

Panel on the Nonprofit Sector

Convened by INDEPENDENT SECTOR

Work Group Recommendations to the Panel on the Nonprofit Sector Posted for Public Comment January 24, 2005

#20: Audit Committees

I. Governance and Fiduciary Responsibility Work Group Recommendations

A. Statement of Problem

An audit is one tool that a board of directors may use to objectively review management's performance. The value of an audit may be compromised if the outside auditor is hired by and reports to the organization's management.

B. Recommendations

1. The Work Group recommends as a best practice that each public charity and each private foundation that has an independent audit, whether legally required or not, should have an audit committee of the board made up of non-staff, independent¹ directors. The board of directors should determine what the membership requirements and duties of the audit committee should be, taking into account the need for fiscal responsibility, cost, and the organization's resources and ability to recruit board and audit committee members. If an audit committee is not formed, the full board should function as the audit committee or that responsibility should be clearly assigned to another board committee.
2. The duties of an audit committee generally should include:
 - Retaining and terminating the engagement of the independent auditor;
 - Reviewing the terms of the auditor's engagement at least every five years;
 - Overseeing the performance of the independent audit;
 - Conferring with the auditor to ensure that the affairs of the organization are in order;
 - Recommending approval of the annual audit report to the full board;
 - Overseeing policies and procedures for encouraging whistleblowers to report questionable accounting or auditing matters within an organization; and
 - Approving any non-audit services performed by the auditing firm.

¹ It should be noted that the Work Group has not discussed a definition for this term.

Note: These recommendations have not yet been reviewed by the Panel on the Nonprofit Sector. They will be part of the deliberations by the Panel as it prepares its interim report.

C. Rationale

Having an independent audit committee may increase the accuracy of audited financial statements by reducing possible conflicts of interest for outside auditors and the directors who are responsible for reviewing and approving the organization's financial statements. However, an audit committee requirement may be burdensome to charitable organizations with small boards of directors and simple organizational structures. Small boards cannot establish committees without adding members, and complex administrative requirements may make recruitment of board members, which is already a challenge for some organizations, even more difficult. The Work Group believes that deferring to the judgment of the individual boards of organizations affected by audit requirements will allow the boards of directors to balance costs imposed by an audit committee requirement—including increased difficulty in board recruitment and a more complicated governance structure—with the benefits gained by having an independent audit committee.

D. Other Considerations

None.

II. Expert Advisory Group Comments

The Expert Advisory Group agreed with Recommendation #1.

The Expert Advisory Group observed that the audit committee duties listed under Recommendation #2 were focused on the outside audit and could lead to an over-reliance on the audit as the only or primary means of ensuring financial integrity. The Expert Advisory Group recommended adding duties associated with the internal audit function, such as:

- Advising on the hiring and evaluation of the chief financial officer;
- Reviewing adoption and implementation of internal financial controls;
- Monitoring the organization's response to potentially illegal or unethical practices within the organization, including but not limited to fraudulent accounting.

Consistent with its addition of internal audit functions to the audit committee duties, the Expert Advisory Group generally recommended that all charitable organizations devote sufficient attention to internal financial controls and noted that large organizations should have a chief financial officer dedicated to this purpose.

The Expert Advisory Group further noted the inappropriateness of audit committees for organizations that are trusts rather than corporations.