition of the Committee

Survey results indicated that a majority of hospital audit committees are composed of three to five individuals. However, as many as twenty of the audit committees studied have six to eight members.

According to respondents, most hospital audit committees have a majority of outside directors and are chaired by an outsider. Unlike audit committees of public companies, hospital audit committees often have inside directors. Respondents reported that 61 percent of the committees have management representation, and in slightly over half of the committees, one of the members is the chief executive officer of the hospital. However, the chairman may be expected to be an outside director since survey results showed 85 percent of the audit committees are chaired by outsiders.

Of the committees surveyed, 85 percent are made up of members appointed by the Board of Trustees or appointed by the board chairman and then confirmed by the entire board. This method of appointment helps to ensure the committee's independence from management. Only one respondent reported that the chief executive officer, in consultation with the chief financial officer, determines the composition of the committee.

Response to the survey showed that committee appointments are most likely to be for a one-year term but may be renewed an indefinite number of times. In 35 of the committees, annual appointment is the rule; in all but one committee, terms are renewable; and, for more than half the committees, the appointment can be renewed indefinitely. Ten committees had members appointed for a six-year maximum term (either a one-year appointment renewable six times, a two-year appointment renewable three times, or a three-year appointment renewable twice). Other terms of service were limited to periods varying from one year (in one case) to ten years.

Responsibilities of the Committee

According to the respondents, specific duties of the committee usually include

- nomination, selection, and engagement of the independent auditor
- evaluating the results of the independent audit
- evaluating the results of the internal audit

Eighty-three percent of the respondents at hospitals with audit committees reported that selection of the auditor is included among the committee's responsibilities, and 93 percent of the audit

Nancy A. Wagner, Ph.D., CPA, is an associate professor of accounting at Georgia Southern College. She is a member of the Georgia Society of CPAs and the AICPA.

Herbert A. O'Keefe, Ph.D., CPA, is a professor of accounting at Georgia Southern College. Dr. O'Keefe is a member of the Board of Directors of the Georgia Society of CPAs and the Financial Management Standards Board of AGA.

William J. Bostwick, Ph.D., CPA, is head of the department of accounting at Georgia Southern College. Dr. Bostwick is a member of the Georgia Society of CPAs and the NAA.

committees among those hospitals surveyed evaluate the results of the independent audit. In this respect, the committees conform to the expected emphasis on the external audit function. A smaller number of committees oversee the internal audit function; of those responding to the questionnaire, 61 percent indicated that determining internal audit scope is within the committee's purview, and 78 percent stated that the audit committee evaluates the results of the internal audit.

The survey suggested that these audit committees are less likely to be involved in approving changes in accounting and control systems. Only 52 percent approve changes in significant accounting policies and only 44 percent approve changes in the accounting control system.

Frequency of Meetings

It is generally agreed that an effectively functioning audit committee must meet at least three times a year: once to review the audit plan, once to evaluate audit results, and once to nominate the independent auditor. Any internal audit oversight responsibilities that the committee assumes can also be placed on the agenda for these three meetings. Survey results showed that the majority of hospital audit committees meet at least quarterly, and nearly three-quarters of the committees meet three or more times per year. For the most part, then, the committees seem to meet frequently enough to fulfill their principal responsibilities according to established guidelines.

More than 60 percent of the committees, according to respondents, meet only once with the independent auditor. And, while one-fourth of the committees meet with the internal auditor at least four times during the year,

about half meet less often, and several do not meet with the internal auditor at all. Some of the committees meet only once with the entire Board of Trustees, but the majority schedule more frequent meetings, and several arrange such meetings on a monthly basis.

Perceptions of the Committee

The survey indicated that hospitals view their audit committees as making a valuable contribution to the Board's communication with the independent auditor, to improvements in internal control, and to the Board's understanding of and involvement in the financial and accounting policies and procedures of the hospital. Among the positive effects cited by respondents are:

Certified public accountants who serve hospital clients should recommend that consideration be given to the establishment of an audit committee.

Improved communication between trustees/directors and the external and internal auditors. Respondents generally believed that the audit committee contributes to board members' understanding of the financial and operational activities and policies of the hospital and

emphasizes the importance of internal control and the significance of audit findings.

Increased likelihood that audit recommendations will be implemented and internal control will be strengthened. Most respondents felt that because the committee is charged with the evaluation of audit results, it is in a position to respond to audit findings and to monitor the implementation of audit recommendations.

Enhanced independence for internal auditors. Respondents focused on improvements in the internal audit function as a primary contribution of the audit committee. In some cases, respondents linked the establishment of an internal audit department to the work of the audit committee.

Survey respondents cited few negative effects resulting from the use of audit committees. However, some of those surveyed were not convinced that committee members had taken enough time to understand the complexities of a hospital financial system and believed that more education was necessary for committee members.

Conclusion

The survey established that the audit committee can contribute to the efficiency and effectiveness of the audit process and can improve the financial information and control systems of hospitals. The evidence clearly suggests that the formation of an audit committee merits increased consideration by hospitals that have not yet adopted the concept. Certified public accountants who serve hospital clients should recommend that consideration be given to the establishment of an audit committee.

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A Message From The Tax Department Editor

Cherie J. O'Neil
VA Tech, Blacksburg, VA 24061

Tax Department of The Woman CPA is a forum for readers to share their knowledge and expertise in taxation. Many of you research tax topics when preparing tax returns for clients and employers, and *The Woman CPA* would like for you to share that research. For example, have you relied on a recent tax case or revenue ruling and feel

discovered an unintended result or a trap for the unwary in one of the new code sections that you think others should know about? Or are there techniques you use in tax planning that you think could be useful to our readers?

If you have never submitted anything for publication, let me briefly review how you should begin. First, make sure your idea is original and one that would be of interest to our readers. Next, outline what you want to say. After you have put your thoughts in a logical order, write your manuscript using your outline as your guide. If what you have written is ten pages or less (double spaced), send it to me for consideration. (If your paper is longer, you may want to consider submitting it for publication as a main article, and in that case, your manuscript should be sent to Dr. Betty Brown, Associate Editor of *The Woman CPA*.) I hope to receive articles from you soon.



readers could benefit from your experience? Or in complying with the many recent tax law changes, have you

Cherie J. O'Neil, Ph.D., CPA, is associate professor of accounting at Virginia Polytechnic Institute and State University. She formerly worked for the IRS as a revenue agent.