

The Role of Audit Committees in Nonprofit Organizations: An Empirical Investigation

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ABSTRACT

Audit committees are an essential component of corporate governance. Public leaders advocate the use of audit committees in nonprofit organizations. This study examines whether the use of audit committees by nonprofits improves organizational accountability, as measured by the likelihood of reported internal control weaknesses, in these organizations. A sample of nonprofit hospitals, subject to the Single Audit Act, was selected for the years 2001 to 2004. We find that the reported internal control weaknesses in administering federal programs in these organizations were significantly less with the presence of an audit committee in 2002, but we do not find such a relationship in the other three years. Our data also show no relationship between audit committees and reported internal control weaknesses in financial reporting associated with these organizations' financial statement audits. We offer our explanations for these somewhat mixed results. Overall, these results seem to support the notion that audit committees function differently in nonprofit organizations than in corporations (Vermeer, Raghunandan, and Forgione, 2006).

Keywords: audit committee; nonprofit; governance; internal control; Single Audit Act

Data Availability: Contact the authors.

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INTRODUCTION

Audit committees are an essential component of corporate governance. In the aftermath of a number of high-profile corporate accounting scandals, audit committees are even more important in management's efforts to provide greater transparency and control in the accounting process. Consequently, audit committees can also be seen as invaluable components of nonprofit governance. While there is a body of research addressing audit committees in corporate governance, there is little empirical evidence about audit committees as a part of governance in the nonprofit setting. This paper adds to the accounting literature by examining the impact of audit committees in the nonprofit sector.

Total giving in 2005 to nonprofit organizations in the U. S. is estimated to be \$260.28 billion. Individuals donated the vast majority of this amount, \$199 billion or 76.5 percent. This represents a \$15 billion increase in total giving over 2004, half of which was attributable to disaster relief giving (AAFRC 2006). Increases in giving have also been accompanied by increases in high-profile scandals involving nonprofits.¹ As of 2003, over 1.5 million entities were recognized as tax-exempt under the Internal Revenue Code section 501(c). Almost two-thirds of those entities – over 960,000 – were classified as 501(c)(3) charities.² Consequently,

¹ Examples of recent scandals include the embezzlement of \$1.9 million by Jacquelyn Allen-MacGregor, an executive of the Capital Area United Way in East Lansing, Michigan. (Associated Press, February 7, 2003), and the resignations of Marsha Evans and Bernadine Healey, former presidents of the Red Cross, amid allegations of mismanagement following the terrorists attacks of September 11, 2001, and Hurricanes Katrina and Rita in 2005 (Bernstein 2005).

² Testimony of George Yin, Chief of Staff, Joint Committee on Taxation, to the United States House Committee on Ways and Means on April 20, 2005. An organization may qualify as a 501 (c) (3) charity for exemption from federal income tax, if it is organized and operated exclusively for one or more of the following purposes: charitable (including charitable hospitals), religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and prevention of cruelty to children or animals. Contributions to any of

this data demonstrates charitable organizations have a significant impact on the national economy.

The precarious environment associated with high-profile cases of fraud, mismanagement, and abuse, coupled with the magnitude of giving in the U.S., has captured the attention of Congress, state legislators and nonprofit advocates. Both the U. S. House of Representatives and the U. S. Senate have held public hearings to address these concerns (U. S. House of Representatives 2005a, 2005b; U. S. Senate 2004, 2005). Federal legislation was passed, providing more regulations for the treatment of charitable contributions of patents and vehicles, the reporting of non-cash contributions, and the documentation of monetary donations.³ Several states, including New York, Iowa, Maine, and California, have enacted legislation to enhance the accountability within the nonprofit sector. The Panel on the Nonprofit Sector, a group of 24 leaders from public charities and private foundations, also addressed the issues of public sector accountability in a report, *Strengthening Transparency, Governance and Accountability of Charitable Organizations*, issued in June 2005 (Independent Sector 2005).

Legislators and nonprofit advocates stress the importance of audit committees in nonprofit organizations as a means of improving accountability. On September 30, 2004, Governor Arnold Schwarzenegger signed the California Nonprofit Integrity Act - requiring California charities with revenues of \$2 million or more to form audit committees. One of the 15 recommendations issued by the Panel of Nonprofit Sector specifically recommends nonprofit organizations form audit committees within the board of directors.

these domestic organizations, except those testing for public safety, are deductible as charitable contributions on the donor's federal income tax return.

³ American Jobs Creation Act of 2004, Public Law 108-357 and Pension Protection Act of 2006, Public Law 109-280

However, nonprofit advocates emphasize the uniqueness of nonprofit organizations and tend to favor self-governance as opposed to federal or state regulations. For example, Chisolm (1995) contends that any adjustments to the legal framework of the nonprofit sector should be carefully and deliberately developed in the context of the organizing principles and core values that are unique to nonprofit organizations. She cautions that redrawing legal standards of behavior to agree with popularly recognized standards of propriety could be counterproductive with nonprofit organizations. Ebrahim (2003) suggests that understanding accountability in the context of nonprofit organizations should be the first step in addressing the accountability concerns associated with the high-profile scandals and the growing number and visibility of nonprofits over the past two decades. He contends that the nature of accountability in the nonprofit sector is multidimensional and relational in nature and cannot be reduced to a concept enforced through oversight and regulation.

There is little documented empirical evidence to either verify or falsify the notion that audit committees would improve accountability in nonprofit organizations. The existing audit committee research focuses primarily on audit committees in large publicly traded corporations (DeZoort et al. 2002; Hermanlin and Weisbach 2003; DeFond and Francis 2005; and Carcello 2005). Hermanlin and Weisbach (2003) recognize this gap in the literature and call for more studies on boards of nonprofit organizations. Consistent with Ebrahim (2003), Vermeer et al. (2006) suggest that nonprofit audit committees may function differently than corporate audit committees. They identify nonprofit hospitals and universities/colleges, particularly those that receive federal grants and are subject to the Single Audit Act, as institutions where audit committees should be expected to exercise effective monitoring functions.

The purpose of this study is to investigate whether, in the most recent years since the related data became available (2001 to 2004), audit committees in nonprofit organizations had an impact on organizational accountability. This study is motivated by the idea that, although the role and the composition of audit committees in nonprofit organizations may change, the effectiveness of audit committees in monitoring accountability in nonprofit organizations in the past provides valuable information for the regulators in search of effective ways to enhance accountability in nonprofit organizations. Our sample consists of nonprofit hospitals subject to the Single Audit Act. We examine the relationship between the presence of audit committee and the reported internal control weaknesses in administering major federal programs as well as in financial reporting as a measure of organizational accountability in these organizations.

The results show that there was a negative relationship between the presence of audit committee, and reported internal control weaknesses in administering major federal programs in the sample organizations in 2002. This relationship seems to suggest that the existence of an audit committee might be a factor that is associated with lower reported internal control weaknesses in administering major federal programs in these organizations. The absence of this relationship in other years seems to suggest that this effect could be mitigated by other factors associated with the temporary events in a particular year that were not controlled in our model. We speculate that the press coverage of corporate accounting scandals and the passage of the Sarbanes-Oxley Act in 2002 were likely among such factors. That is, during 2002, nonprofits might have become more aware to the importance of the audit committee functioning as a monitoring mechanism for governance after the federal law was passed imposing more stringent requirements on corporate audit committees. Consequently, the audit committees in these organizations became more active or more effective in monitoring.

The possible reasons for the absence of a relationship between audit committee and the frequency of reported internal control weaknesses administering major federal programs in 2003 and 2004 are less obvious and therefore more interesting. It could be the result of an overall improvement in internal control across the whole industry in the wave of Sarbanes-Oxley Section-404 implementation (Tieman 2003; Technical Assistance for Community Services 2004). It is also possible that some temporary events occurred in these two years, preventing the effect of audit committee to be observed in our data. If the lack of an observed relationship is associated with the influence of the Section 404 implementation, it is difficult to predict this influence in the long run since the Sarbanes-Oxley Act does not cover nonprofits.

Prior research suggests that the corporate audit committee has a positive impact on financial reporting. We do not find a significant relationship between audit committee and reported internal control weaknesses associated with financial statement audits of these nonprofit organizations. Instead, we find the possible impact of auditor type (Big 4 or not) and the size of nonprofit organizations on reported internal control weaknesses. These findings are consistent with prior research suggesting that nonprofit audit committees might only play a rather limited role in monitoring financial reporting (e.g., Miller 2002; Hillman and Dalziel 2003; Brown 2005; Miller-Millesen 2003; Vermeer et al. 2006).

The remainder of the paper is organized as follows. The next section provides the literature background and develops hypotheses. The research methods are described in the third section and the results are presented in the fourth section. The final section concludes the paper.

BACKGROUND AND HYPOTHESES

Prior Literature on Audit Committees

A considerable number of studies have been conducted on corporate audit committees. Many archival studies provided evidence suggesting that the quality of financial reporting is higher for corporations that have an audit committee than for corporations that do not have an audit committee (c.f., Beasley 1999). Abbott et al. (2004) examined the characteristics of audit committees and the likelihood of financial restatements and drew a similar conclusion. Other research focused on identifying factors that contribute to the diligence of audit committees, including committee composition, authority, and resources or to the effectiveness of audit committees (c.f., DeZoort et al. 2002). Additionally, Gendron et al. (2004) conducted an extensive field study, interviewing actual audit committee members to investigate the practices of effective audit committees. In general, these studies indicated a positive association between the presence of an audit committee and the quality of financial reporting. DeFond and Francis (2005), in a summary of audit research after the Sarbanes-Oxley Act of 2002, indicated that more research needs to be done on audit committees after the enactment of Sarbanes-Oxley Act of 2002. They called for research to build on the existing audit committee literature in order to develop a deeper institutional understanding of auditing issues.

Very little research is available in the area of audit committees in nonprofit organizations. A few studies addressed the presence of audit committees in local governments (West and Berman 2003, Nix and Nix 1996, and Montondon 1995). A major work on audit committees in nonprofit organizations was done recently by Vermeer et al. (2006). They examined the composition of nonprofit audit committees and factors associated with their composition. They surveyed 118 chief financial officers of nonprofit organizations. Ninety-six of the sample

entities (75 percent) had an audit committee. Of this sample, 36 percent of the nonprofits had audit committee members who were not completely independent and 86 percent had at least one financial expert on the committee.

Vermeer et al. (2006) did not test the monitoring effect of nonprofit audit committees. However, their reasoning and findings about the composition of nonprofit audit committees are relevant to this study in many ways. For example, they argue nonprofits that receive government grants, particularly those subject to the Single Audit Act, are more likely to be associated with audit committees that are effective in monitoring. They also argue that within the nonprofit sector hospitals and university/colleges are more likely to have audit committees that are effective in monitoring. These arguments have a direct impact on our sample selection.

Single Audit Act

Grants for domestic assistance programs administered by the federal government through states, local governments and nonprofit organizations exceed \$400 billion per year (Cureton 2004). Prior to 1984, each federal agency established separate accounting, reporting and auditing requirements for administering awards issued by that federal agency. The Single Audit Act of 1984 was intended to improve financial management and establish uniform requirements for audits of federal financial assistance received by states and local governments (Wilson and Kattelus, 2002). In 1996, the act was amended to include nonprofit organizations and, in 1997, the Office of Management and Budget (OMB) issued guidelines for administering programs and conducting audits under the act. This guidance was published in OMB Circular No. A-133, *Audits of States, Local Governments, and Nonprofit Organizations*.

The audit requirements of the Single Audit Act apply to major federal programs administered by the grant recipient. The independent auditor uses a risk-based approach to

determine which programs are to be audited as major programs. Generally, the auditor considers the current and prior audit experience, oversight by federal agencies and pass-through entities, and the inherent risk of the federal program. This assessment is performed using a four-step approach. First, the auditor classifies each federal program as either Type A (large dollar expenditure) or Type B (small dollar expenditure). Next, the auditor determines which Type A programs are considered low-risk (step two) and which Type B programs are considered high-risk (step three). At a minimum, the auditor shall audit as major programs all high-risk Type A programs and either one-half of all high-risk Type B programs or one high-risk Type B program for each low-risk Type A program (step four). The audit is required to include at least 50 percent of the total federal awards expended.⁴

Research concerning nonprofit organizations that receive federal funds under the Single Audit Act is sparse. One study (Keating et al. 2005) examined how compliant nonprofits were with the requirements of the Single Audit Act. The study examined a number of characteristic factors that affect the likelihood of entities reporting adverse findings. However, audit committee was not one of those factors.

Weaknesses in Internal Control

Nonprofit organizations need adequate internal controls to properly administer federal programs. Inadequate, poorly designed, or improperly applied internal controls could lead to the misappropriation of federal resources or the failure to ensure the program objectives, procedures and compliance requirements have been met. These failures could prevent or deny eligible individuals from receiving needed services. Weaknesses in internal control could also lead to the

⁴ If the auditee meets the criteria for a low-risk auditee, the auditor is only required to audit 25 percent of total federal grant expenditures.

federal government imposing sanctions in the form of fines, suspension or debarment (OMB 2 CFR Parts 180 and 215).

Internal control weaknesses in administering federal programs are reported under two categories by the degree of severity – reportable conditions (less severe) and material weaknesses (more severe). Reportable conditions are significant deficiencies in the design or operation of the internal control over compliance that could adversely affect an organization’s ability to administer a major federal program in accordance with laws and regulations. Material weaknesses are reportable conditions of such magnitude that one or more of the internal control components does not reduce to an acceptably low level the risk that noncompliance with laws and regulations may occur and not be detected timely (AICPA 2005). OMB Circular No. A-133 requires independent auditors to identify reportable conditions and material weaknesses in internal controls over major federal programs.

Deficiencies in internal control for financial audits are also classified as reportable conditions and material weaknesses. Reportable conditions in financial statement reporting are significant deficiencies in the design or operation of internal control that could adversely affect the entity’s ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Material weaknesses are reportable conditions 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 error 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 functions (AICPA 2005).

Development of Hypotheses

Prior research concerning corporate audit committees typically uses agency theory to develop and test hypotheses (e.g., Carcello and Neal 2000, 2003; Klein 2002). Given that the economic theory of maximizing shareholder value is not applicable in a nonprofit setting, resource dependency theory was often used as a framework in examining a diverse set of issues concerning nonprofit organizations and their boards (e.g., Anheier 1997; Hillman and Dalziel 2003; Brown 2005; Miller-Millesen 2003; Vermeer et al. 2006). This theory posits that an organization's need for resources determines the organization's structure and activities (Pfeffer and Salancik 1978). Noting the differences in perspective between agency theory and resource dependence theory, Hillman and Dalziel (2003) assert that while agency theorists focus on a board's role in monitoring management behavior, resource dependence theorists focus on a board's role in obtaining and securing resource. This difference suggests that nonprofit audit committees may have a relative weak monitoring function, since the focus of a nonprofit board may be on obtaining resources rather than on monitoring the use of resources. However, the monitoring function of nonprofit audit committees may be enhanced when monitoring the use of resources is a necessary requirement for obtaining the resource.

Vermeer et al. (2006) applied resource dependency theory in asserting nonprofit organizations that receive government grants, particularly those that are subject to the Single Audit Act, are more likely to have effective monitoring by audit committees. The receipt of government grants brings with it many additional reporting and internal control requirements, which may create a need for an audit committee to perform the monitoring function or a need to enhance the monitoring function of the existing audit committee. These needs suggest that audit

committees in nonprofit organizations subject to the Single Audit Act are likely to improve the internal control of these organizations in administrating major federal programs.

Using the same logic for a need to enhance the monitoring function of audit committees, Vermeer et al. (2006) also argue that within the nonprofit sector hospitals and universities/colleges are more likely to have effective monitoring by audit committees. Hospitals and universities/colleges have much higher levels of complexity in their operations compared to other nonprofit organizations. Almost all hospitals, for example, deal with the extensive and complex regulations related to the Medicare and Medicaid programs. A need for enhanced internal control in hospitals may enhance the monitoring function of nonprofit audit committees in hospitals.

Based on these discussions, we identify a special segment within the nonprofit sector, namely nonprofit hospitals,⁵ to investigate the possible effect of nonprofit audit committees on internal control in administrating major federal programs that are subject to the Single Audit Act. We assert that audit committees in nonprofit hospitals subject to the Single Audit Act improve internal control in administrating major federal programs in these organizations, which leads to the following hypothesis:

H1: Nonprofit hospitals subject to the Single Audit Act are less likely to have reported internal control weaknesses in administering major federal programs with an audit committee in place than without an audit committee in place.

In addition to reporting internal control weaknesses related to administering major federal programs, independent auditors are also required to report internal control weaknesses associated with financial statement audits of nonprofit organizations. Resource dependence theory, again, suggests the need for enhanced internal control over financial reporting in nonprofit hospitals

⁵ We should note that the U. S. Congress was particularly interested in the management of nonprofit hospitals as organizations that receive federal funds. (U.S Congress 2005b).

subject to the Single Audit Act. As far as fraudulent or manipulative reporting adversely affects the chance for the organization to obtain or secure its desired amount of resource inflow, a nonprofit board is motivated to enhance the monitoring function of its audit committee to provide adequate internal control over financial reporting. These discussions lead to the following hypothesis:

H2: Nonprofit hospitals subject to the Single Audit Act are less likely to have reported internal control weaknesses related to financial statement audits with an audit committee in place than without an audit committee in place.

RESEARCH METHOD

Data

Data concerning internal control weaknesses in nonprofit organizations were obtained from the Federal Audit Clearinghouse (FAC) database for the years 2001 to 2004. Prior to 2001, information was not available on organizational type (nonprofit) or mission type (hospital). This database was created for four reasons: 1) to disseminate audit information to federal agencies; 2) to support OMB oversight and assessment of federal award audit requirements; 3) to assist federal agencies in obtaining OMB Circular A-133 data and reporting packages; and 4) to help auditors and auditees minimize the reporting burden of complying with OMB Circular No. A-133 audit requirements (FAC website). The database was constructed from information contained in the *Data Collection Form for Reporting On Audits of States, Local Governments, and Nonprofit Organizations, SF-SAC (3-20-2001* (hereafter Data Collection Form). Both the auditee and the independent auditor are required to certify the accuracy of the information. The independent auditor documents control weaknesses in administering major federal programs on Question 4 (“Is a reportable condition disclosed for any major program?”) and Question 5 (“Is any reportable condition reported as a material weakness?”) of Part III of the Data Collection

Form. The independent auditor also documents control weaknesses in financial statement reporting on Question 3 (Is a reportable condition disclosed?") and Question 4 (Is any reportable condition reported as a material weakness?") of Part II of the Data Collection Form.

Table 1 contains a summary of the sample selection process by year. The selection process began by including all entities listed in the FAC database as *nonprofit* organizations with a mission type described as *hospital*. Based on these criteria, the original number of observations included 182 entities in 2001, 224 entities in 2002, 231 entities in 2003, and 126 entities in 2004. The drop in the total number of entities included in the FAC database from 2003 to 2004 is mainly due to a change in federal regulations. For fiscal years ended December 31, 2003, the dollar threshold for requiring an entity to have an audit in conformance with the Single Audit Act was raised from \$300,000 in total federal expenditures to \$500,000. We excluded government-operated hospitals and other health care organizations that were not hospitals, such as nursing schools, mental health service providers, and hospital management services. These entities were excluded because their governance processes, funding structures, organizational configurations, and mission focuses were extremely different from those of non-governmental, nonprofit hospitals. We also excluded hospitals that did not have relevant financial data available on the GuideStar database. Each of the remaining nonprofit hospitals was contacted by telephone to obtain information about the hospital's audit committee and internal audit function. After completing the process of telephone interviews, we eliminated those hospitals that did not respond after the second request. This selection process yielded a sample of 145 hospitals in 2001, 174 hospitals in 2002, 189 hospitals in 2003, and 116 hospitals in 2004 for this study.

Model Description

This study investigates how the presence of an audit committee may improve internal control in nonprofit organizations subject to the Single Audit Act. For this purpose, we test the relationship between the presence of audit committee and reported weaknesses in internal controls in administering major federal programs (*WEAKNESSMP*) and over financial reporting (*WEAKNESSFS*), using two logistic regression models. The predictor variable in both models is the presence of an audit committee (*COMMITTEE*). Since this information was not publicly available, nonprofit entities in our sample were contacted by telephone. Respondents were asked to provide information about whether the organization had an audit committee and an internal audit function during the period covered by the study. Two hundred forty-five of 290 organizations contacted provided the information.

Control Variables

In applying resource dependency theory to the nonprofit setting, Vermeer et al. (2006) identified several organization-specific factors, along with audit committee, that could affect internal control environment in nonprofit organizations. These include alternative monitoring mechanisms, such as auditor type (Big 4 versus non-Big 4), internal audit function, fund restrictions, debt status, and organization size in terms of the organization's total assets. We include these factors with two exceptions, fund restrictions and debt status, because these factors seem too specific for the purpose of our study. In addition, because we examine both internal controls in administering major federal programs and internal controls over financial reporting in association with these organizations' financial statement audits, we include three program-specific variables (based on the publicly available data) in our models. They are the size of major federal program in terms of the dollar threshold for Type A (large) programs, the total

expenditures of the federal grants, and the risk classification of the organization (whether the organization is a low-risk auditee). Thus, our models include six control variables: auditor type (*BIG4*), internal audit function (*INTAUDITOR*), the organization's total assets (*SIZE*), the dollar threshold for Type A programs (*THRESHOLD*), total expenditures of federal grants (*EXPENDED*), and the risk classification of the organization (*LOWRISK*).

According to Vermeer et al. (2006), using a Big 4 auditor can be associated with a nonprofit audit committee that is either more effective or less effective in monitoring. If a Big 4 auditor were used as a substitute monitoring mechanism, then those nonprofits that use a Big 4 auditor would be less likely to have an audit committee that is effective in monitoring. However, Big 4 auditors may be reluctant to be associated with a nonprofit organization having an audit committee that is weak in monitoring. Similarly, an internal audit function can be a substitute monitoring mechanism or something associated with an audit committee that is strong in monitoring. Thus, no direction of effect is predicted for these two variables. Consistent with resource dependence theory, we expect that large organizations and large programs are more complex and therefore can have increased demand for monitoring. Lastly, low-risk auditees are *supposed* to be less likely to have internal control weakness. These considerations suggest a negative relationship between the remaining variables in our models and reported internal control weaknesses.

Regression Models

$$\text{Model 1: } Prob(\text{WEAKNESSMP}) = \beta_0 + \beta_1\text{COMMITTEE} + \beta_2\text{INTAUDITOR} + \beta_3\text{BIG4} \\ + \beta_4\text{SIZE} + \beta_5\text{EXPENDED} + \beta_6\text{THRESHOLD} + \beta_7\text{LOWRISK} + \text{error}$$

$$\text{Model 2: } Prob(\text{WEAKNESSFS}) = \beta_0 + \beta_1\text{COMMITTEE} + \beta_2\text{INTAUDITOR} + \beta_3\text{BIG4} \\ + \beta_4\text{SIZE} + \beta_5\text{EXPENDED} + \beta_6\text{THRESHOLD} + \beta_7\text{LOWRISK} + \text{error}$$

Variable Descriptions:

WEAKNESSMP =	1 if reportable condition in administering major federal programs, else 0
WEAKNESSFS =	1 if reportable condition in financial reporting, else 0
COMMITTEE =	1 if audit committee is present, else 0
INTAUDITOR =	1 if internal auditor is present, else 0
BIG4 =	1 if audited by Big 4 accounting firm (Big 5 for 2001), else 0
SIZE =	natural log of the organization's total assets
XPENDED=	natural log of the organization's total federal expenditures
THRESHOLD =	dollar threshold for determining Type A federal programs
LOWRISK =	1 if low risk auditee, else 0

RESULTS

Descriptive Data

Table 2, Panel A contains the frequency counts of the dichotomous variables for each year from 2001 to 2004. The majority of the nonprofit hospitals did not report weaknesses in internal controls in administering federal programs (84 percent or greater each year) or weaknesses in financial reporting (88 percent or greater each year). This indicates nonprofits hospitals in our sample as a whole have adequate internal procedures in place to ensure the proper reporting of financial data and administration of federal programs. The percentages of hospitals with audit committees in place during the year in question ranged from a low of 62 percent in 2001 to a high of 69 percent in 2004. The increase in the percentage of hospitals with audit committees in 2004 coincides with the passage of the California Nonprofit Integrity Act requiring large nonprofits in California to form audit committees. In the Vermeer et al. (2006) study for the year 2004, 75 percent of nonprofits included in the sample had audit committees. In comparison, 69 percent of nonprofit hospitals subject to the Single Audit Act in 2004 in our study had audit committees, contrary to our expectations based on resource dependence theory.

Hospitals with internal audit functions were at 63 percent for all years, except 2003 when 57 percent had internal audit functions. These percentages were higher than the percent of nonprofits that had an internal audit function in Vermeer et al.'s (2006) sample (53 percent). A

plausible explanation is that internal audit functions in some nonprofit hospitals subject to the Single Audit Act substituted for audit committees. It is interesting to note the percentage of hospitals using Big 4 audit firms (Big 5 in 2001) has steadily decreased from a high of 80 percent in 2001 to 75 percent in 2004. This could represent a shift in the clientele of the large accounting firms, following the demise of Arthur Andersen and the imposition of stricter regulations by the Public Company Accounting Oversight Board (PCAOB). However, 84 percent of organizations in Vermeer et al.'s (2006) sample (of 2004) used a Big 4 auditor.

Insert Table 2 here

Panel B of Table 2 contains the descriptive statistics for the continuous variables. The mean of total assets in 2001 was \$394 million with a median value of \$262 million. By 2004 the mean had grown to \$491 million with a median of \$254 million. Total federal awards expended averaged \$9.63 million in 2001 and grew to an average of \$32.85 million by 2004, with median values of \$1.49 million and \$3.88 million, respectively. Both of these variables are skewed; therefore, the analysis was conducted using a natural log transformation of the variables. Changes in these size measures are indicative of the changes in the federal regulations. Smaller entities were exempted from Single Audit reporting requirements in 2003.⁶ This resulted in the 2004 sample containing fewer hospitals that were larger in size.

Regression Results

Table 3 provides the regression results, in which the presence of an audit committee is used to explain the probability of the nonprofit hospital reporting internal control weaknesses in administering federal programs. The models for all four sample years are significant ($p < 0.05$),

⁶ For fiscal years ending after December 31, 2003, the threshold was raised from \$300,000 to \$500,000. See OMB Circular No. A-133, revised by Federal Register, Vol.68, No. 124, June 27, 2003. As a result of this change, the average dollar threshold for Type A programs rose from \$384.20 million in 2001 to \$529.84 million in 2004 in our sample.

with Chi-squares of 29.15, 21.11, 14.67, and 19.79, respectively. *COMMITTEE* is significantly ($p = 0.02$) and negatively associated with *WEAKNESSMP* in 2002, but not in other years. These results provide partial support for H1.

Insert Table 3 Here

Searching for possible reasons for the lack of effect for *COMMITTEE* in the other three years, we find (as shown in Table 3) *BIG4* is negative, significant ($p < 0.01$) in 2001, and marginally significant ($p = 0.08$) in 2004, while the variable is not significant in 2002 and 2003. It appears that hospitals selecting Big 4 audit firms were less likely to have reported control weaknesses in administering federal programs and, consistent with the argument that a Big 4 auditor is used as a substitute monitoring mechanism, that a stronger effect of auditor type in 2001 and 2004 mitigated the effect of audit committee. No effect of *BIG4* or any factors other than *LOWRISK* in 2003, however, suggests that the likelihood of reported internal control weakness could be determined by the risk factors alone or by other factors not investigated in this study. Prior research suggests that internal control in nonprofit organizations is complicated by the dual role of nonprofit organizations as both principals and agents and some other unique characters of accountability in nonprofit organizations (Ebrahim 2003). Our results suggest that internal control in nonprofit organizations can be under the influence of various factors, including temporary factors such as the changing political and legal environment (the Sarbanes-Oxley Act of 2002 is clearly a noticeable environment-changing event during the sample period), in a complicated way. It seems that no single factor investigated in our study had consistent influence on internal control in nonprofit organizations.

It is notable that *THRESHOLD* is significant in all four sample years ($p < 0.02$) and *LOWRISK* is significant in 2001, 2002, and 2003 ($p < 0.05$). Other variables in the model are not

significant in any sample year. Contrary to our expectations, *THRESHOLD* is consistently positive. A possible explanation is that for some reason auditors might tend to use a more conservative approach in assessing internal controls in administering major federal programs when auditing larger programs. It seems interesting that the categorical measure *THRESHOLD* (dollar threshold for determining the type of federal programs) is a significant factor for *WEAKNESSMP* while the amount of expenditure (*EXPENDED*) is not.

Table 4 provides the regression results related to internal control weaknesses in financial reporting. The models for all four sample years are significant ($p < 0.05$), with Chi-squares of 41.24, 15.65, 24.19, and 19.66, respectively. Regressions results, however, show no significant relationship between *COMMITTEE* and *WEAKNESSFS* for any sample year to support H2. Searching for possible reasons for the lack of effect for *COMMITTEE*, we find *BIG4* is negative and significant in 2001, 2003, and 2004 ($p < 0.05$). *SIZE* is negative and significant in 2001 ($p < 0.05$). It is possible that the effects of these and other factors suppressed the effect of *COMMITTEE*.

We include *THRESHOLD*, *EXPENDED*, and *LOWRISK* in the *WEAKNESSFS* model to see whether federal program variables might be also related to the reported quality of internal control over financial reporting. Our results seem to suggest the existence of this relationship. *LOWRISK* is associated with low reported internal control weaknesses concerning financial reporting in 2001 (marginally, $p = 0.10$), 2002 ($p < 0.01$), and 2003 ($p = 0.04$). *THRESHOLD* is negative and significant in all sample years ($p < 0.01$), as predicted, which is consistent with high accounting requirements for larger programs. *EXPENDED* is marginally significant in 2001 ($p = 0.07$). However, the effect of this variable was not in the expected direction. Taking the face value of this result, it seems to suggest that larger amounts of federal grant expenditure may in

some way contribute to higher numbers of reported internal control weaknesses concerning financial reporting in that particular year. More research is needed to further explore this observation.

Insert Table 4 here

CONCLUSION

This study investigates whether audit committees improve internal control in nonprofit hospitals subject to the Single Audit Act. Financial data of nonprofit hospitals subject to the Single Audit Act, for the years 2001 to 2004, was obtained from the GuideStar database. Information concerning internal control weaknesses was obtained from the FAC database, and telephone interviews were used to gather data concerning audit committees and internal audit functions. A sample of 145 nonprofit hospitals was selected for 2001, 174 in 2002, 189 in 2003, and 116 in 2004. This sample was selected based Congressional concerns and the need for more research related to hospitals and educational institutions (Vermeer et al. 2006).

Our results suggest that audit committees can be an effective element of organizational governance in nonprofit organizations. However, it appears that the monitoring effect of nonprofit audit committees can be mitigated by other factors. Although we explored some of these factors in this study, our data does not clearly indicate under what conditions nonprofit audit committees have their best measurable performances of monitoring. It is also possible that nonprofit audit committees essentially function as complements to other control mechanisms, as suggested by Vermeer et al. (2006).

This paper extends the literature of audit committee. Audit committees are considered an essential component of corporate governance. In the aftermath of high-profile corporate accounting scandals, legislators implemented the Sarbanes-Oxley Act of 2002 to strengthen the

composition and responsibilities of audit committees. As public apprehension grows concerning management scandals in the nonprofit entities, federal legislators are considering increasing regulations of audit committees in nonprofit organizations. Some state legislatures, California in particular, have already passed laws requiring the use of audit committees by nonprofit organizations. However, as Ebrahim (2003) points out, although increasing oversight and regulation of nonprofit organizations is a natural response to the public's concerns for accountability in nonprofit organizations, it is necessary to understand the unique context of nonprofit organizations where the issue of accountability should be addressed. While intuitively the presence of an audit committee in a nonprofit entity suggests the entity's organizational accountability will be strengthened, it is important to establish empirical evidence of this relationship. To date, very little research has been done concerning audit committees in nonprofit organizations.

The results of this study, however, should be interpreted with caution. We would like to note the following. First, we use reported internal control weaknesses to measure the quality of internal control. Although this is an objective and highly reliable measure of internal control, we are unable to distinguish internal control *per se* and the reporting of internal control. Second, the sample size for those nonprofits that reported internal control weaknesses is relatively small, which reduces the power of testing, thus likely *deflating* our results (particularly considering the possibility that there were more internal control weaknesses than the number being reported). Third, there are other variables not controlled in this study that may further explain the differences in the results of our analyses using multi-year data and multiple predicted variables (internal control in administering major programs and internal control associated with financial statement audits). For example, the inclusion of "ineffective" audit committee may be able to

account for some differences in our results. Further research should explore additional factors and further investigate the unique way in which audit committees function in nonprofit organizations.

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TABLE 1
Sample Selection

Selection Criteria	Number of Observations				
	2001	2002	2003	2004	Total
Entities Listed in Federal Audit Clearinghouse Database as "Nonprofit" Organizations with "Hospital" Mission Type	182	224	231	126	763
Less: Governmental Entities	4	6	5	3	18
Less: Organizations Not Considered Hospitals ^a	6	9	9	2	26
Less: Entities With Missing Data	27	35	28	5	95
Total Observations	145	174	189	116	624

^aThese include nursing schools, mental health service providers, hospital management services, etc.

TABLE 2
Sample Statistics

Panel A: Frequency Counts for Dichotomous Variables

<u>Variable Name</u>	<u>Number of Nonprofits Coded 1</u>				<u>Number of Nonprofits Coded 0</u>			
	2001	2002	2003	2004	2001	2002	2003	2004
WEAKNESSMP	17(12%)	25(14%)	21(11%)	18(16%)	128(88%)	149(86%)	168(89%)	98(84%)
WEAKNESSFS	13 (9%)	21(12%)	15 (8%)	14(12%)	132(91%)	153(88%)	174(92%)	102(88%)
COMMITTEE	90(62%)	115(66%)	119(63%)	80(69%)	55(38%)	59(34%)	70(37%)	36(31%)
INTAUDITOR	91(63%)	109(63%)	107(57%)	73(63%)	54(37%)	65(37%)	82(43%)	43(37%)
BIG4	116(80%)	136(78%)	138(73%)	87(75%)	29(20%)	38(22%)	51(27%)	29(25%)
LOWRISK	75(52%)	85(49%)	108(57%)	68(59%)	70(48%)	89(51%)	81(43%)	48(41%)

Panel B: Descriptive Statistics for Continuous Variables

<u>Year</u>	<u>Variable Name</u>	<u>Mean</u>	<u>Median</u>	<u>Standard Deviation</u>	<u>25th Percentile</u>	<u>75th Percentile</u>
2001	Total Assets (\$M)	394	262	480	89	488
	Awards Expended (\$M)	9.63	1.49	27.53	0.69	4.84
	SIZE	18.98	19.38	1.66	18.30	20.00
	EXPENDED	14.59	14.21	1.51	13.44	15.39
2002	Total Assets (\$M)	399	251	515	73	461
	Awards Expended (\$M)	10.07	1.56	29.42	0.69	5.33
	SIZE	18.94	19.34	1.67	18.11	19.95
	EXPENDED	14.64	14.26	1.52	13.44	15.49
2003	Total Assets (\$M)	371	192	529	59	425
	Awards Expended (\$M)	18.69	1.83	76.41	0.79	6.36
	SIZE	18.74	19.07	1.77	17.90	19.87
	EXPENDED	14.81	14.42	1.65	13.58	15.66
2004	Total Assets (\$M)	491	254	682	84	530
	Awards Expended (\$M)	32.85	3.88	99.94	1.35	15.80
	SIZE	19.00	19.35	1.84	18.24	20.09
	EXPENDED	15.48	15.17	1.74	14.12	16.58

Financial data are from the GuideStar database; audit committee and internal auditor information are from telephone interviews; and, all other data are from the Federal Audit Clearinghouse database.

Variable Definitions:

WEAKNESSMP = 1 if reportable condition in administering major federal programs, else 0

WEAKNESSFS = 1 if reportable condition in financial statement reporting, else 0

COMMITTEE = 1 if audit committee is present, else 0

INTAUDITOR = 1 if internal auditor is present, else 0

BIG4 = 1 if audited by Big 4 accounting firm (Big 5 for 2001), else 0

LOWRISK = 1 if low-risk auditee, else 0

SIZE = natural log of total assets

EXPENDED = natural log of total federal awards expended

TABLE 3

Ability of Audit Committee to Explain the Likelihood of Nonprofit Organizations Reporting Internal Control Weaknesses in Administering Major Federal Programs

$$\text{Model: } Prob(\text{WEAKNESSMP}) = \beta_0 + \beta_1\text{COMMITTEE} + \beta_2\text{INTAUDITOR} + \beta_3\text{BIG4} + \beta_4\text{SIZE} + \beta_5\text{EXPENDED} + \beta_6\text{THRESHOLD} + \beta_7\text{LOWRISK} + \text{error}$$

<u>Parameter</u>	<u>Predicted Direction</u>	<u>2001 Coefficient (p-value)</u>	<u>2002 Coefficient (p-value)</u>	<u>2003 Coefficient (p-value)</u>	<u>2004 Coefficient (p-value)</u>
Intercept		1.89 (0.70)	-4.04 (0.31)	-5.19 (0.20)	1.13 (0.77)
COMMITTEE	-	0.76 (0.28)	-1.17 (0.02)	0.24 (0.68)	-1.04 (0.16)
INTAUDITOR	?	-0.37 (0.58)	0.25 (0.65)	0.12 (0.84)	0.53 (0.47)
BIG4	?	-2.30 (0.00)	-0.27 (0.67)	-0.34 (0.60)	-1.30 (0.08)
SIZE	-	-0.16 (0.43)	0.08 (0.64)	0.13 (0.58)	-0.26 (0.17)
EXPENDED	-	0.00 (0.99)	0.09 (0.66)	0.07 (0.67)	0.20 (0.40)
THRESHOLD	-	1.73 (0.01)	1.65 (0.01)	9.66 (0.02)	9.43 (0.01)
LOWRISK	-	-1.49 (0.04)	-1.20 (0.03)	-1.48 (0.01)	-0.77 (0.22)
Model Chi-square		29.15	21.11	14.67	19.79
Model p-value		p < 0.01	p < 0.01	p = 0.04	p < 0.01
McFadden's Pseudo R ²		0.28	0.15	0.11	0.20

Variable Definitions:

WEAKNESSMP = 1 if reportable condition in administering major federal programs, else 0

COMMITTEE = 1 if audit committee is present, else 0

INTAUDITOR = 1 if internal auditor is present, else 0

BIG4 = 1 if audited by Big 4 accounting firm (Big 5 for 2001), else 0

SIZE = natural log of total assets

EXPENDED = natural log of total federal awards expended

THRESHOLD = dollar threshold for determining Type A federal programs

LOWRISK = 1 if low-risk auditee, else 0

TABLE 4
Ability of Audit Committees to Explain the Likelihood of Nonprofit Organizations Reporting Internal Control Weaknesses in Financial Statement Reporting

$$\text{Model: } \text{Prob}(\text{WEAKNESSFS}) = \beta_0 + \beta_1 \text{COMMITTEE} + \beta_2 \text{INTAUDITOR} + \beta_3 \text{BIG4} + \beta_4 \text{SIZE} + \beta_5 \text{EXPENDED} + \beta_6 \text{THRESHOLD} + \beta_7 \text{LOWRISK} + \text{error}$$

<u>Parameter</u>	<u>Predicted Direction</u>	<u>2001 Coefficient (p-value)</u>	<u>2002 Coefficient (p-value)</u>	<u>2003 Coefficient (p-value)</u>	<u>2004 Coefficient (p-value)</u>
Intercept		1146.49 (0.95)	2.35 (0.54)	89.23 (0.99)	0.84 (0.84)
COMMITTEE	-	-1.15 (0.21)	-0.40 (0.44)	-0.43 (0.49)	-1.02 (0.21)
INTAUDITOR	?	1.60 (0.10)	0.70 (0.24)	-0.08 (0.91)	0.80 (0.32)
BIG4	?	-3.09 (0.00)	-0.17 (0.79)	-1.78 (0.02)	-1.61 (0.04)
SIZE	-	-0.50 (0.05)	-0.16 (0.30)	-0.01 (0.97)	-0.32 (0.12)
EXPENDED	-	0.65 (0.07)	-0.05 (0.83)	0.05 (0.83)	0.32 (0.22)
THRESHOLD	-	-1.85 (0.01)	-1.70 (0.01)	-1.16 (0.01)	-1.11 (0.01)
LOWRISK	-	-1.49 (0.10)	-1.91 (0.01)	-1.45 (0.04)	-1.04 (0.15)
Model Chi-square		41.24	15.65	24.19	19.66
Model p-value		p < 0.01	p = 0.03	p < 0.01	p < 0.01
McFadden's Pseudo R ²		0.47	0.12	0.23	0.23

Variable Definitions:

- WEAKNESSFS = 1 if reportable condition in financial statement reporting, else 0
- COMMITTEE = 1 if audit committee is present, else 0
- INTAUDITOR = 1 if internal auditor is present, else 0
- BIG4 = 1 if audited by Big 4 accounting firm (Big 5 for 2001), else 0
- SIZE = natural log of total assets
- EXPENDED = natural log of total federal awards expended
- THRESHOLD = dollar threshold for determining Type A federal programs
- LOWRISK = 1 if low-risk auditee, else 0