Do We Really Need an Audit Committee?

~ R. David Bustard

As an executive of a nonprofit organization or as a member of its board of directors, the last thing you want to see when you pick up your morning newspaper is your organization's good name in the front page's lead article that contains the words "fraud," "misappropriation," "default," "bankruptcy," or similar troubling words. Yet, notwithstanding an executive's or a board's sincere best intentions, this has, unfortunately, happened to more than one nonprofit organization. The repercussions of such an article (or, more likely, series of articles) can be tragic. Years of dedication, hard work, and commitment by founders, board members, and loyal employees to develop goodwill toward the organization and its special cause can be lost, sometimes irrevocably. The consequences are felt most tragically by the individuals and causes the organization's founders intended to benefit, but they also have an impact on all of an organization's stakeholders, including its volunteers, employees, board members, and dedicated sustaining donors.

This brief article will discuss and advocate for the inclusion of an engaged, independent, and aggressive audit committee in your nonprofit organization's governance structure. It will discuss the audit committee's role in the organization, its recommended composition, what activities it must engage in to fulfill its mandate, and certain best practices that your organization should adopt to maximize its effectiveness.

Ultimately, the goal of this article is to enhance the sensitivity of nonprofit executives and members of nonprofit boards to the benefits of creating audit committees, if they are not yet part of an organization's structure, and to introduce some of the basic tools and concepts to get new audit committees started or to enhance the effectiveness of existing audit committees.

Is a Separate Audit Committee Really Necessary? We Already Have a Finance Committee.

While audit committees have been important in the corporate world for some time, their value in the nonprofit environment is of more recent vintage, and it has been increasing as the requirements for public reporting and the demands of regulatory oversight of nonprofit organizations have increased. The demands for enhanced regulatory oversight come from public funding providers, as well as from private funding organizations and individual donors. Each of those funding sources looks to your organization's governing board to be responsible for control of these resources and for assurance that its donor and program requirements are being met. It is, perhaps, the board's most vital mission to serve as a faithful steward of the resources provided to it by its funding sources and thus to effectively serve the organization's intended beneficiaries. We cannot overstate the value of assigning these responsibilities to a small group of board members whose attentions are focused on the unique challenges of financial reporting, risk identification, and internal controls.

Yet, notwithstanding their increased prevalence, according to a survey published by the Stanford Business School in 2015, 42 percent of nonprofits still do not have audit committees. The fact that audit committees are not universal in nonprofits may be attributed to a lack of resources or to a failure to fully understand and appreciate the contributions that an audit committee can make to the organization's effectiveness and the avoidance of potential threats to the organization's mission. Most observers and many commentators identify the audit committee as an essential component of any organization's governance, whether it be for-profit or not-for-profit. In contrast to the more commonly seen finance committee, the audit committee has oversight responsibility for financial reporting, internal and external financial auditing, legal and regulatory compliance, and internal controls over financial reporting. The finance committee, more common to most organizations, focuses its attention less on actual financial controls and risk management and more on the organization's budget and all revenue and expense activities that impact the budget.

Distinguishing the audit committee from other board committees, and underlying and motivating its work, are its responsibilities for financial oversight to protect the organization's assets, its initiatives to identify and reduce the risk of fraud, and its mandate to ensure the accuracy of its financial reports. In addition, an effective audit committee works closely with both external and, if part of the organization's structure, internal auditors to monitor their testing of internal controls and the implementation of risk management processes.

Who Should Be on the Audit Committee?

Depending on the size and complexity of the organization, the audit committee typically comprises three to five members of the board of directors. To ensure independence, none of the committee members should be members of management, and all of them should be financially independent of management and of the outside auditors. Ideally, all of the members should have some background in business or finance and should possess a healthy streak of skepticism. At least one committee member should have deep financial expertise and knowledge of the organization's compliance requirements. If otherwise qualified, that member should be designated to serve as the committee's chair.

What Does the Audit Committee Do?

An important tool in fulfilling the committee's mandate is the creation of an audit committee charter, and one of the committee's first tasks upon its inception should be the creation of that charter. After the committee has drafted its charter, the committee should present it to the full board for review, comment, and ultimate adoption. The charter should clearly articulate the committee's purpose and responsibilities. It should specify the committee's membership composition and its meeting schedule and other operational requirements. It should clarify its responsibilities for the selection and work of the organization's independent auditors and its oversight of regulatory compliance and risk management. In addition, it should include a requirement for periodic self-evaluations intended to assess, with input from the organization's full board, the committee's effectiveness in fulfilling its designated responsibilities.

The essential function of the audit committee is to oversee the organization's financial reporting and the auditing of the financial reports. At the most fundamental level, the audit committee appoints the organization's outside auditor, negotiates the auditor's engagement annually, and oversees the actual audit process. To fulfill its auditor-selection function, the audit committee should interview several candidate firms to evaluate which one has the best relevant experience in auditing similar organizations and to determine if it has a staff that can interact effectively with the organization's management and with the members of the audit committee. The auditors should be able to demonstrate to each committee member's satisfaction a clear understanding of the organization's mission, the regulatory environment in which the organization operates, and a familiarity with the challenges faced by similar organizations, as well as the financial controls that have been most effectively used to meet those challenges. Ultimately, the auditors must report directly to the audit committee and not to management, and each committee member should have a high degree of confidence in the competency of its chosen audit team.

Once an outside auditor has been selected, the firm should meet with the organization's management, including, most importantly, its financial team members, in order to achieve a thorough understanding of the organization and any unique challenges it faces. The committee should direct the audit team to develop and present its audit plan for the organization's upcoming fiscal year, including an annual audit calendar prescribing the dates on which critical tasks are to be completed and reviewed at committee meetings. Once the audit plan has been submitted, the committee should carefully review the plan and meet with the audit team to discuss any particular areas of financial challenge or organizational concerns before the process begins. To the extent the members feel necessary, those planning meetings may, and perhaps should, take place without management in attendance, in order to promote the opportunity for candid discussion of those challenges and concerns.

Upon the audit's completion, the auditors should present a draft of the audit to the audit committee for review, and that review process should include a meeting with the auditors and the organization's financial management to discuss the audit's findings, any deficiencies revealed through the audit, all recommended remedial measures deemed necessary to prevent recurrence of the identified deficiencies, and any disagreements or concerns that management may have with respect to those findings or any recommended remedial measures.

The audit committee should lead the organization in identifying potential risks that may face the organization, including, for example, risks from investments, economic downturns, natural disasters, regulatory compliance, staffing challenges, or employment practices. Each committee member should clearly understand how those risks might impact the organization and its ability to fulfill its mission. Working closely with other board committees, the audit committee can play a lead role in developing controls that are best suited to mitigate those risks and in implementing the policies and procedures needed to put those controls in effect.

Finally, to ensure the effectiveness and proper implementation of these policies and procedures intended to reduce the identified risk(s), the committee should monitor and periodically review with management and external and internal auditors the effectiveness of the controls they have put in place. When controls are found to be ineffective, the audit committee may need to explore the engagement of other resources to assist in developing and implementing additional or alternative controls that will be more effective in managing those risks.

Executive Sessions

Among the most valuable exercises for the audit committee are regular meetings with individual members of management and with the lead members of the outside audit team. Typically, those meetings are part of the audit wrap-up. Each meeting should be one-on-one with the manager and should not include any members of management other than the individual invitee. Such sessions allow senior management members and auditors to raise matters of concern in what should be a candid and relaxed environment. Questions should be posed in a non-threatening way that fosters an open and constructive dialogue to help the committee understand the greatest risks faced by the organization and to elicit management recommendations for effectively addressing and reducing risk. Each interview should conclude with an open-ended question, inviting the manager to air any matters that may be of concern.

Conclusion

In the final analysis, your nonprofit organization's designation of a knowledgeable and proactive audit committee structure can be one of its most valuable assets, communicating to your most important constituencies a strong message of credibility, reliability, and professionalism. If thoughtfully designed and consistently and conscientiously implemented, your nonprofit board's audit committee can go a long way in preventing your organization from being the lead story in your morning paper.

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