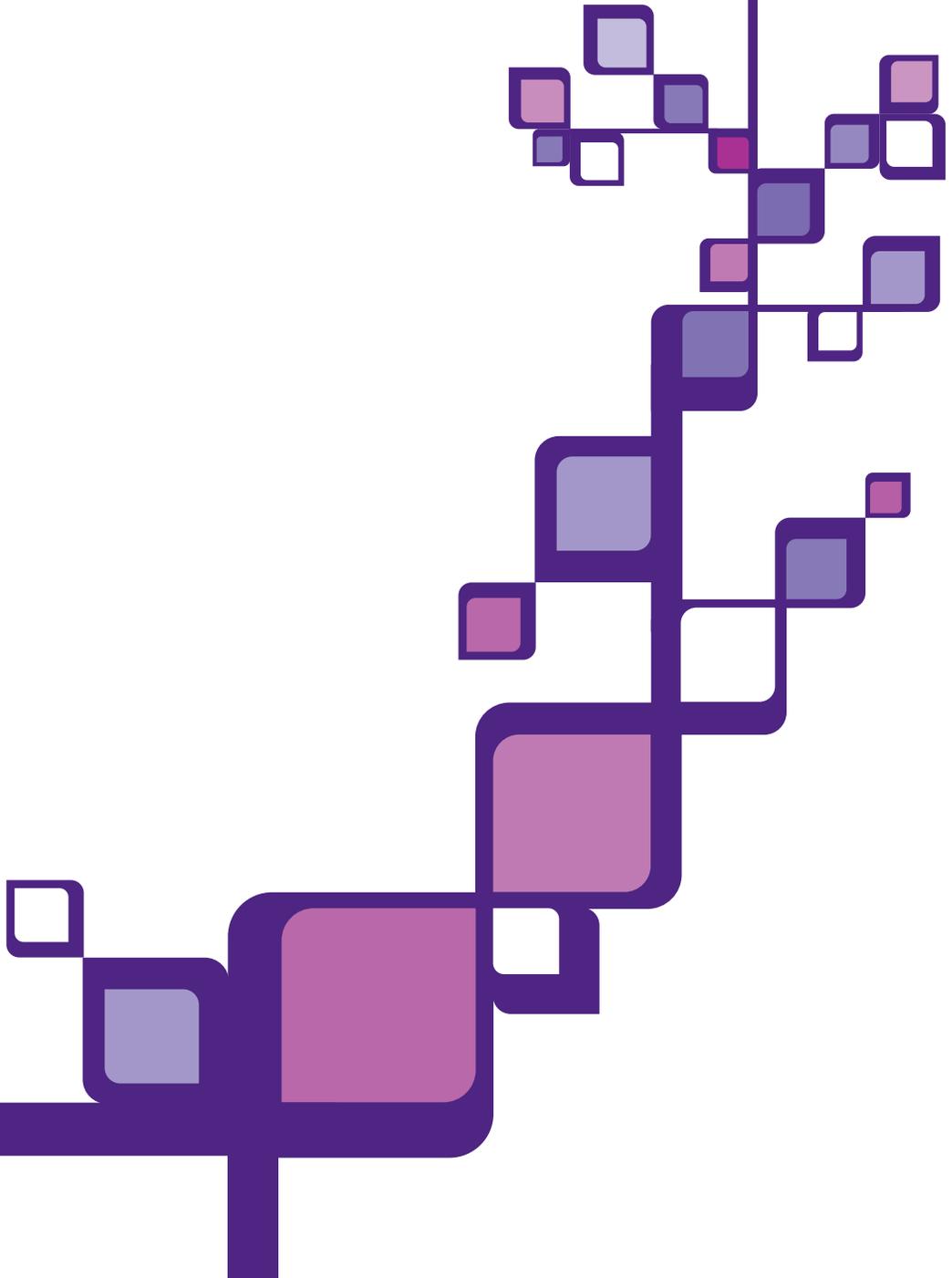
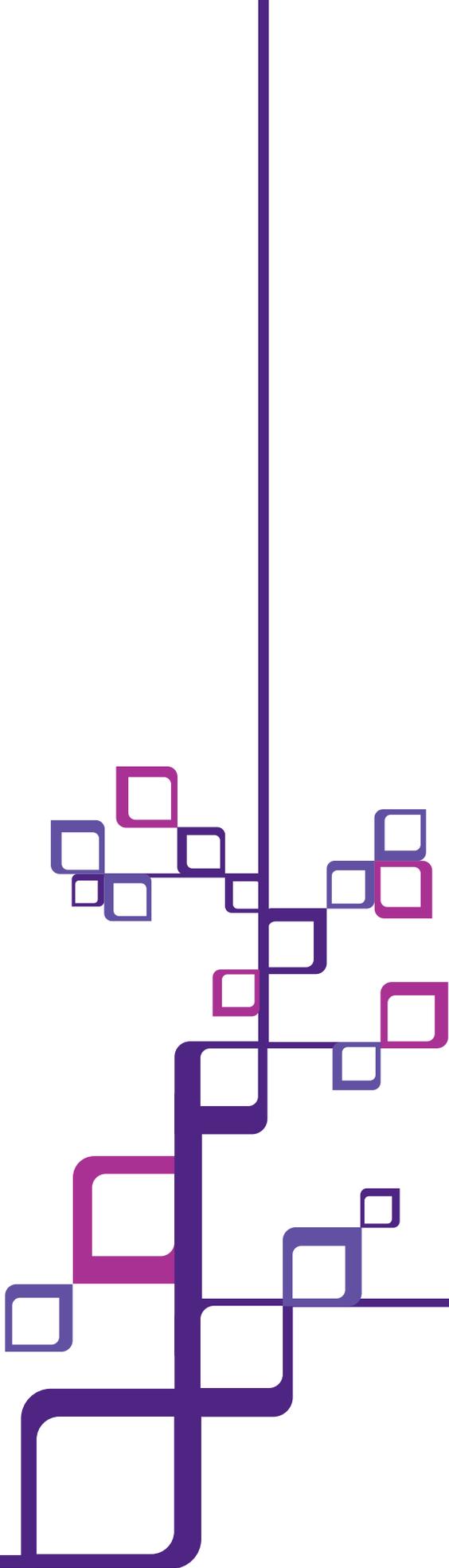


# Not-for-Profit Audit Committee Guidebook





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## The not-for-profit audit committee's guide to protecting your organization's reputation

Your organization's most valuable asset is its reputation, and that reputation must be able to withstand today's increased scrutiny. As an audit committee member, you are a guardian of that precious asset.

Audit committees exist to help the board maintain the organization's overall integrity, financial credibility and long-term viability. A sharpened focus on accountability, transparency and ERM has brought the role of the audit committee into the public eye. Ensuring that the organization prepares accurate financial statements, exercises responsible financial management, maintains compliance with laws and regulations, and manages operating risks effectively are critical tasks for every audit committee member.

Understanding that your role as an audit committee member is both rewarding and challenging, Grant Thornton LLP has created this guidebook to provide an overview of the composition, functions and duties of an audit committee.

We are committed to providing outstanding service to meet the audit, tax and advisory needs of our not-for-profit clients. For more detailed information and answers to your questions, contact our Not-for-Profit and Higher Education professionals.



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# Accountability and independence: Guiding principles of the audit committee

## The current environment

Not-for-profit organizations are under scrutiny as never before. From the White House to grantors to individual contributors to regulators, the expectations of not-for-profit organizations to perform their mission wisely and cost-effectively has never been greater. Audit committees are charged with the critical role of assessing their organization's capability to discharge its fiduciary duties effectively, accurately and with integrity.

At the federal level, the IRS has demonstrated a strong interest in organizations' good governance practices and their compliance with tax laws and regulations. There is special sensitivity to proper use of federal grants and contracts — the U.S. Government Accountability Office has issued several reports concerning the financial practices of not-for-profit organizations, and the Senate Finance Committee has addressed governance practices for many years. If you are a recipient of federal financial support, your granting agencies are also subject to an increased level of accountability to Congress.

At the state level, attorneys general, through their responsibility to oversee charitable organizations, are concentrating their energy on enforcing compliance with regulations.

At both the federal and state levels, the tax-exempt status of your organization is seen as a significant form of government subsidy, carrying with it the responsibility for ethical behavior.

As for third parties, news organizations will report any real or perceived transgression by a not-for-profit organization and its directors/trustees or staff. Banks, bond insurers, state debt intermediaries, watchdog groups and ratings agencies have all raised their standards of transparency and financial health.

Boards do not want any distraction from the achievement of their organization's mission; therefore, they, too, are setting higher standards for governance and financial practices.

The responsibility for ensuring that organization leadership meets the heightened expectations of today's increasingly stringent climate falls directly on the audit committee.

## Guiding principles

The guiding principles of the audit committee can be summed up in two words: accountability and independence.

### Accountability

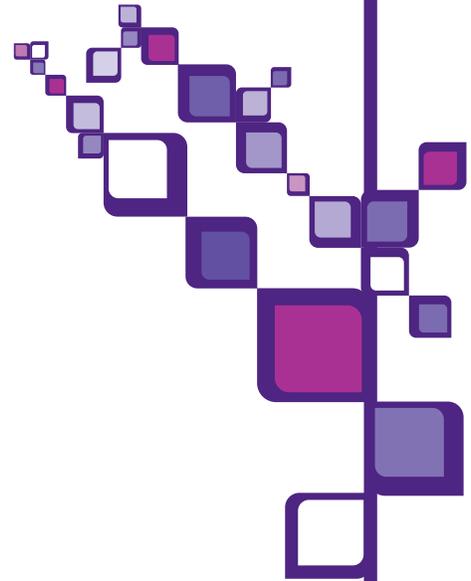
A not-for-profit organization is accountable to stakeholders such as donors, grantors, organizations that provide financing, regulators and people who use the resources of the organization. Those stakeholders rely on the organization to protect its reputation, and to properly and prudently use the monies it receives — whether fees, donations, grants or exchange contracts. In addition to being accountable to its stakeholders, the organization has a much broader responsibility to society at large because of its tax-exempt status. Tax exemption is a way to recognize the societal value of the services the organization delivers. It is also a method by which all taxpayers underwrite those services. In effect, every taxpayer is a stakeholder in your organization.

In order to govern effectively, the board must verify that management has adopted financial practices that are compliant with regulations and best practices, and adhere to high ethical standards. The audit committee's primary role is to instill confidence in stakeholders that the organization's financial and tax status, internal controls, risk management, and compliance procedures allow it to fulfill its mission and achieve long-term viability.

### **Independence**

The audit committee is charged with ensuring that management is conducting business at arm's-length basis with all parties, and avoiding conflicts of interest and inside dealings. To carry out this charge effectively, the audit committee itself must be independent of both management and the external auditors. The audit committee concerns itself with three facets of independence:

- The external auditor's opinion on the financial statements must be based only on its independent professional judgment, without improper influence from management.
- The organization's internal auditors must be independent from management and able to report problems and findings openly to the audit committee.
- The organization's board members and management must be independent from vendors. If overlapping financial interests or personal relationships exist, they must be fully disclosed, and the appropriate personnel must recuse themselves from discussions and voting on related matters. The board needs to approve a plan to monitor the conflicted relationships so that they do not create bias in business decision-making.



# Basic roles and responsibilities

## The audit committee's roles in the organization's governance

### Three main roles

**First, the audit committee represents the board in overseeing all material aspects of the organization's financial reporting, accounting policies and internal controls that promote good financial stewardship.**

To ascertain whether the organization is exercising proper stewardship over its assets, the audit committee must understand the organization's financial management practices, as well as monitor management's corrective actions with respect to the findings of the internal and external auditors' testing and review of the organization's internal controls and regulatory compliance procedures. These activities are meant to safeguard the organization's assets, promote the reliability and accuracy of its financial reporting, and mitigate the risk of fraud.

**Second, the audit committee is often the board committee primarily responsible for inquiring into how the business risks of the organization are being planned for and managed.**

Other board committees — such as investment, HR or personnel, executive, and development — will have a role in overseeing specific areas of risk. However, it is usually the audit committee that asks the overarching questions that help determine if the planning for and internal controls governing those risks are adequate.

To do this, the audit committee should understand the organization's risk profile in terms of governance, personnel, financial, process and operational, regulatory compliance, technology, economic, legislative, competitive, and fraud risk. Specific areas to address include:

- Investment practices
- Significant tax risks and tax positions on particular transactions
- Relationships with affiliated organizations
- Disaster recovery plans
- Adherence to donor and grantor requirements (especially unusual or problematic gifts)
- Inquiries from state charities' registration bureaus
- Insurance/litigation claims and adequacy of coverage
- Vulnerability to technology breaches from outside the organization
- Leadership's adherence to conflict-of-interest policies
- Risks associated with various financing agreements and structures
- Overall organization profile compared with industry standards and unclaimed property reporting

The business risk tasks most commonly assigned to an audit committee include business risk assessment and mitigation:

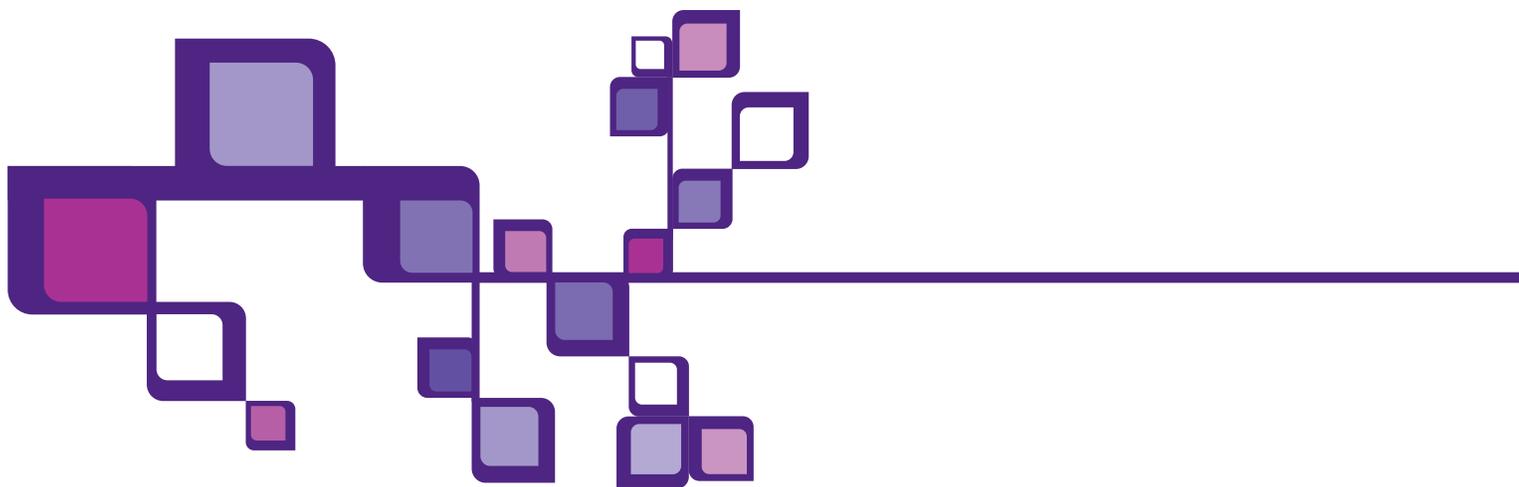
- Understanding the comprehensive assessment of the business and reputational risks faced by the organization, along with assessing management’s plan to manage those risks
- Holding management — including the CEO — responsible for the effective design and implementation of an internal control structure over financial reporting, nonfinancial reporting, asset stewardship, compliance with laws and regulations, protecting personal employee identification and information, and private and confidential employee data
- Providing to the internal and external auditor open access to the audit committee for discussion of issues, concerns and scope of work
- Approving the annual internal audit plan and reviewing the reports prepared by internal auditors
- Overseeing the whistleblower policy and process, and confirming that employees have a confidential way to report concerns regarding fraud, financial impropriety and misuse of funds
- Creating an appropriate tone from the top

**Third, the audit committee plays a pivotal role in overseeing the organization’s audit (internal and external) and compliance functions.**

Every not-for-profit organization must comply with applicable tax, legal, ethical and regulatory requirements. For not-for-profit organizations, regulatory standards dictate financial, billing, safety, employment, grants and contracts, spending and investing practices. In addition, most not-for-profit organizations must adhere to regulations specifying how they carry out their programs and what types of matters must be reported to regulators.

An effective audit committee must have a basic understanding of the compliance standards that affect the organization and how the organization adheres to those standards. The audit committee also needs to know which regulatory matters are assessed by the internal and external auditors, and which regulatory matters fall outside the scope of financial management and are instead managed by program staff. In most instances, it is the audit committee that inquires into the role of the organization’s compliance officer and ascertains that key committees and the board are kept informed of pertinent issues.

The audit committee is also responsible for overseeing the external and internal audit functions. Audit committee members should meet with the organization’s external auditors at least twice a year — once to discuss the audit workplan and once to review the audit findings before they are presented to the board. It is best practice to have internal audit attend all audit committee meetings.



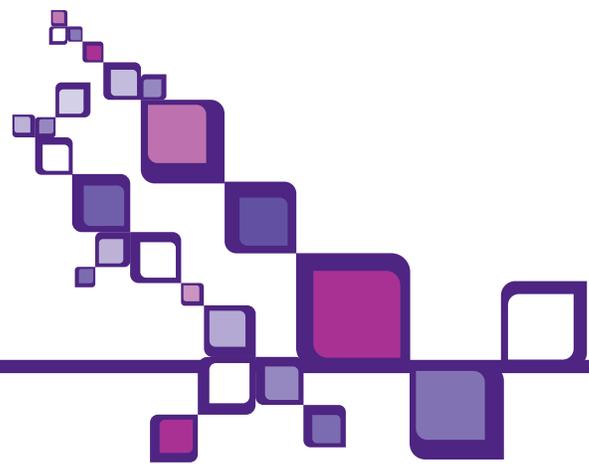
The oversight tasks most commonly assigned to an audit committee in this area include:

### Internal and external audit

- Recommending and appointing an independent audit firm
- Discussing the propriety of financial statement presentation and the adequacy of footnote disclosures
- Reviewing disclosures in financial statements to confirm clear and appropriate communication of financial information
- Reviewing and approving the scope of the workplan for the internal and external audits
- Reviewing findings of internal audits and associated control issues
- Receiving and acting upon the results of the internal and external audits
- Requiring follow-up and corrective action plans to be presented by management
- Monitoring implementation of management letter and internal audit recommendations
- Reporting to the board the results of the internal and external audits
- Evaluating the performance of the internal and external auditors
- Resolving disagreements between the external auditors and management
- Reviewing and approving the contract for any nonaudit services provided by the external auditors (optionally, for fees exceeding a certain threshold) if so required based on policy or audit committee charter

### Compliance

- Reviewing internally and externally produced reports on the organization's compliance with laws and regulations that have a direct and indirect effect on financial reporting, and on compliance with the organization's internal policies and procedures that are designed to ensure compliance
- Reviewing the Forms 990 and 990-T that are filed with the IRS
- Making certain that conflict-of-interest and code-of-ethics policies are implemented and applicable to employees and the board
- Reviewing significant conflicts of interest and related-party transactions
- Ensuring the existence of whistleblower procedures through which stakeholders, including employees, can raise concerns without fear of retaliation
- Ascertaining that a record-retention policy is in place and being followed



### **Distinction between audit and finance**

Some smaller organizations have joint audit and finance committees even though the trend has long been toward the establishment of a separate standing audit committee.

Some states require not-for-profit organizations to have a separate audit committee since the role of an audit committee is quite different from that of a finance committee. A finance committee's principal task is the approval and monitoring of the budget and financial results; performing this function requires individuals who understand the organization's programmatic structure and mission. An audit committee, however, views the organization's financial reporting, disclosure, compliance, internal control and risk processes from a critical perspective to understand and assess organizational weaknesses.

A board-approved charter should spell out the audit committee's exact authority and responsibilities. (For an example of an audit committee charter, see Appendix II.)

Given the audit committee's charge to oversee compliance, financial reporting, fiscal stewardship and business risks — essentially acting as the conscience of the organization — many organizations' charters include the authority to conduct special investigations and engage experts when circumstances require.

### **Composition**

The audit committee is generally composed of three to five members, the majority of whom should be board members. (Some states now require that all audit committee members be trustees.) Regulations permitting, audit committee members who are not on the board can serve effectively and in many instances can serve as accounting or financial statement experts if no board members have that expertise. All audit committee members should be independent of the organization's management — that is, they must not accept, directly or indirectly, any salary or compensatory fees from the organization.

As a general rule, the board treasurer should not serve on the audit committee. The audit committee monitors the organization's financial results, thus creating a conflict with the role of the treasurer. Sometimes there is an overlap between members serving on the audit, finance and investment committees. If such an overlap occurs, it is important that it be kept to a minimum and that there is no overlap for the majority of audit committee members.

Furthermore, in order for the audit committee to act as the conscience of the organization, it is important that it be independent of relationships that could compromise this integrity. Therefore, it is best that no officers of the board serve on the audit committee, and there should be limited participation of other committee members.

## Attributes

- Knowledge of the primary activities and operations of the organization
- A solid grounding in business and finance
- A good understanding of internal control concepts
- Financial literacy (i.e., an understanding of basic financial terminology and the ability to read and interpret financial statements)
- Knowledge of business risk and ability to link key operational and financial risks to related controls and control processes
- An understanding of compliance issues unique to the organization

One or more members should be a financial expert, possessing professional knowledge of financial reporting (including GAAP) and internal controls over financial reporting. Ideally, the financial expert should have specific knowledge of financial reporting practices used by not-for-profit organizations.

Of course, the supply of individuals with such backgrounds will vary considerably from one organization to the next. If your organization does not have board members with a financial background, you should actively recruit bankers, accountants and other financial professionals to fill this need.

## Characteristics required

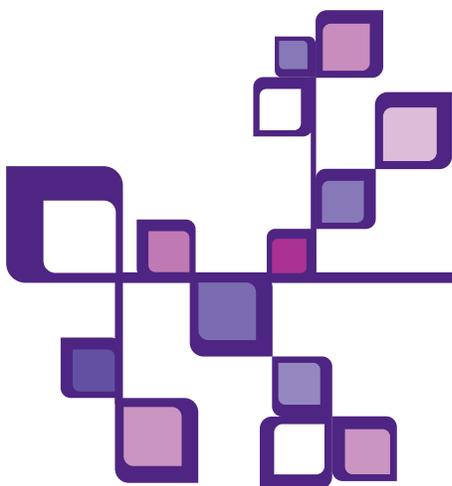
It is very important for audit committee members to possess the skills to listen and actively question what they are told. The audit committee members must be able to maintain a healthy skepticism, and should ask management pointed questions about practices, policies and needed improvements. They should pursue issues until satisfied with the answers received. Individuals who are uncomfortable asking challenging questions or coming to critical conclusions can't serve effectively on an audit committee. The role of the audit committee is not to challenge management for the sake of being challenging, but rather to ensure that needed improvements to controls, risk management and financial practices are diligently put in place.

The final characteristic an audit committee member must possess is a willingness to commit the time and effort necessary to do the job. Depending on your organization's size and structure, this time commitment could be substantial.

## Member liability

Board members of not-for-profit organizations face potential personal legal liabilities. The question of whether serving on an audit committee entails any further legal risk is a legitimate one. Since many of the events that could result in liability for the board stem from failures in internal controls, the audit committee is partly responsible for protecting itself — and the board — from such liability.

Before accepting any board position, investigate whether the organization carries adequate directors' and officers' (D&O) insurance coverage, which protects boards against allegations of wrongdoing. When reviewing the D&O policy, be sure it covers legal costs, which will be incurred regardless of the outcome of a lawsuit. You may wish to consult with legal counsel regarding the relevant laws in your state. You may also want to ask your insurance agent about individual policies that might cover such exposure.



# Users of the financial statements

A not-for-profit organization is unique in the breadth and diversity of the constituencies that have a strong interest in its financial health. All of those constituencies are potential users of the organization's financial statements.

## Internal users

The board uses the financial statements to understand the organization's revenues and expenditures, along with the scope and limitations of its financial assets. For the board, the financial statements are among many tools used to evaluate the organization's risk profile. Further, the board uses the external auditor's management letter to assess the effectiveness of the organization's internal controls over financial reporting.

Management uses the financial statements for the same purposes that the board does. In addition, it uses the management letter as a roadmap for improving the organization's internal controls over financial reporting.

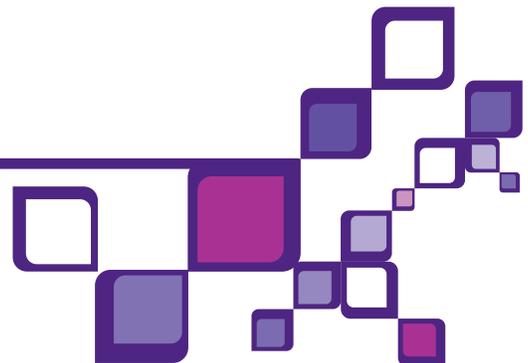
Both the board and management should use the financial statements to benchmark similar not-for-profit entities. Since GAAP creates consistency across organizations, these internal users can compare assets, revenue sources and expenditure patterns to information contained in the financial statements of peer or aspirant organizations.

Other users of the financial statements can include staff and volunteers.

## External users

Donors and granting agencies use the financial statements to assess an organization's financial position and performance. A clean opinion is seen as validating the financial condition of the organization. Banks and ratings agencies use the financial statements to evaluate the financial strength and viability of the organization, which becomes important when it applies for a loan. Accrediting and licensing agencies use the financial statements to determine the soundness of an organization as a service provider. News organizations use the financial statements — along with the Forms 990 and 990-T, and other filings — to seek background information on the organization, usually when following up on an embarrassing disclosure. Watchdog groups such as Charity Navigator use the financial statements to contribute to their ratings.

Given the wide range of potential users — and uses — of an organization's financial statements, it is essential that audit committee members evaluate them carefully and critically.



# The insider's perspective: Working within a not-for-profit organization

An effective audit committee must work with a variety of groups within an organization — the board, the management team and the internal audit department. It is essential that prospective audit committee members understand their role in each of these relationships.

## **The audit committee and the board**

The audit committee represents the board in fulfilling some of its responsibilities for risk management and financial oversight of the organization.

The audit committee should report at each board meeting (or at a minimum, twice per year). Topics to be addressed include:

- The plans for and results of internal and external audits, and any audit-related issues that merit the board's attention
- Issues of business risk and financial accountability
- Internal control or procedural issues
- New systems and controls evaluated and put in place
- Regulatory issues
- Pension audits
- Forms 990 and 990-T review

## **The audit committee and management**

Management is responsible for creating and maintaining internal controls, and the audit committee is responsible for understanding if those controls are designed and implemented adequately (supported by findings and recommendations from the internal and external auditors).

While the audit committee works collaboratively with external and internal auditors, and management, the audit committee is independent of each of these groups and must come to its own conclusions.

The audit committee should discuss internal control issues with management and review management's plans for correcting them. In some cases, management may recommend against implementing an auditor's suggestions on a cost-benefit basis — or even recommend an alternative solution. The audit committee should consider these suggestions, discuss them with the auditors if necessary, and bring any unresolved matters to the board's attention.

The emergence of ERM as an integral part of organizational risk-related activities creates a new role for the audit committee in understanding and assessing internal processes and management-led risk committee initiatives for identifying, managing and mitigating risk.

The audit committee can provide management with valuable, objective experience and expertise not available in-house and can serve as a sounding board for any issues related to reputation, strategic risk, operations, finance, internal controls and the public trust. By giving management an opportunity to discuss sensitive matters up front, the audit committee can help fend off potential problems before they arise.

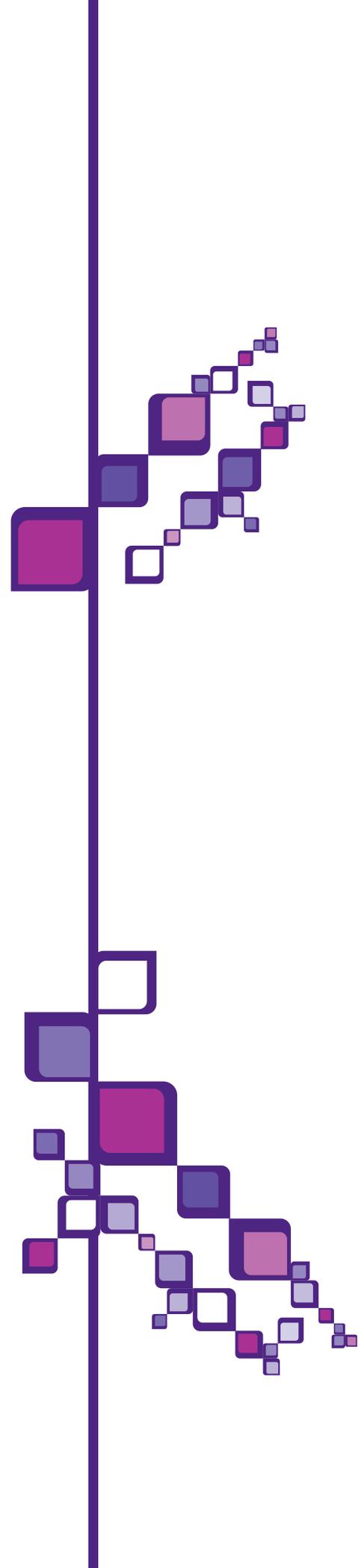
### **The audit committee and internal audit department**

Today, audit committees expect more from their internal audit functions than they did in the past. If your not-for-profit organization has an internal audit function, the audit committee should work with it in much the same way that it works with the external auditors. To be effective and independent, the internal audit department should be directly accountable to the audit committee. The head of internal audit should have confidential access to the audit committee chair. Additionally, the audit committee should evaluate the performance of the internal audit leader.

The audit committee should review and approve the internal audit workplan. This workplan should be based on a thorough risk analysis and list the areas within the organization targeted for detailed examination. The audit committee should review the internal audit department's findings and discuss any internal control issues that have arisen.

Audit committees are also looking to internal auditors to monitor the status of findings and recommendations to verify that appropriate corrective action plans are being implemented and old patterns of behavior are not being repeated. The organization should require the internal audit department to issue periodic reports regarding the status of corrective action plans, present these reports to the audit committee and possibly re-audit the affected internal controls after a certain period of time has elapsed.

If your organization does not have an internal audit function, it should consider establishing one either internally or via outsourcing.



# Working with the external auditors

As an audit committee member, you will spend much of your time working with the organization's external auditors, who have been appointed by the audit committee — or the board itself — to assist in assessing the organization's financial condition and stewardship functions.

Most audit committees meet two to four times per year. At a minimum, the committee should hold one meeting with external auditors to plan the audit and one to review results. It is best practice for internal audit to attend meetings with external auditors — and all audit committee meetings, for that matter.

## The pre-audit meeting

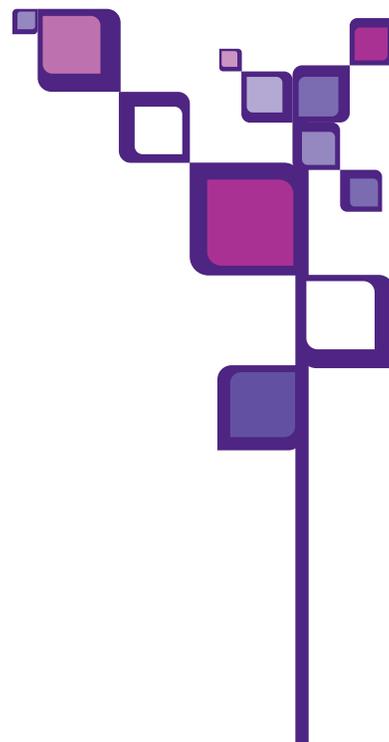
Prior to the audit, the audit committee should meet with the external auditors to review their workplan and set expectations for the upcoming work. An auditor's workplan details its strategy for conducting the audit. The workplan identifies those areas that the auditor has targeted for the closest scrutiny, and sets a schedule for the audit.

Audit committee members should review the workplan with the external auditors in light of the prior year's audit results and the audit committee's own concerns regarding business risks, internal controls and other pertinent issues. If the audit committee has concerns about a specific financial area, the external auditors' workplan should include it. If the workplan does not include that area, the audit committee must determine with the external auditors whether to add it. The audit committee must then review and approve the cost of any additional work it requests.

The pre-audit meeting is also the venue for external auditors to solicit input from the audit committee on areas of financial statement and internal control risk, including the risk of fraud. The audit committee should discuss with the external auditors any internal control issues or other issues raised by the prior year's audit. The audit committee should inform the external auditors of the steps, if any, that management has taken to resolve those issues and should seek the external auditors' opinion of those solutions.

During the pre-audit meeting (as well as the post-audit meeting), the audit committee should meet in separate executive sessions with external auditors, internal auditors and management. These executive sessions should be a standard part of the pre-audit meeting.

If an executive session deals with situations involving compliance or whistleblowing, the audit committee may want to have its own legal counsel present.



### **The post-audit meeting**

As its name implies, the post-audit meeting is held after the external auditors have completed their fieldwork. At this meeting, the external auditors will present to the audit committee their audit results — including draft reports, supplemental financial information and related audit reports — for review and discussion. In addition, external auditors' professional standards require that they communicate the following matters to the audit committee:

- **The auditors' responsibility under GAAP**  
The external auditors must communicate their level of responsibility for reviewing and reporting on the organization's internal control structure, and determining if the financial statements are free of material misstatement. The external auditors must explain to the audit committee that an audit is designed to deliver reasonable, not absolute, assurance that the financial statements are presented fairly and in accordance with GAAP.
- **Significant accounting policies**  
The external auditors should inform the audit committee about the selection of, changes in or application of significant accounting principles (including the options that might have been available) and financial reporting practices and policies during the period being audited. Discussions should include the effects of these practices and policies — and any likely changes to them.
- **Management judgments and accounting estimates**  
Accounting estimates are an integral part of an organization's financial statements. These estimates can be particularly sensitive because of the possibility that actual amounts may differ significantly from them. The external auditors should educate the audit committee about the process employed and assumptions made by management to formulate sensitive accounting estimates, and the basis for the auditors' conclusions regarding the reasonableness of those estimates. Post-retirement benefit obligations and the allowance for uncollectible accounts related to pledges receivable are examples of significant estimates.

- **Significant audit adjustments**

The audit committee should be informed of all significant adjustments made as a result of the audit that may not have been otherwise detected by management or staff. The external auditors must also provide the audit committee with a listing of proposed audit adjustments that were not recorded because neither the external auditors nor management considered the amounts involved to be material to the financial statements — either on an individual basis or in the aggregate.

- **Responsibility for other information in documents containing audited financial statements**

The auditors should discuss their level of responsibility for and involvement with information in other documents containing audited financial statements such as published annual reports or debt offerings.

- **Disagreements with management**

The external auditors should discuss any disagreements with management about matters related to accounting principles, financial reporting practices and policies, and auditing matters that could be significant to the financial statements or the external auditors' report. Areas of disagreement might include application of accounting principles, judgments about accounting estimates, the scope of the audit or the wording of the external auditors' report.

- **Consultation with other accountants**

If the external auditors are aware that management has consulted with other external auditors on matters pertaining to auditing, accounting or financial reporting matters, the views of those auditors should be discussed with the audit committee.

- **Major issues discussed with management prior to retention**

The external auditors and audit committee should review any major management issues raised when they were retained, including discussions about accounting principles, financial reporting practices and policies, and auditing standards and procedures.

- **Difficulties encountered in performing the audit**  
The external auditors should inform the audit committee of serious difficulties in working with management while performing the audit. Such difficulties might include failure to provide necessary information, unreasonable delays, unavailability of client personnel or failure of client personnel to promptly complete requested schedules.

In addition, the audit committee should discuss the following topics with the external auditors:

- Comparison of actual with anticipated audit results
- Any need to expand audit procedures and the reasons for doing so
- Propriety of financial statement preparation and adequacy of footnote disclosures
- Changes in report format or note disclosures from the previous year and reasons for making those changes
- Evaluation of personnel involved in preparing and monitoring financial information
- Nonaudit services and related fees during the prior year
- The report that the audit committee chairman will present to the board

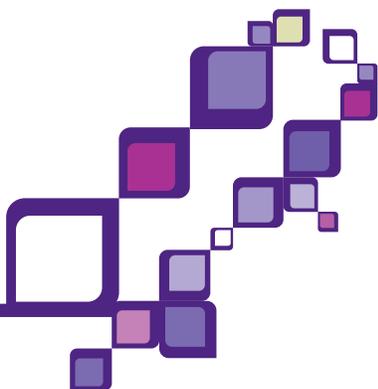
During the post-audit meeting, the audit committee should meet in separate executive sessions with only committee members present, with the external auditors, with the internal auditors and with management. These executive sessions should be a standard part of the post-audit meeting.

Again, if an executive session deals with situations involving compliance or whistleblowing, the audit committee may want to have its own legal counsel present.

### Evaluating the external auditors

Part of the audit committee's responsibility is to evaluate the work of external auditors. The audit committee should consider many factors when performing this evaluation:

- **Timeliness of service**  
Your external auditors should have a strong commitment to and demonstrated track record in timely service delivery. Working with your organization to plan and execute the audit, communicating regularly with you, and responding quickly to your questions and concerns are all essential to concluding the audit promptly, as well as meeting your expectations and those of the board.
- **Ability to address issues unique to your organization's risk profile**  
The audit firm must be able to understand your organization's funding streams, cost methods, licensing requirements, regulatory environment and general business conditions — in other words, the aspects that make up your organization's unique risk profile. Your staff should not have to teach the firm's staff how to work with not-for-profit organizations. Instead, the audit firm should provide critical information and business advice that will help improve your organization's operations.



- **General industry knowledge**  
Auditors need experience in providing guidance and information relevant to not-for-profit organizations and their many stakeholders. Donors, federal and state funding agencies, charity watchdogs, bonding agencies, regulators, the IRS, state charity bureaus, and consumers all rely on your organization's financial information, and your audit firm must be able to view that information through each of those lenses. Ideally, the audit firm can demonstrate its commitment to the not-for-profit sector by keeping abreast of new standards; contributing to thought leadership publications; and building good relationships with bankers, regulators and charity watchdogs.
- **Specific industry accounting and reporting expertise**  
The not-for-profit sector has specific accounting requirements that an auditor should know thoroughly. Demonstrated expertise in not-for-profit accounting and reporting is essential.
- **Experience with tax requirements pertinent to not-for-profit organizations**  
Exemption from tax does not mean exemption from tax consequences. And the tax-exempt status of not-for-profit organizations is in the spotlight — Forms 990, 990-PF and 990-T are disclosed publicly. Because retaining its tax-exempt status is essential for a not-for-profit organization, accurate reporting and tax compliance are equally essential. The auditor must have enough experience to understand the tax regulations, risks and concerns unique to not-for-profit organizations.
- **Sufficient staffing**  
Insufficient staffing, staffing turnover or inadequately trained personnel can lead to delays or poor performance. A further consideration is whether the audit will be staffed from out-of-town offices.
- **Price**  
While price should not be the sole determining factor in your choice of auditor, it is certainly a consideration. Be sure to evaluate the proposed auditor's qualifications and value relative to the fee that is proposed.
- **Chemistry**  
The auditors' ability to build trust and have a positive working relationship is critical to a productive professional relationship with management. Respect and rapport are essential to an effective working relationship, and are necessary to resolve technical and business issues, as well as to provide recommendations to improve the organization's internal control environment and business practices.
- **Providing value**  
An audit is not a commodity service. Your organization's relationship objective should be far more than merely getting a signed, clean opinion from an auditor. The audit should be viewed as an opportunity to add value to the organization and reduce its risks. An audit firm should possess the breadth of industry and business knowledge to offer ongoing, meaningful insights on the external landscape, internal operations and practices, and how the organization is positioned to respond to threats and challenges. The firm should also have the capability to assist management in keeping the board and audit committee informed of significant industry trends, challenges, threats and opportunities.

# The monitoring function of the audit committee

## Internal control and enterprise risk monitoring

The work of the audit committee does not conclude with the issuance of the financial statements or internal audit reports. Rather, the audit committee is expected to:

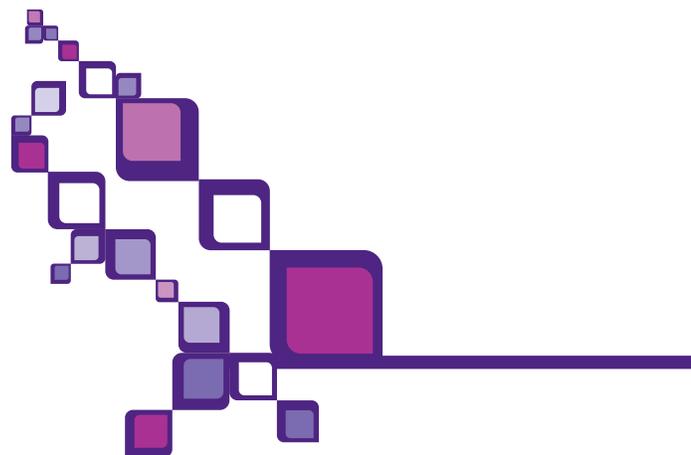
- Understand the organization's internal control environment and overall risk profile
- Conclude whether effective internal controls are in place
- Monitor the progress of corrective action until the organization's internal controls are working properly and mitigating risks effectively
- Assess whether risks that might prevent the organization from achieving its objectives or maintaining its reputation have been identified
- Know how the organization mitigates these key risks

Standard frameworks have been developed to guide organizations in their understanding and assessment of effective internal control, and their ability to identify and effectively communicate enterprise-wide risks. The Committee of the Sponsoring Organizations of the Treadway Commission (COSO) and ISO are popular sources of risk management principles, guidelines and models. The COSO model has gained prominence, particularly in U.S.-based organizations. The ISO standard has become the internationally agreed standard for the implementation of risk management principles, and thus has become popular for organizations with overseas operations.

These models help define the relationships between strategic, operational, financial reporting and compliance functions, and the control attributes that must be present for effective internal control. They also create a framework for identifying risks, communicating risks throughout the organization, establishing the organization's risk tolerance, and updating and monitoring risk.

Increasingly, not-for-profit organizations are using risk assessment processes to identify enterprise-wide strategic risks and create an organizational risk profile that identifies the critical threats to the organization's reputation and strategic goals. These risks reflect the evolution of the organization's business model, and changes in the risk profile and external environment.

Management risk committees or work groups perform these risk assessments, identify mitigating factors and develop actionable plans to ensure that the critical risks are being effectively managed by the organization. The audit committee plays a key role in supporting the creation of this function and overseeing the results.



### Dealing with fraud

Your external auditor should be expected to plan and perform the external audit to obtain reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud. The external auditor is not expected to identify any possible fraud. However, the external auditor does conduct testing that may detect fraud. The external auditor is expected to identify erroneous or fraudulent activities that materially affect external financial reporting.

The external auditor's testing usually includes:

- Inquiries of management and other employees
- Inquiries relating to whistleblower complaints
- Review of related-party activity
- Review of internal control documentation
- Performance of substantive procedures that include a review of journal entries and accounting estimates
- Evaluation of the rationale for significant transactions and related accounting treatments

Management is responsible for:

- Maintaining a culture of honesty and high ethical standards
- Designing, establishing and implementing controls that prevent, deter and detect fraud
- Adopting sound accounting policies
- Establishing and maintaining internal controls that facilitate timely reporting of material financial events that affect annual and interim financial results

The audit committee is responsible for:

- Evaluating management's identification of fraud risks and creation of the appropriate tone at the top
- Verifying that management has implemented appropriate fraud deterrence and prevention measures and controls
- Considering the potential for management override of controls or other inappropriate influence over financial reporting
- Insisting on effective whistleblower policies
- Receiving regular reports of potential instances of fraud

### Dealing with nonfinancial reporting and disclosures

A new area of fraud that is receiving public attention is the reporting of a host of nonfinancial data (e.g., a not-for-profit higher education institution's acceptance rates and incoming class SAT/ACT scores) to regulators, rating agencies, accrediting bodies and evaluative bodies. This type of data is generated throughout the organization on a variety of hardware and software systems. The audit committee should understand if there are adequate internal control processes and management review practices to assure this data is complete, accurate and properly reported.

**Importance of management’s discussion and analysis**

Management’s discussion and analysis (MD&A) disclosures may be posted on the organization’s website accompanying the financial statements or included as part of an annual report that also contains the audited financial statements, letter from the CEO and message from the CFO.

This narrative should serve as an educational tool for the board and the organization’s stakeholders regarding the financial condition of the organization.

MD&A disclosures should indicate key sources of revenue and types of expenses; trends in revenue and expense categories; key accomplishments, risks and disappointments; and any other information that management believes will assist board members in performing their fiduciary duties.

MD&A disclosures can also describe changes to organizational outcomes, trends in programmatic needs, development statistics, future capital plans and comparisons with other organizations. The audit committee should be familiar with the sources of any information that is included in MD&A disclosures but that is not derived from the financial statements. It is important that the descriptive information and statistics do not mislead the public as to the effectiveness of the organization.

**The management letter**

Also accompanying the financial statements is the external auditor’s management letter, which makes recommendations to enhance internal controls and related procedures.

A key audit committee function is to review the recommendations and management’s response, and then to monitor the implementation of these recommendations as part of its stewardship over the organization’s assets and reputation.

The management letter recommendation and implementation grid that follows depicts the type of monitoring that audit committees and management should perform.

The grid shows how the recommendations made by the external auditors and the corrective action plans developed by management could be documented. The grid presents the current status of the implementation of the recommendations, personnel responsible for implementation, deadline for full implementation and any implementation-related costs.

A similar process should be put in place for internal audit recommendations.

**Management letter recommendation and implementation grid**

Management letter action items for the year ended June 30, 20XX							
Action item	Action plan	Due date	Responsible parties	Status	Completion status	\$ from operating budget	\$ from capital budget
<b>Current-year recommendations</b>							
Comment 1							
Comment 2							
Comment 3							
Comment 4							
<b>Prior-year recommendations</b>							
Comment 1							
Comment 2							
Comment 3							
Comment 4							

# Appendix I:

## Selecting the external auditors

### Recommended practices

**First**, know that the decision is yours. The evaluation and selection of the external auditor must be made by the audit committee, not by management. The audit committee may solicit the views of management, but the responsibility for monitoring the external audit function rests with the audit committee.

**Second**, decide carefully based on the criteria discussed earlier whether a change is warranted. If it is, soliciting qualified audit firms to propose on performing the audit on a three- to five-year cycle is standard practice. An alternative is to consider partner rotation with your current provider. The responsibility to evaluate the services of — and possibly replace — your current external auditor should not be taken lightly.

**Third**, agree on the relative importance of your evaluation criteria before reviewing proposals.

**Fourth**, determine the critical business, financial and regulatory issues facing your organization, and agree on the size, depth of resources, industry expertise and range of capabilities that a firm must possess to address these issues.

**Fifth**, provide potential firms the opportunity — before they propose — to meet with management in person, review past audited financial statements and internal control letters, offerings, IT and operating units/segments, and establish how your organization's internal audit department (if one exists) could potentially support the external audit.

### Template for RFP<sup>1</sup>

#### Description of the organization to be served

- Purpose and mission
- Governance and management structure
- History (e.g., when the organization was founded and how it has developed)
- Tax status
- Location(s); indicate where books and records are kept
- Structure of finance function (e.g., staffing, and centralized versus decentralized)
- Financial overview (e.g., amount of revenue, sources of revenue, types of expenses, and types and amounts of assets)
- Technology supporting financial operations
- Sources for additional information (e.g., a website)
- How the services requested in the request for proposal (RFP) are currently executed
- Nature of any regulatory reviews that may be upcoming or are currently underway

<sup>1</sup> This template outlines certain typical items to be included in an RFP. It is not tailored to specific situations and includes more items than would usually be listed in a single RFP.

### **Specific service(s) required**

- The scope of work that the vendor is expected to perform, including deliverables to be provided
- Standards to be followed by the vendor in providing services
- Other vendor obligations to the organization such as regular reporting, problem-solving and method of billing
- Length of the service contract

### **Qualifications of the prospective vendor**

- Size (in terms of annual revenue, staffing or other metrics)
- Financial viability
- Commitment to the not-for-profit sector (e.g., thought leadership, industry sponsorship, issuance of accounting/tax updates, and continuing professional education seminars/webinars offered)
- History of successful client service
- Length of time providing specific services requested
- Experience with similar types of entities (including provision of references)
- Level of training and experience of staff members to be assigned to the engagement
- Commitment to diversity and social responsibility in the firm's delivery of services and in its governance, employment, environmental and investing practices
- Geographic proximity to the organization being audited
- Clear processes of communication and problem resolution
- Inclusion of peer review reports
- Confirmation that no disciplinary action has been taken against the firm by regulatory bodies or professional associations
- Confirmation that the vendor is independent of the entity (for audit services)
- Willingness to propose a fixed or an all-inclusive fee for the service period

### **Requirements of the proposal**

- Transmittal letter signed by a corporate officer or authorized agent of the vendor
- Description of the firm (date founded, services provided, business philosophy or approach, quality standards)
- Location of the office to provide the requested services
- Individuals who will be responsible for delivery of the services, as well as the qualifications of those individuals (i.e., specific training, experience, and length of service with the firm and industry)
- Similar information for all other key personnel who will be responsible for service delivery
- The names and contact information for organizations of a similar type currently served by the bidder
- A comparison of the firm's proposed services with the specific services requested in the RFP
- Identification and qualifications of any subcontractors, and the functions to be performed by each subcontractor
- Methodology used for pricing and fee structure
- Quote of fee(s) to provide requested services
- Approach to additional requested services and billing for such services

### **Decision-making process**

- Contact person within the organization who is coordinating the RFP process and can respond to questions about the process and the organization
- Contact person (if different) who can respond to technical questions about the services required
- Date when the proposal must be received by the organization
- Number of copies — including electronic copies — of the proposal
- If not elsewhere specified, the criteria to be used for evaluation of proposals

# Appendix II:

## Sample audit committee charter

Acting on behalf of the board, the audit committee is charged with overseeing all material aspects of the organization's financial reporting, internal controls, risk management and audit functions.

The audit committee's role includes a particular focus on the qualitative aspects of financial reporting and organization processes for the management of risk and compliance with significant applicable tax, legal, ethical and regulatory requirements. The audit committee's role also includes coordination with other board committees and maintenance of strong, positive working relationships with management, internal and external auditors, counsel, and other committee advisers.

The audit committee shall report this information to the board and provide its recommendations for action to be taken by the board and management in order to strengthen the organization's system of internal controls, compliance procedures and financial reporting process.

The audit committee shall oversee the internal and external auditors, and monitor management's progress in responding to the internal and external auditors' findings.

### **Composition**

The audit committee shall be composed of no fewer than three and no more than five independent nonexecutive board members. No member of the audit committee shall be an officer or employee of, or receive any compensation from, the organization.

The board treasurer may not serve on the audit committee.

The president, executive director or CEO shall be an ex officio nonvoting member of the audit committee but must be excluded, along with other management officials, when the audit committee is in executive session.

Committee members shall have (1) knowledge of the primary activities of the organization; (2) the ability to read and understand nonprofit financial statements, including a statement of financial position, statement of activities and changes in net assets, statement of cash flows and key performance indicators; and (3) the ability to understand key operational and financial risks, and related controls and control processes. The committee shall have access to its own counsel and other advisers at the committee's sole discretion.

At least one member, preferably the chair, should be literate in nonprofit financial reporting and control, including knowledge of tax and regulatory requirements, and should have past or current employment experience in finance or accounting, or other comparable experience or background. Ideally, this individual should have specific experience with a similar organization.

### **Roles and responsibilities**

#### **Risks and controls**

- Reviewing and assessing the organization's operating and financial risk management process, including the adequacy of the overall control environment and controls in selected areas representing significant risk
- Reviewing significant risks and exposures, and the plans to minimize or respond to them
- Assuring that management is setting the appropriate tone in communicating the importance of internal controls and establishing policies and procedures to mitigate risk
- Reviewing and assessing the organization's system of internal controls for detecting accounting and financial reporting errors, fraud and defalcations, legal and tax code violations, and noncompliance with the organization's code of conduct; in that regard, reviewing the related findings and recommendations of the internal and external auditors, together with management's responses

- Determining whether internal control recommendations made by internal and external auditors have been implemented by management
- Making certain that the internal and external auditors keep the audit committee informed about fraud, illegal acts, deficiencies in internal control and other audit-related matters
- Determining which aspects of internal control and compliance procedures are being tested annually by the internal and external auditors
- Understanding the nature of significant deficiencies and material weaknesses reported with the financial statements and reportable findings under Government Auditing Standards
- Reviewing with legal counsel any matters that may have a material effect on the financial statements
- Reviewing the results of the annual audits of trustees' and officers' expense accounts, and management prerequisites prepared by the internal or external auditors
- Identifying best practices, and developing and recommending corporate governance principles applicable to the organization

### Financial reporting

- Reviewing with management and the external auditors the results of the annual audit and related footnotes, including any difficulties or disputes with management, any significant changes in the audit plans, the rationale for (and quality of) adoptions of and changes in accounting principles, and soundness of accounting estimates requiring significant judgments
- Assessing whether the annual financial statements and related footnotes reflect appropriate accounting principles
- Reviewing the MD&A disclosures and concluding as to their reasonableness based on the audit committee's knowledge of the organization
- Reviewing and assessing the key financial statement issues and risks, their effect or potential effect on reported financial information, the processes used by management to address such matters, related auditors' views, and the basis for audit conclusions
- Reviewing recent professional and regulatory pronouncements, and understanding their effect on the organization's financial statements

- Reviewing the management letter and monitoring the organization's compliance with its recommendations
- Approving changes in important accounting principles and the application thereof in both interim and annual financial reports
- Advising financial management and the external auditors that they are expected to provide a timely analysis of significant current financial reporting issues and practices

### Compliance with laws and regulations

- Reviewing the effectiveness of the organization's system for monitoring compliance with laws and regulations
- Satisfying itself that all regulatory compliance matters have been considered in the preparation of the financial statements
- Reviewing the Forms 990 and 990-T and all of their disclosures, especially those regarding executive compensation, fees paid to vendors, activities unrelated to the organization's exempt purpose and transactions with related entities
- Reviewing the findings of any significant examinations by regulatory agencies
- Reviewing any state funding and cost reports filed

### Internal audit

- Ascertaining that the organization has the appropriate structure and staffing to carry out its internal audit responsibilities effectively
- Reviewing and approving the annual internal audit plan as recommended by internal audit based upon a comprehensive internal audit risk assessment
- Approving any changes to the approved annual internal audit plan
- Receiving and acting upon the reports presented by internal audit
- Evaluating the effectiveness of internal audit personnel, including the head of internal audit
- Concurring in the appointment, replacement, reassignment or dismissal of the head of internal audit

### External audit

- Selecting and retaining the organization's external auditors
- Approving the external auditors' fees
- Reviewing and approving the external auditors' proposed audit scope and approach
- Reviewing the performance of the external auditors and recommending their retention or discharge
- Reviewing and confirming the external auditors' assertion of their independence in accordance with professional standards
- Reviewing and approving the engagement of the external auditors to perform services over \$X in fees — including consulting services — unrelated to the audit

### Reporting responsibilities

- Reporting to the board at least annually with appropriate recommendations regarding the audit committee's activities and any key external audit issues
- Ascertaining whether the internal and external auditors have communicated issues and concerns to each other for appropriate follow-up and action
- Confirming with the internal and external auditors that they will report all relevant issues to the committee in response to agreed-upon expectations and as required by their professional standards
- Reviewing any submissions to the organization's whistleblower hotline
- Reporting to the board any reported conflicts of interest or related-party transactions

### Other responsibilities

- Meeting with the external auditors, internal auditors and management in separate executive sessions at least twice annually
- Confirming that significant findings and recommendations made by the internal and external auditors are received, discussed, and acted upon appropriately and promptly
- Reviewing and updating the audit committee charter
- Discussing with management the enterprise-wide risk assessment process and management action plans
- Understanding the control procedures to ensure that nonfinancial data reported to regulatory, accrediting and evaluative bodies is accurate and complete
- Reviewing and approving the organization's conflict-of-interest, code-of-ethics and whistleblower policies
- Reviewing and determining the appropriate response to reported conflicts of interest, related-party transactions and whistleblower complaints
- Conducting or authorizing investigations into any matters within the committee's scope of responsibilities; the committee will be empowered to retain independent counsel and other professionals to assist in conducting any investigation
- Providing an annual performance assessment of the committee, comparing the work of the committee with the requirements of its charter

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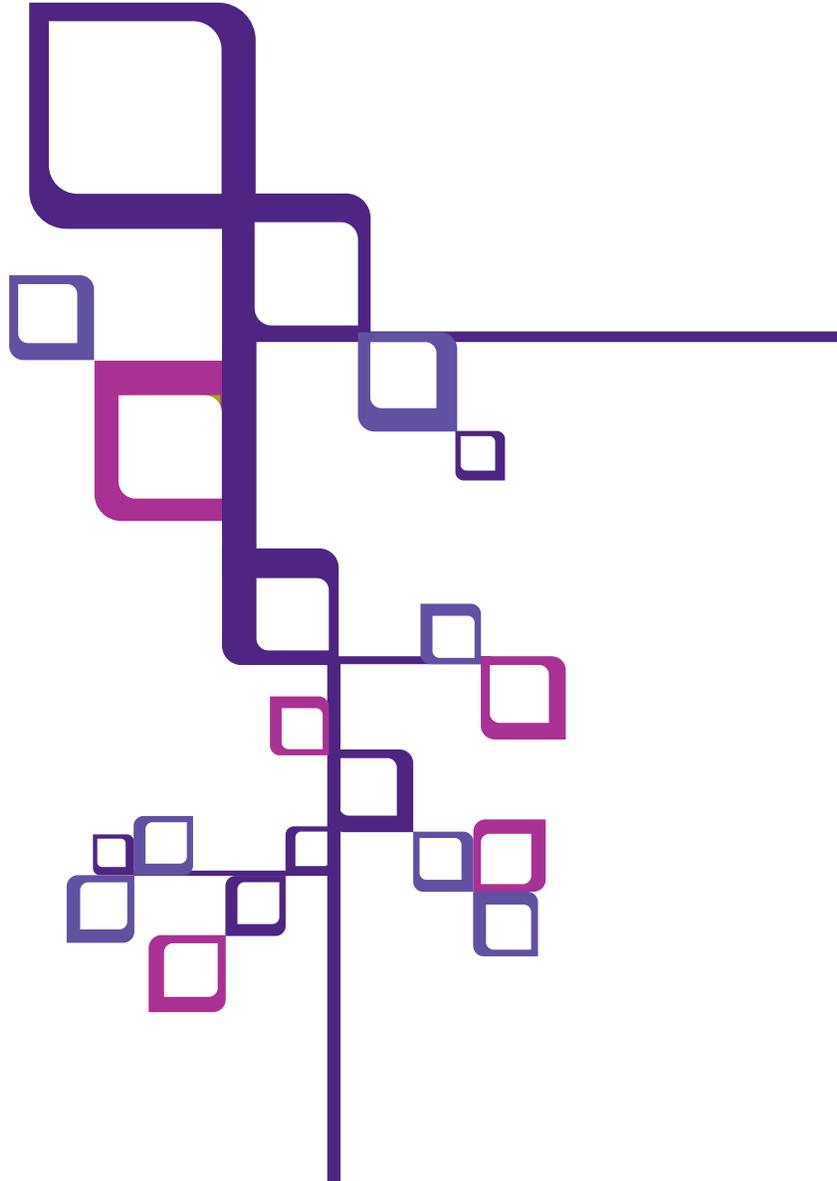
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