



The Governance Institute's E-Briefings



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Welcome to The Governance Institute's E-Briefings!

This newsletter is designed to inform you about new research and expert opinions in the area of hospital and health system governance, as well as to update you on services and events at The Governance Institute. Please note that you are receiving this newsletter because you are a Governance Institute member or expressed interest at one of our conferences.

News, Articles, and Updates

The 2011 Agenda for the Non-profit Audit Committee

Michael W. Peregrine, Esq., Partner, McDermott Will & Emery, LLP
Scott D. Steffens, Partner, Grant Thornton, LLP

This article is the third in a series on efficient board committee practices (refer to the September 2010 issue of E-Briefings to read about strategic alignment committees and the November 2010 issue for the previous article on executive compensation committees).

The audit committee continues to have one of the most substantive and challenging agendas of all elements of non-profit governance. The transitional economy—together with certain recent legislative, compliance, and regulatory developments—has substantially affected legal expectations of audit committee performance. It is no overstatement to suggest that responding to such based developments requires the most fundamental emphasis on audit committee practice since the enactment of Sarbanes-Oxley. The non-profit board is thus well advised to focus closely on the charter, composition, and effectiveness of the audit committee.

Precipitating Factors

A series of recent factors and legislative developments contribute to the call for the non-profit board to closely review audit committee practice:

The corporate accountability environment.

The recent financial crisis has precipitated an extraordinary climate of accountability in which "finger-pointing" and attempts to assess

responsibility for financial and other corporate loss have become the order of the day. A perspective exists that there is a direct correlation between corporate financial weakness and instability, and the quality of board oversight. State attorneys general and other charity regulators are increasingly willing to hold boards more directly accountable when the non-profit organization suffers "preventable" harm or loss. This is in recognition of the fundamental board role as stewards of charitable assets—and the state's interest in preserving and protecting such assets for continued charitable use. Charity regulators have expressed concern with the extreme financial and investment risks assumed by some non-profits that have been exposed in such unfavorable public manner. This is reflected in a willingness to challenge the quality of board oversight in egregious situations such as the September 2009 Stevens Institute of Technology case where New Jersey's attorney general sought to have the institution's president and board chair removed because of a variety of alleged fiduciary oversight breaches for compensation matters. (The case was resolved by a significant settlement in January 2010 providing for governance practices that the attorney general referred to as "best in class.")

These and similar actions demonstrate a willingness of charity regulators to target directors in investigations involving non-profit organizations.

Fraud against non-profits. Fraud and other forms of defalcation committed *against* non-profits are at near epidemic levels. The majority of this fraud is conducted by employees, rather than in Madoff-like scandals. Asset misappropriation, in various forms, constitutes the vast majority of reported fraud. The IRS now enquires about incidents of defalcation in the Form 990. State charity officials have made organizational fraud protection and prevention a high priority.

IRS governance initiative. The IRS remains deeply committed to supporting charity governance as a means of promoting tax compliance. Most recently, this governance commitment has been manifested through such developments as: (a) the commitment of IRS Commissioner Sarah Hall Ingram to increased governance oversight; (b) new governance training materials and audit examination materials for IRS agents and examiners; (c) the governance aspects of the IRS “FY 2011 Workplan” for charities; and (d) IRS recommended governance practices for exempt organizations that encourage adoption of an independent audit committee and focus on appropriate asset accounting and on auditor reports.

State activity. The role and function of the non-profit audit committee is the subject of much state level activity/scrutiny, whether by means of statute (e.g., California Nonprofit Integrity Act); non-profit guidelines (e.g., Massachusetts, New York), or litigation (the aforementioned Stevens Institute of Technology case). The California act remains the most prominent state articulation of expectations concerning the role, structure, and operations of the non-profit audit committee.

Best practices. The establishment and operation of a properly structured audit committee consisting of qualified, independent members is recognized as a non-profit governance best practice or guiding principle by a variety of sources, including the Panel on the Nonprofit Sector, the AICPA, the National Association of College and University Business Officers, the American Bar Association, the National Association of Corporate Directors, and the IRS.

Enterprise risk management. The emerging application of enterprise risk management principles to the non-profit sector requires close vertical and horizontal coordination by governance and management to assure proper evaluation of all material risks affecting the organization—while avoiding a de-emphasis of important audit and compliance issues.

Emerging Issues Requiring Audit Committee Attention

Given these developments, board leadership and the audit committee should work together to jointly address the following key issues:

Scope of duties. This is the critical question of whether the audit committee has “too much on its plate” in order to function effectively. In addition to traditional audit duties relating to the selection, and monitoring the work of, the independent auditor, focus should be on other roles that may have been assigned to the audit committee (e.g., compliance, finance). What is the “tipping point” when the combination of duties becomes overwhelming for the committee? This may be a particularly relevant concern when traditional oversight functions such as finance and/or compliance are combined into the audit committee. In other situations, investment management, board nominations, and/or conflict-of-interest management are added to the audit committee. Enterprise risk management is often assigned to the audit committee even though many view it as a responsibility of the entire board. There is no absolute best practice in this regard (especially because size of the organization and size of the board are key factors) yet, Sarbanes-Oxley and related themes are supportive of a separate, pristine committee. The effectiveness of the audit committee will decline should it become a “dumping ground” for oversight tasks.

Committee composition. Key issues associated with audit committee composition include: (a) the qualifications/competence/availability of committee members; (b) whether the audit committee is comprised exclusively of independent board members; and (c) whether the board’s conflict-of-interest policy is regularly and vigorously applied to all matters coming before the audit committee. In many respects, these issues arose from core Sarbanes-Oxley provisions considered applicable to the non-profit

sector. However, the concern regarding aggressive conflict-of-interest management arises primarily from recent controversies and scandals in the non-profit sector involving conflicted directors playing an inappropriate role in audit/financial management of the charity.

TARP spillover. Taking a cue from the troubled company legislation and related Congressional oversight, the audit committee may increasingly be called upon to evaluate the appropriateness of business risks proposed by management (such as new business ventures and investments) to be assumed by the corporation. Many feel that the audit committee is the most appropriate governance vehicle by which such risks can be evaluated.

Compliance coordination. In situations where it is not directly responsible for the corporate compliance function, the audit committee should nevertheless coordinate its activities, and those of internal audit, with compliance and legal. Committee oversight responsibility for tax compliance and reporting matters (e.g., audit, compliance) should be clarified. The audit committee should also be alert to the danger that compliance and related issues will “fall through the cracks.” The general counsel and compliance officer should attend audit committee meetings. In this regard, the audit committee should recognize the possibility that auditors may not immediately recognize the legal implications of issues they identify and lawyers may not immediately recognize the audit/accounting implications of issues they identify.

Board reporting. Given the focus on the audit committee’s diligence, a variety of reporting issues should be considered, including whether: (a) the audit committee meeting frequency is sufficient to deal with its workload; (b) the committee’s meeting minutes are complete, descriptive, and distributed to all board members; (c) the committee reports to the executive committee, and to the full board, with appropriate frequency; and (d) the committee has the opportunity to conduct a pre-or-post filing review of IRS Form 990.

Management letters. The audit committee’s attentiveness to the issues presented in the auditor’s “management letter of recommendations” is of increasing importance. The general counsel and corporate compliance officer should be fully involved in the review

process, and the full board should be briefed on all material issues cited by the auditors, for oversight purposes. This is especially the case given the extent to which board consideration of auditor concerns formed such a major portion of the Stevens Institute of Technology complaint.

Financial whistleblowing. Many sophisticated non-profits have added a parallel “whistleblower” reporting process, separate from corporate compliance, by which interested parties may confidentially report to the audit committee concerns regarding perceived accounting, financial, purchasing, and related irregularities. Such parallel reporting must be closely coordinated, however, with the general counsel as there exists a significant risk of legal issues going unnoticed from such a process.

Resources. It is particularly important in this environment that the audit committee is provided with the resources and budget to engage third party advisors and legal counsel (in addition to the independent auditor) as may be necessary. Except in extraordinary circumstances, these engagements should be in the name of the corporation and coordinated through the general counsel, even if the reporting relationship is with the audit committee. Further, careful attention should be given to assuring that appropriate organizational financial and accounting staff are invited to serve as staff to, and regularly attend, committee meetings (in addition to the general counsel).

Recommendations

The audit committee performs a crucial oversight role for the non-profit organization. In order to assure its continued effectiveness, the audit committee (in conjunction with the board) may wish to consider the following steps:

- Re-examine the committee charter and scope of duties.
- Place closer focus on committee agendas, with priority items emphasized by chair. Identify standing items for discussion by meeting and have management provide status on open items from previous meetings.
- Work with the nominating committee to assure proper audit committee membership composition and succession planning.

- Consider periodic self-evaluation at audit committee level.
- Review allocation of meeting time between discussion and questions (more) and presentations (less).
- Focus on quality and clarity of meeting materials and committee information.
- Conduct regular executive sessions with the external auditor, internal auditor, and management at every meeting.
- Increase coordination with legal and compliance functions.
- Reconsider the effectiveness of horizontal and vertical internal reporting relationships.
- Increase the level of dialogue with the independent auditor.

- Schedule regular committee general education sessions.
- Increase management education on financial developments.
- Constantly monitor potential for committee-level conflicts.
- Re-evaluate the sufficiency of internal controls regarding fraud and embezzlement.
- Monitor frequency of committee meetings and member attendance.

The Key: Consider what's working, what's not working, and what may be falling through the cracks. Remember, from the law's perspective, the audit committee is increasingly "where the action is" with respect to non-profit governance.

The Governance Institute thanks Michael W. Peregrine, Esq., and Scott D. Steffens for contributing this article. They can be reached at MPeregrine@mwe.com and Scott.Steffens@us.gt.com.