ASAE & The Center for Association Leadership
www.asaecenter.org

Audit Committees: Does Your Association Need One

***Dollars & Cents,* March 2006**

By: *Nat Bartholomew*

Recent legislation mandating audit committees has spawned many questions about—as well as resources for—nonprofit fiscal governance.

The buzz about audit committees can be traced to the passage of the California Nonprofit Integrity Act of 2004. With the stroke of the governor's pen, California effectively legislated that certain philanthropic organizations must, among other things, undergo an annual financial audit governed specifically by an audit committee. Other states had shown cards that indicated they were going to legislate this issue, but California actually did it. Not only that, the statute affects national philanthropic organizations doing business in the Golden State.

California's rules

Charitable corporations, unincorporated associations, and trusts that have registered with California's attorney general and have annual gross revenues of $2 million or more must appoint an audit committee. Members of the board-appointed audit committee can include non-board members, but all committee members must be independent (i.e., may not be members of the not-for-profit organization's staff, receive compensation other than director's compensation, or have a material financial interest in any organization doing business with the not-for-profit organization).

If the not-for-profit has a finance committee, the audit committee must be separate from this group and the chair of the audit committee cannot be a member of the finance committee. Furthermore, members of the finance committee must constitute less than 50 percent of the audit committee.

Hospitals, religious, and educational organizations are exempt from this state statute.

More state legislation?

In the wake of California's bold move, many 501(c)(6) organizations and other associations, as well as philanthropic organizations that didn't meet that state's established criteria, wondered if they should create an audit committee. Even if the California law did not apply to them, was further legislation headed their way? Was California blazing a trail for other states to follow?

To date, only a few states have followed suit or made changes to statutes already on the books:

- Beginning last June, philanthropic organizations with revenues of $200,000 or more and doing business in Connecticut must file audited financial statements with the state's Department of Consumer Protection.

- As of April 2005, charitable organizations receiving $500,000 or more in a fiscal year and operating in Kansas (PDF) must file audited financial statements with the secretary of state.

Bills are pending in Massachusetts, New Jersey, New York, Ohio, Pennsylvania, and Texas.

Federal legislation and the Panel on the Nonprofit Sector

It was not a matter of if, but when. The Panel on the Nonprofit Sector—convened at the encouragement of the U.S. Senate Finance Committee—stirred things up in June 2005 with the release of its final report to Congress. "Strengthening Transparency, Governance, and Accountability of Charitable Organizations" contains 15 recommendations. The 4th recommendation suggests thresholds for both financial audits and reviews, and the 14th specifically addresses audit committees.

With respect to fiscal governance, the panel suggests that an organization's board of directors "should include individuals with some financial literacy" and furthermore, the board "should consider establishing a separate audit committee." The words *should* and *consider* leave a good bit of wiggle room as to whether a not-for-profit must create an audit committee. At this point, there exists no federal law addressing the role of the audit committee should your organization decide to create one.

What to do?

As many loyal *Dollars & Cents* readers probably know, some things are legislated and others fit into that overused category called *best practices.* Currently, audit committees are not legislated, except in California, and that only affects philanthropic groups. In addition, there exists no proposed or pending legislation on the matter except for statutes that may concern philanthropic organizations some time in the future.

An argument for best practices

The National Council of Nonprofit Associations offers a number of resources for audit committees, but what's striking are the convincing arguments the council assembled for the creation of an audit committee:

"While many organizations may already have a finance committee in place, it is important to remember that an audit committee has different responsibilities. While the finance committee reviews investment policies and monitors the funds of the organization on a regular basis, the audit committee provides independent oversight into the organization's accounting and financial reporting and oversees the organization's annual audits (external and internal). The audit committee may oversee a broad range of areas under the blanket of this primary purpose. These areas include:

- Governance
- Ethics
- Adequacy of internal controls (i.e. review of accounting or fiscal operations manual).
- Compensatory reviews of executive level staff.
- Accuracy of records and reports presented to the board of directors.
- Proper authorization of activities and expenditures.

- Review of the tax-exempt status and identification of activities that could jeopardize this status.
- Protection of employees raising concerns about serious accounting or auditing irregularities."

An argument against audit committees

The most common argument against the formation of an audit committee is most often made by smaller organizations, where the pool of available and qualified volunteers needed to create an added layer of governance does not exist. Given the size of these organizations, the functions of the audit committee would typically be performed by the finance committee. This is not just an argument; this is the reality faced by thousands of small nonprofit organizations. Much like it's impossible to segregate duties when there is no staff available to add to a financial process, there are limitations on the fiscal fiduciary roles volunteers can perform. Most proposed legislation does take this into account by creating thresholds for compliance based on gross revenues earned.

Audit committee guidance and resources

Is there good news in all of this? Yes—there are now more resources for associations dealing with this issue than ever before. The most concise resource is free and available to all not-for-profit organizations from the American Institute of Certified Public Accountants. *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* provides checklists, matrices, questionnaires, a sample RFP for certified public accountant services, and other materials to help the audit committee do its job.

The final word

At the close of 2005, the Senate Finance Committee had not yet proposed national legislation to mandate audit committees or provide guidance on just what the roles and responsibilities of the audit committee member should be. That being said, there is overwhelming support for moving audit committees into the best practices category, and why not? There are now significant resources to help you get the job done.

Nat Bartholomew, certified public accountant, is partner, Langan Associates, P.C., Arlington, Virginia. E-mail: bartholomewn@langancpa.com