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Building a Better Audit Committee

Understanding Your Committee's Purpose, Roles and Responsibilities is Critical

Audit committees are rapidly becoming a nonprofit "best practice." The establishment of a well-functioning committee is an integral part of good governance, financial reporting and risk management oversight for any sized organization.

Since the passage of the Sarbanes-Oxley Act of 2002, public companies have been required to retain audit committees. During recent years, many nonprofits have also found the committee structure to be a prudent step not only in reporting and risk management, but also for external and internal audit functions, compliance with legal and regulatory requirements and implementation of internal controls over these areas.

The Audit Committee's Role

As a rule, audit committees should operate as an arm of the board of directors, specifically the one that holds responsibility for proper financial management. Smaller nonprofits may be tempted to assign audit functions to their finance committee, however, finance groups have different responsibilities — primarily centered on monitoring the budget and approving the distribution of the organization's financial resources.

The audit committee should take a much broader view, overseeing the conduct and integrity of financial reporting, including establishing and implementing accounting policies and internal controls to promote good financial stewardship. The goal is to protect the nonprofit's assets, strengthen the reliability and accuracy of financial reporting, and reduce the risk of fraud.

On a practical level, financial reporting oversight translates to, among other things:

- Reviewing Forms 990 and reporting to regulatory agencies
- Looking for red flags in financial statements that might signal improper revenue recognition or other kinds of fraud (for example, unexplained fluctuations in revenues or expenses)
- Reviewing audit results, the nonprofit's responses and follow-up actions
- Evaluating the appropriateness of obtaining second opinions on auditing issues.

Ultimately, the audit committee should ensure that all financial reports are accurate and transparently present the organization's performance.

Managing Risk

The committee must understand the nonprofit's overall risk profile (as determined by a comprehensive risk assessment). The risk profile considers, among other things:

- Investment practices
- Disaster recovery plans
- Insurance coverage
- Compliance with laws
- Regulations and donor and grantor requirements

The committee also looks at internal policies and procedures. The organization's risks are evaluated in light of its "appetite for risk." The committee should assess internal controls over those risks and, if necessary, assure that remedial measures are effectively implemented.

Interacting with Auditors

The audit committee should regularly interact with both internal auditors, reviewing and approving both the annual internal audit plan and internal auditors' reports. The committee also may be responsible for approving the appointment of the head of internal audit.

Additionally, the audit committee is responsible for hiring, overseeing and compensating external auditors and is, therefore, considered the auditors' client. It should have regular communications with the auditors, including meetings to discuss a work plan before the audit and to review any findings before they're presented to the board.

Maintaining Independence

In addition to the roles and responsibilities described above, the committee must maintain its independence. Audit committee members cannot accept any consulting, advisory or other compensatory fee from the organization. Independence from management is also critical. Committee members should not have been an officer or employee of the nonprofit in the prior three years, or the immediate family member of such a person.

The American Institute of Certified Public Accountants recommends that some audit committee members also be members of the board of directors. However, some states limit the number of audit committee members who also are on the finance committee.

Financial Expertise: An Audit Committee Necessity

The composition of nonprofit audit committees might vary, but one thing is certain — at least one member of the committee should have strong financial expertise.

The committee's financial expert will bring a working knowledge of financial reporting (including Generally Accepted Accounting Principles) and internal controls. Bear in mind that it's not enough that he or she have experience in the for-profit world —knowledge of nonprofit-sector accounting and financial reporting issues is important as well.

And don't make the mistake of turning to the organization's treasurer. Because the audit committee is charged with independently monitoring financial results, appointing the treasurer to the committee could create a conflict.

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If you have any questions, please feel free to contact your Seiler professional at (650) 365-4646 or email info@seiler.com. We would be happy to discuss appropriate courses of action for your particular circumstance.

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