Audit Committees and the Not-for-Profit Organization

KLR Not-for-Profit Services Group

January 2015

www.KahnLitwin.com
Boston ♦ Cambridge ♦ Newport ♦ Providence ♦ Shanghai ♦ Waltham
888-KLR-8557 ♦ **TrustedAdvisors@KahnLitwin.com**

Audit Committees and the Not-for-Profit Organization

Board members of many not-for-profit organizations are asking themselves if they should create another sub-committee of the Board – the Audit Committee.

Since as early as 1967, the American Institute of Certified Public Accountants (AICPA) has advocated the formation and effective use of audit committees comprising outside directors as part of the corporate governance process to protect the public interest. In 1977, the AICPA's Board of Directors reaffirmed this position, urging AICPA members to encourage corporate clients and employers to establish audit committees. In 1978, the AICPA's Special Committee on Audit Committees concluded that audit committees were necessary for both corporate directors and independent auditors to fulfill their respective responsibilities. Of course, these comments were primarily directed toward **public companies** although they apply – in concept – equally to large not-for-profit organizations.

Since 1977, many other studies have been performed on the benefits of the effectiveness of audit committees that resulted in substantive recommendations for improvement in the corporate governance process. The AICPA and the accounting profession have been avid supporters of these studies, as well as their conclusions and recommendations.

The first question we always ask is whether the not-for-profit organization has a functioning Finance Committee comprised of individuals well versed in the business aspects of the organization. Since the mission of the not-for-profit organization is the achievement of its tax-exempt purpose – the social good – its Board is primarily mission oriented. A Finance Committee, although mindful of the mission, but whose primary goal is sound fiscal management, is an essential ingredient to a sound organization overall.

When such a Finance Committee is in place, meeting four to six times per year, **we do not believe that a separate Audit Committee is needed** unless the not-for-profit organization is very large, highly complex, and diversified geographically. In such a situation, the need for an internal audit function to supplement the annual external audit, supervised by a Board level Audit Committee is probably warranted. However, with the exception of national not-for-profit organizations with nation-wide affiliate networks, the typical not-for-profit organization with a properly functioning Finance Committee does not need an Audit Committee.

In discharging their role as it relates to the annual audit, the Finance Committee should possess the following characteristics:

1. A familiarity with how organization activities are reflected in the financial statements;
2. Some understanding of the auditing process; or
3. Lacking the above, at least a natural curiosity and an inquiring mind.

Consideration should be given to individuals with experience in business such as bankers, internal auditors, retired CPAs, corporate officers, etc.

The Finance Committee should be concerned with the following things, at a minimum:

1. The adequacy of internal control (a system in which the operating or recording function can be broken down into elements that are performed by different people, each checking the work of the others)
2. The accuracy of the records and the reports to the governing body (usually the board of directors)
3. The proper authorization of activities and expenditures
4. The determination of the physical existence of assets
5. A review of the tax-exempt status and identification of any activities that may endanger it
6. Ascertaining that payroll taxes, licenses, sales taxes, other taxes and corporate reports are properly filed in a timely manner.

The Finance Committee should work toward establishing a close relationship with the external audit firm and should meet with that firm separate from management. One of the cornerstones of the foundation of high quality financial reporting is that the Committee have *candid* discussions with outside auditors regarding issues implicating judgment and impacting quality. A key word in this principle is "candid." During these meetings the Finance Committee should establish the importance of independent communication and information flow between the Committee and the auditors. It should insist on an unbiased, robust examination of the numbers to ensure their credibility and integrity. The AICPA stresses that this oversight role be timely, robust, diligent and probing.

The AICPA goes on to state, "Integral to this reliance is the requirement that the outside auditors perform their service without being affected by economic or other interests that would call into question their objectivity and, accordingly, the reliability of their attestation. Specific questions that the Committee should answer in regard to the annual audit process, might include the following:

1. The adequacy of staffing of the audit.
2. The experience levels of the auditors assigned to the audit, including their experience with the organization and the not-for-profit industry.
3. The effort devoted to audit planning by the more experienced partner and manager. (Poor or inadequate audit planning may raise a red flag and risk for the audit committee that sufficient experience and expertise is not being devoted to judgmental and risky business and financial reporting issues.
4. The adequacy of the audit procedures on areas that require significant judgment and that have the greatest inherent risk when it comes to the numbers.

The GAO has recently promulgated new standards on auditor independence especially as it relates to "non-audit" services. While these new standards will affect whether smaller audit firms can even perform certain non-audit services, there are considerations for the Finance Committee whenever non-audit services are requested. Some writings have suggested that the Finance Committee consider ten factors when non audit services are performed, as follows:

1. Whether the service is being performed principally for the Finance Committee.
2. The effects of the service, if any, on audit effectiveness or on the quality and timeliness of the entity's financial reporting process.
3. Whether the service would be performed by specialists (e.g., technology specialists) who ordinarily also provide recurring audit support.
4. Whether the service would be performed by audit personnel, and if so, whether it will enhance their knowledge of the entity's business and operations.

5. Whether the role of those performing the service would be inconsistent with the auditors' role (e.g., a role where neutrality, impartiality and auditor skepticism are likely to be subverted).
6. Whether the audit firm personnel would be assuming a management role or creating a mutual or conflicting interest with management.
7. Whether the auditors, in effect, would be "auditing their own numbers."
8. Whether the project must be started and completed very quickly.
9. Whether the audit firm has unique expertise in the service.
10. What are the anticipated results of the non-audit services?

KLR

ABOUT OUR FIRM

KLR is a New England Regional Public Accounting Firm that is ranked among the Top 100 firms in the United States. From its six office locations in Boston, Cambridge, Waltham, Providence, Newport & Shanghai, the 200+ person firm provides assurance, tax, and business advisory services to private and publicly-held companies throughout the United States and abroad. KLR is a member of Leading Edge Global Alliance, the 2nd largest international professional association of independently-owned accounting, financial, and business advisory firms.

*Please note that this whitepaper is a general summary of the law and omits many important details, footnotes and caveats. It is no substitute for informed advice from a tax professional based on your particular circumstances.

Please see **www.kahnlitwin.com** for a detailed description of Kahn, Litwin, Renza & Co., Ltd.