

Nonprofits without Audit Committees | RISK DISASTER

It's not just a good idea, it's vital to your organization's financial well-being.

BY JOHN R. OWEN, III

In the wake of Enron and other business scandals, the audit committee has resurfaced as a key tool for preventing fraud and ensuring sound financial management. But in the nonprofit world, the boards of many organizations operate without audit committees in the mistaken belief that charities do not need them.

Why Is an Audit Committee So Essential?

Financial improprieties aren't limited to for-profit enterprises. Nonprofit organizations have also had to weather recent headline-grabbing scandals. A nonprofit organization, no less than a profit-making business, needs a strong, independent board of directors to prevent or detect financial mismanagement within the organization and, in extreme cases, stave off disaster. And the board of directors must have an audit committee to do its job properly.

Several factors make nonprofit organizations especially vulnerable to fraud:

- an atmosphere of trust within the organization
- a steady stream of cash donations
- reliance on volunteers to perform important tasks
- limited supervisory or investigative resources

- unpaid boards of directors with little or no financial expertise.

Some nonprofit boards mistakenly believe that an audit committee is unnecessary because the outside auditor will conduct the required financial supervision. But it is not the job of the outside auditor to detect mismanagement or fraud. Rather, the board of directors is responsible for supervising management, the financial reporting process, and internal controls.

The audit committee is the board's main tool for carrying out these responsibilities of financial oversight, thereby protecting the nonprofit and avoiding liability for breach of fiduciary duty. The role of the audit committee is to serve as the direct line of communication between the board and the outside auditor. The audit committee is also charged with oversight of management's performance with respect to its financial responsibilities and disclosure obligations. A board of directors with a diligent audit committee is much more likely than an unspecialized board to discover any financial irregularities before they can threaten the organization.

What Does the Audit Committee Do?

Here are the main responsibilities of the audit committee:

- **Choose an auditor.** The most important function of the audit committee is to select the outside auditor. A mistake commonly made by nonprofits is to have management choose the auditor. The audit committee, acting without management interference, should select the auditor and ensure that the auditor can act without any conflict of interest.
- **Work closely with the auditor** to monitor the nonprofit's financial condition. Audit committee members should freely consult with the auditor and should schedule formal updates with the auditor before the end of the nonprofit's fiscal year.
- **Ensure that the organization has an open door policy toward fraud.** Employees must feel free to report suspected fraud to upper-level management or the board of directors.

Who Should Be on Your Audit Committee?

An audit committee should consist of independent directors with financial management expertise. They should have some understanding of the audit process, but they may require additional training. It is especially important that audit committee members understand their role in carrying out the board's oversight responsibilities and the potential for director liability if they fail to do their job.

What Could Happen without Audit Committees?

Until nonprofits become serious about devoting resources to preventing financial irregularities, we can expect to see continued misappropriation of charitable funds and resulting mistrust of nonprofits by the public. Nonprofits must regulate themselves effectively or the federal government may step in with legislation like the Sarbanes-Oxley Act, which imposed strict new requirements on the audit committees of public companies, or even with a new regulatory agency—an “SEC” for nonprofits.

There is little that a single nonprofit organization can do to stem the tide of

regulation, but it can at least plan for its own survival. The best way for a nonprofit to ensure its long-term financial stability is for the board of directors to carry out its responsibility to keep the organization’s financial house in order through a well-trained, knowledgeable audit committee. ■

**Nonprofits
are especially
vulnerable
to fraud.**

Resources

Goehner, Del, “Protecting Your Organization Against Financial Misuse,” *Nonprofit World*, Vol. 17, No. 4.

Muehrcke, Jill, ed., *Accounting & Financial Management, Leadership Series*.

O’Reilly-Allen, Margaret, “How to Have an Audit without Breaking the Bank,” *Nonprofit World*, Vol. 20, No. 4.

Ross, Frank, “The Audit Committee: Why You Need One, How to Form One,” *Nonprofit World*, Vol. 6, No. 6.

These resources are available from the Society’s Resource Center, www.snpo.org.

John R. Owen, III, is a shareholder of Polito & Smock, P.C. (444 Liberty Avenue, Suite 400, Pittsburgh, PA 15222-1237, jowen@politolaw.com), specializing in business, tax, and tax-exempt organization law, and a director of the Pennsylvania Association of Nonprofit Organizations. Amy J. Herne, Esq., of Polito & Smock assisted in the preparation of this article.

A GIFT FOR YOUR BOARD

Give your board members the gift of an invaluable resource—membership in the Society for only \$15 per board member!

If you’re a member of the Society for Nonprofit Organizations, everyone on your board can become an affiliate Society member for only \$15. Each board member will receive an annual subscription to *Nonprofit World*, with advice for boards in every issue, plus all the other benefits of membership (see back cover).

This small investment can return great dividends to you in knowledgeable, productive board service. Just e-mail your board list to info@snpo.org. To learn more about turning your board into affiliate members of the Society, call

**734-451-3582
today.**

(Special offer for Society members only)