

Best Practices

What Makes a Great Audit Committee?



With increased scrutiny on nonprofit governance, forming — and using — an independent audit committee has quickly become a best practice of better-performing nonprofit organizations.

A well-balanced audit committee typically consists of two to five members who bring a wealth of industry, general business, and financial knowledge and experience to the table. Best are individuals who have been directly involved in roles bearing immediate financial responsibility — such as CEOs, CFOs, bankers, public accountants, auditors and investment advisors — or who have supervised others in these roles.

At least one member of the audit committee should be a “financial expert.” To meet this definition, this individual, through education and experience, must:

- Understand generally accepted accounting principles (GAAP).
- Understand financial statements.

- Understand financial risks.
- Understand the impact of business decisions on the financial statements.
- Be able to identify balance sheet risks.
- Understand revenue recognition issues on the financial statements.

Note that if a financial expert cannot be found to serve on the committee, an outside consultant may need to be brought in to address issues that are beyond the scope of the members’ knowledge. The American Institute of Certified Public Accountants (AICPA) has an Audit Committee Matching System to help nonprofits find potential audit committee members with the necessary expertise. Visit www.aicpa.org for details.

How Should They Serve?

In a word: Independently. To be truly effective, an audit committee must be separate from the finance committee. This means that no staff members

should serve as voting members, and no managers — not even the CFO — should be voting members of this committee.

Audit committee members should be able to resist any attempt by management to override or undermine their authority. And they should be free of any conflicts of interest with the organization. This includes recent employment with the organization, family relationships with management, and direct business relationships with the organization or its leaders.

How Should They Function?

Of course, audit committee members should function with integrity and an unbiased perspective. Just as important, they should operate with a healthy degree of skepticism. This means:

- Not taking at face value what they are told about how the organization operates.

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A Closer Look at Quasi-Endowments

The concept of an endowment is well known to anyone in the nonprofit world — restricted funds that create indefinite investment income for a specific purpose.

But more nonprofits are now utilizing what is known as a “quasi-endowment” to gain some flexibility in funding special expenditures or future projects.

Quasi-endowments — also known as “board designated endowments” and “funds functioning as endowments” — are established by the nonprofit organization, not by specific donor intent. Principal and income may be utilized at the discretion of the organization.

Unlike permanent and term endowments, the board can end its restriction for any reason and remove any funds from the quasi-endowment at any time it chooses. Quasi-endowments are established using either donor or institutional funds — typically excess operating support and revenue or unrestricted bequests. A more specific definition can be found in Statement of Financial Accounting Standards (SFAS) 117:

“An organization’s governing board may earmark a portion of its unrestricted net assets as a board-designated en-

dowment (sometimes called “funds functioning as endowment” or “quasi-endowment”) to be invested to provide income for a long but unspecified period. The principal of a board-designated endowment, which results from an internal designation, is not donor restricted and is classified as unrestricted net assets.”

Does It Make Sense for Your Organization?

There are a variety of reasons a board might establish a quasi-endowment. For example, a nonprofit may not be ready to launch a true endowment campaign, yet it wants to provide some stability by investing resources and using only the interest for operating expenditures. Likewise, a board might establish a quasi-endowment if a donor is not ready to establish a true endowment (i.e., a donor restricted endowment).

Whatever the reason for establishing a quasi-endowment, boards are well advised to first take some appropriate steps:

- **State how the fund will be used.** Policies can be constructed in such a way that, while it is legally considered unrestricted, a quasi-endowment will

function much as a permanently restricted endowment fund. On a practical note, some boards structure their quasi-endowments so that interest and dividends must accumulate until they reach a certain point, at which time the income can begin to be used. Just as important as stipulating how the funds will be used is outlining the mechanism by which the restrictions placed on the endowment by the board can be reversed.

- **State what funds will be used.** Clearly delineate what funds can and cannot become a part of the principal of the quasi-endowment fund. For example, a statement might prohibit certain contributions from being added to board designated funds.

- **Establish an investment policy.** Outline how the quasi-endowment fund will be invested and who will oversee the investments — for example, a committee, a bank trust department or an investment broker.

Accounting for Quasi-Endowments

Quasi-endowment funds are earmarked by the board — rather than by donors or regulators — to act like permanently restricted funds from which income is available for general operations or certain specific purposes. Accounting standards established by the Financial Accounting Standards Board (FASB) require nonprofits to report quasi-endowments as unrestricted funds.

Quasi-endowments are reported on Line 27 (unrestricted net assets) at Part X of IRS Form 990. They are also reported on Part V (Endowment Funds) of Schedule D (Supplemental Financial Statements). ■

Is Your Organization Ready for a Traditional Endowment?

The timing may never be better to cultivate traditional endowments for your nonprofit. Researchers say the generational transfer of baby boomer wealth could result in at least \$6 trillion for charity during the next 50 years.

Starting an endowment takes time, and nonprofits should move carefully. But your organization may be ready if it:

- Has at least a 10-year operational history.
- Regularly meets its budget.
- Has a stable board and staff.
- Has built reserves equal to at least one-fourth of its annual budget. ■

Questions about quasi-endowments? Our experienced accounting professionals can provide the guidance you need. Call us today to schedule an appointment.

Selecting an Audit Committee

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- Being prepared to ask management hard questions about practices and policies.
- Being comfortable coming to critical conclusions.

Look for Leadership

Audit committee members should exhibit solid leadership — from running the committee in a professional manner to serving as role models for the rest of the organization.

In particular, the audit committee chair is responsible for setting the tone of the group. He or she should work hard to prevent “group think” and collusion.

Rather, committee members should be encouraged to critically test, analyze and evaluate ideas on their own.

Why Have an Audit Committee?

The short answer is that an increasingly skeptical public is watching. IRS Form 990 now asks very specifically if an organization has an audit committee. A “no” answer begs questions from potential funders and others as to why an organization is not following a suggested best practice.

In addition, certain states require an audit committee if the organization solicits charitable donations.

Help Is Available

To help audit committees operate more effectively, the AICPA has compiled an *Audit Committee Toolkit* that includes actionable tools (matrices, questionnaires, RFPs, evaluations, how-to, etc.). Visit www.aicpa.org for details. Also, the Association of Certified Fraud Examiners (ACFE) offers guidance on fraud prevention, detection, investigation and establishing internal controls on its website at www.acfe.com. ■

Please contact us for more information regarding audit committee selection.

Three Things Your Audit Committee Should Be Doing

Your audit committee should be highly involved in the organization's financial reports, ensuring that presentation and disclosure of matters of significance are handled fairly and transparently. This includes:

1) Engaging the auditor – The first job of the audit committee is to engage the audit firm. The committee should then evaluate the auditors annually and re-engage or disengage them based on that evaluation. If the committee chooses to remain with the same accounting firm for an extended time, it may consider requesting a change in the partner overseeing the account (e.g., the audit partner and audit manager rotate off at least every seven years).

By staggering the rotation of the partner and manager, the organization benefits from having a fresh pair of eyes on the audit while maintaining continuity with the firm that knows it best. If a change in auditors is required, the audit committee should then be at the helm during the RFP process and selection of new auditors.

2) Communicating with the auditor – Modern auditing standards now require

certain ongoing, two-way communication between the auditor and your audit committee or board of directors on such topics as:

- Planning the audit.
- Significant findings from the audit.
- Difficulties encountered in performing the audit.
- Observations arising from the audit that apply to your financial reporting process.
- Any “significant deficiencies” or “material weaknesses” in your organization's internal controls as it relates to your financial reporting. One example would be a lack of appropriate segregation of duties created by staff vacancies or turnover that could qualify as a material weakness.

Schedule periodic conference calls between the audit committee chair and the audit firm to discuss audit status and issues. Designate a point person to review misstatements discovered

during test procedures, discuss control deficiencies and approve the draft financial statements and notes.

3) Reviewing the audit – To truly segregate duties and provide financial oversight, the audit committee should meet with the auditors — at some point in time — without management present. This can be done once the audit and management letters have been prepared and reviewed by management. The audit committee should also consider meeting in executive session without the presence of management to discuss audit findings before reporting results to the full board of directors.

Consider an Audit Alternative

In lieu of an audit, consider retaining an outside CPA for what is called a “financial statement review.” Such a review doesn't conclude with an auditor's “opinion” as to whether the financial statements were prepared in accordance with generally accepted accounting principles (GAAP) — just that nothing suggesting the financial statements are not in accordance with GAAP came to the outside CPA's attention. ■

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Nonprofit Marketing in a Multi-Channel World

To paraphrase Mark Twain, the rumors of direct mail's death have been greatly exaggerated. The reality is that savvy nonprofits are integrating direct mail and online fundraising to great success.

These organizations understand that donors are increasingly operating in a "multi-channel" world. That means the recipient of your direct mail package may be spurred to visit your website for further research — and ultimately opt to make an online gift. Likewise, donors who have traditionally given via direct mail are increasingly signing up for email communications and online marketing programs with the nonprofits they support.

The good news is that a multi-channel strategy is associated with increased gift frequency, increased gift value and increased lifetime donor value. Consider these two simple ideas for ensuring that your direct mail and online fundraising efforts enhance each other:

1) Use direct mail to boost online giving. Consider adding an online giving option to your direct mail packages. This could be as simple as including a Web address for an online giving page in the body of your letter, as well as alongside the credit card and check options in the reply device. Donors are then led to a landing page with coordinated design



and messaging. *Tip:* Make sure that the printed URL is easy to remember (e.g., PetRescueOnline.org).

2) Use email to boost direct mail response. In the same way that you might make a call telling donors to expect an important letter, you can email your donors telling them to watch the mail or wait for the call. Also try following up a special appeal with an email saying, "We hope you read our recent letter. Just click here to make your donation online today. It's convenient and saves us money." ■



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