



Not-for-Profit Executive Webinar

Governance, Risk and the Role of the Audit Committee

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We will address questions in Q&A at the end of the program.
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The image shows two views of a software interface. The left view is a slide titled "Today's presenters..." with two presenters: Mark Oster, Partner-in-Charge, Advisory Services, Grant Thornton LLP; and Michael Peregrine, Partner, McDermott, Will & Emery LLP. The right view shows the same slide with an "Inbox" panel overlaid. The "Inbox" panel has a table with columns for "username", "question", and "answer".

| username | question | answer |
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Trends in Board Governance in the Not-for-Profit Sector

November 17, 2009

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Conflicts Policy

- The word "conflict" in this context is used to denote when a person has, for whatever reason, multiple loyalties. Most of us have such multiple loyalties in our different roles: employee, board member, parent, political party member, business investor, spouse, etc.

Goal: disinterested decision-making

- A Conflicts Policy is working when an EO can truthfully say all of the decisions it makes at every level are made only with the interests of the organization in mind.
 1. Disclosures
 2. Recusal

Conflicts of loyalties

Watch out!

- We can all recognize conflict of interests involving direct economic benefit, and we can avoid them even if they aren't technical violations of law
- The real challenge is in dealing with non-economic conflicts of interest – conflicts of loyalties
- Conflicts of loyalties will fester if the organization does not deal with them
- The law doesn't necessarily reach conflicts of loyalties, but we can use policies and procedures to help clients management them

How to deal with conflicts of loyalties

- “Transparency” is an over-used word in our sector, but is the least bad way to deal with conflicts of loyalties
- Policy should encourage community involvement and require disclosure of affiliations
- Board can then decide whether an affiliation is sufficient to require abstention or complete recusal
- Consider noting, on the grants list, where a disqualified person is a board member or otherwise has a significant involvement

New Form 990

- Audit committees are ensuring that their organizations have adequate procedures and controls in place to properly prepare the new Form 990
- Boards and audit committees are developing new policies to carefully review and approve the new Form 990 before it is filed with the Internal Revenue Service
- Board members are also attending briefing sessions to ensure that they understand the information that is disclosed in the new Form 990
- Audit committees are also carefully reviewing governance disclosures required in the new Form 990 and enhancing governance practices

Polling Question

Who should review the governance disclosures required in the Form 990?

- A. Board
- B. Audit Committee
- C. Both
- D. Neither



Governance Matters (continued)

- Whistleblower Policies
- Code of Ethics
- Record Retention and Destruction Policies
- Form 990 review and approval
- Executive Compensation and Benefits
- Gift Acceptance Policies
- Other Governance Matters



Compliance Coordination

- Assuming that it is not directly responsible for the corporate compliance function, the Audit Committee should coordinate its activities, and those of Internal Audit, *with Compliance* and Legal.
- The Audit Committee should be alert to the danger that issues will “fall through the cracks.”
- The General Counsel and Chief Audit Executive should attend Audit Committee and *Board* meetings.

Board Reporting

- Is the Audit Committee's meeting frequency sufficient to deal with its workload?
- Are its meeting minutes complete, descriptive and distributed to all Board members?
- How regularly does the Audit Committee report to the to the full Board?

Auditor's Management Letter

- The Audit Committee's attentiveness to the issues presented in the auditor's "Management Letter" is of increasing governance and regulatory importance.
- The General Counsel and Chief Audit Executive should be fully involved in the process, and the full Board should be briefed on all material issues cited by the auditors, for oversight purposes.

Finance Whistleblowing

- Many sophisticated nonprofits have added a parallel “whistleblower” reporting process, separate from corporate compliance, by which interested parties may report concerns regarding financial, accounting and related potential irregularities.
- Such parallel processes must be closely coordinated with the General Counsel or Chief Audit Executive; there is great organizational risk to “siloing.”???

Resources

- The Audit Committee should have the resources and budget to engage third-party advisors and legal counsel (in addition to the independent auditor) as may be necessary.
- Except in extraordinary circumstances, these engagements should be in the name of the corporation even if the reporting relationship is with the Audit Committee.

What Level of Reserves is Adequate?

- Grant Thornton conducted a study of this issue over nearly a year.
- Comments were solicited from over 50 NFP executives including board members, CEO's, COO's, CFO's as well as service providers to the NFP sector including accountants, attorneys, bankers, fundraising specialists and other professionals
- Twenty six Grant Thornton not-for-profit partners and over fifty Grant Thornton managers contributed their experience and insight to this study.

What Level of Reserves is Adequate?

- Many NFPs have been criticized for retaining excessive reserves or for not accumulating enough in reserves
- Trying to apply a “general” measurement/percentage to ALL not for profit organizations would be a mistake
- Reserves measures often used – 6 months to 2 years of operating expenses
- Need to assess reserve levels differently depending on which sector a NFP falls within – i.e., higher education, foundation, religious, museum, social services, professional association, etc.

What Level of Reserves is Adequate?

- Many NFP organizations have not established a formal reserve policy. The reserve policy should clearly articulate the policy and its linkage to the mission and activities of the organization. The policy should be approved by the full governing board.
- Management should also establish a comprehensive reserve plan which is linked to the strategic plan and annual operating and capital budgeting process. The plan should be monitored by the organization's finance or audit committee on an ongoing basis and discussed periodically with the full Board.

What Level of Reserves is Adequate?

- Boards and management really need to assess what level of reserves their organizations require. There are many Boards and management teams who have never really asked the question in any in depth manner—what level of reserves is adequate?
- Once the reserve plan is finalized, it should be publicized to both internal and external constituencies. This plan can help development functions and board members more clearly articulate why their organizations are “not rich” and why these funds have been set aside.

Polling Question

All not-for-profit organizations should have 2 – 6 months of operating expenses in reserve, regardless of the type of organization it is.

- A. True
- B. False



Who are the charity "watchdogs"?



- **American Institute of Philanthropy**
(www.charitywatch.org)



- **Better Business Bureau's Wise Giving Alliance** (www.give.org)



- **Charity Navigator** (www.charitynavigator.org)



- **Standards for Excellence Institute**
(www.standardsforexcellenceinstitute.org)



- **Combined Federal Campaign**
(www.opm.gov/cfc)

Other sources of charity information that are not considered in this presentation

- **Guidestar** (www.guidestar.org)
 - Source of 990s and other useful information but doesn't provide ratings
- **Moody's Investors Services** (www.moodys.com)
 - Along with Standard & Poors and Fitch, rates creditworthiness of not-for-profit organizations that issue public debt



What do they do?



- Publish their standards and/or explanations of their rating/evaluation approach
- Make their reports available on the web
- Rate organizations identified by donor request or that fund raise intensively
- Four out of five review information submitted by organization; Charity Navigator relies only on Form 990 and public information
- Except for Charity Navigator, appeals are possible

Key financial issues of most "watchdogs"

- Transparency (esp. public access to financial data)
- Program expense as % of total expense
- Fund raising cost as % of fund raising achievement
- Reserves, working capital, or net assets sufficient to cover some amount of annual operating costs
- Independent audit
- Fund raising practices and donor privacy



Key governance issues of most "watchdogs"

- Conflict of interest policies
- Evidence of adequate board oversight
- Compensation practices
- Number of outside directors
- Number of board meetings
- Evidence of assessment/evaluation of program effectiveness



Polling Question

It is possible for your organization to appeal the rating from any of the watchdog agencies once the rating has been issued.

- A. True
- B. False



What are their limitations?

- Information is limited:
 - Information provided by organization itself may be inaccurate or biased
 - Public information, such as 990, presents an incomplete picture
- Effectiveness of a mission-based organization is difficult to measure (more on next slide!)



What raters can't evaluate

- Whether the mission is being achieved
- Whether each dollar spent on program is well spent
- Anything that is hard to measure in financial or quantitative terms



What are the potential **benefits** to your organization?

- A good rating inspires confidence within the organization
- A good rating may increase financial support



What are the **risks** to your organization?

- A poor rating can hurt morale within the organization
- A poor rating can erode the confidence of your stakeholders
- A poor rating can divert your attention as you try to persuade your stakeholders of its inaccuracy



What can you do to minimize or avoid those risks?

- Establish a "watchdog" relations function similar to a public company's investor relations function
- Monitor analyst reports and respond to those reports, when appropriate
- Enhance both internal and external reporting to incorporate key ratios and analysis used by the watchdogs
- Prepare a "management discussion and analysis" using plain language



Polling Question

All not-for-profit organizations should establish a 'watchdog' relations function to minimize risks from being issued a poor rating.

- A. True
- B. False



Questions?



Legal Developments for the Nonprofit Audit Committee

Not-For-Profit Executive Webinar: Governance, Risk and the Role of the Audit Committee

November 17, 2009

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Goals of the Presentation

1. Identify new legal trends and developments directly affecting the scope, composition, duties and liability exposure of the audit committee of the nonprofit corporation.

Goals of the Presentation (cont'd.)

2. Discuss the precipitating factors with respect to each of the identified trends and developments.
3. Suggest a series of action items which boards can adopt in response to the new trends and developments.

How We're Going to Get There

1. Why Things are Changing
2. What's Actually Changing
3. What to Do About It

Note: Obtaining Copies of Referenced Cases and Other Documents

- § Recent economic, compliance and regulatory developments have substantially impacted legal expectations of Audit Committee performance. Responding to recessionary (and recovery)-based developments requires the most fundamental change to nonprofit Audit Committee practice since Sarbanes-Oxley.

Part I: Factors Precipitating Change for the Nonprofit Audit Committee

1. The Corporate Accountability Environment

§ The recent financial crisis has precipitated an extraordinary climate of accountability in which “finger-pointing” and attempts to assess responsibility have become the order of the day.

1. The Corporate Accountability Environment (cont'd.)

§ A perspective exists that there is a direct correlation between financial instability/weakness and the quality of board oversight.

1. The Corporate Accountability Environment (cont'd.)

Charity regulators are increasingly willing to hold boards more directly accountable when the nonprofit suffers “preventable” harm or loss. This is a nod to the fundamental duty of stewardship of charitable assets.

See, e.g., Stevens Institute; Gantler v. Stephens.

1. The Corporate Accountability Environment (cont'd.)

Note:

- § Willingness of charity regulators to target nonprofit directors in investigations of nonprofit organizations
- § Concerns with respect to financial, investment risks assumed by nonprofits.

2. Fraud Against Nonprofits

Academic studies have confirmed the dramatic increase in fraud committed against nonprofits (apart from *Madoff*). Asset misappropriation, in various forms, constitutes the vast majority of reported fraud. State charity officials have made fraud protection and prevention a high priority.

2. Fraud Against Nonprofits (cont'd)

Greenlee, Fischer, Gordon and Keating, “An Investigation of Fraud in Nonprofit Organizations: Occurrences and Deterrents”.

3. IRS Governance Initiative

- § Corporate governance is a formal “pillar” of the IRS’ educational and compliance initiative for the nonprofit, tax-exempt sector. This has manifested itself through both the redesigned Form 990 as well as increased sector compliance check audit and examination activity.
- § Reflects perspective of directors as stewards of a charity’s financial resources.

3. IRS Governance Initiative (cont'd)

- § IRS “Implied Jurisdiction” over governance of tax exempt organizations
- § Commitment of new IRS TE/GE Commissioner
- § New training guidelines on governance for “EO” audit and examination activity
- § Governance guidelines encouraging adoption of independent audit committee:
 - Appropriate asset accounting
 - Focus on auditor reports

4. State Activity

The role and function of the nonprofit Audit Committee is the subject of much state level activity/scrutiny, whether by means of statute (*e.g.*, California Nonprofit Integrity Act) or attorney general standards (*e.g.*, New York state, Massachusetts).

5. Development of Best Practices

Establishment and operation of a properly structured Audit Committee consisting of qualified, independent members is recognized as a nonprofit corporate governance “best practice” by a variety of sources, including The Panel on the Nonprofit Sector and the Internal Revenue Service.

5. Development of Best Practices (cont'd)

See also:

- § AICPA Audit Committee “Toolkit” for Nonprofit Corporations
- § NACUBO guidelines
- § Urban Institute report

6. Enterprise Risk Management

§ The emerging application of enterprise risk management principles to the nonprofit sector requires close vertical and horizontal coordination (involving general counsel) to assure proper evaluation of all risks affecting organization, while avoiding a de-emphasis of important audit and compliance issues.

Polling Question

Asset misappropriation constitutes the vast majority of reported fraud.

- A. True
- B. False



Part II: Emerging Issues Requiring Audit Committee Attention

1. Scope of Duties

This is the question of whether the Audit Committee has “too much on its plate” in order to function effectively. In addition to selection, and monitoring the work of, the independent auditor, what other roles have been assigned to the Audit Committee? What is the “tipping point”?

1. Scope of Duties (cont'd)

Substantial additional duties are required of audit committees should they assume responsibility over corporate compliance (e.g., “Audit and Compliance Committee”); investment management; corporate governance standards and/or conflicts of interest management.

§ “Avoiding the afterthought”

1. Scope of Duties (cont'd)

Additional concern may arise with respect to the extent of the committee's business risk/EMT and IT risk responsibilities.

2. Committee Composition

The “big three” related issues to be confronted are:

- (a) The qualifications/competence/availability of committee members;
- (b) Whether the Audit Committee is composed exclusively of independent board members; and
- (c) Whether the board’s conflicts of interest policy is regularly and vigorously applied to all matters coming before the Audit Committee.

3. The Limitations of Business Judgment

- § Case law consistently serves to protect Audit Committee members from personal liability, in the absence of gross negligence or bad faith – an extraordinary hurdle for plaintiffs.
- § Charity regulators may not, however, deem this a barrier to investigation when charity assets are considered at risk.

3. The Limitations of Business Judgment (cont'd)

⌋ Note:

Compare broad application of Business Judgment Rule in *CitiGroup* decision v. breach of fiduciary duty allegations filed by New Jersey Attorney General in *Stevens Institute* case.

3. The Limitations of Business Judgment (cont'd)

Key: A record that reflects exercise of “constructive skepticism” at the committee level, including close review of the auditors’ work and direct questioning of the audit engagement team on financial/internal controls issues of importance to the nonprofit.

3. The Limitations of Business Judgment (cont'd)

The ability of Audit Committee members to exercise valid business judgment will depend in part on the quality of information they receive (special focus on key performance indicators and risk information) and how it is presented.

4. Spillover from TARP?

Taking a cue from recessionary-related Congressional reaction (e.g., TARP), the nonprofit Audit Committee should more closely evaluate the appropriateness of business risks proposed by management to be assumed by the corporation. If not the Audit Committee, then who?

p Remember: the audit committee lessons of Sarbanes are still valid.

5. Impact of Auditor Consolidation

- § The nonprofit Audit Committee should be attentive to issues related to audit partner/firm rotation, and audit firm independence, in an era of consolidation in the public accounting sector.
- § It should also more closely examine the nonprofit/tax exempt organizations expertise of auditor candidates – do they possess the requisite industry focus and commitment?

6. Compliance Coordination

Assuming that it is not directly responsible for the corporate compliance function, the Audit Committee should coordinate its activities, and those of Internal Audit, with Compliance and Legal. The Audit Committee should be alert to the danger that issues will “fall through the cracks.” The General Counsel and Compliance Officer should attend Audit Committee meetings.

6. Compliance Coordination (cont'd)

Related Risks to Manage:

- § Auditors may not immediately recognize the legal implications of issues they identify.
- § Lawyers may not immediately recognize the audit/accounting implications of issues they identify.

Key: The Auditors and General Counsel must communicate!

7. Board Reporting

- § Is the Audit Committee's meeting frequency sufficient to deal with its workload?
- § Are its meeting minutes complete, descriptive and distributed to all Board members?
- § How regularly does the Audit Committee report to the Executive Committee and to the full Board?
- § Coordination with Conflicts Committee and Board Review of Form 990.

8. Auditor's Management Letter

The Audit Committee's attentiveness to the issues presented in the auditor's "Management Letter" is of increasing governance and regulatory importance. The General Counsel and Corporate Compliance Officer should be fully involved in the process, and the full Board should be briefed on all material issues cited by the auditors, for oversight purposes.

9. Financial Whistleblowing

Many sophisticated nonprofits have added a parallel “whistleblower” reporting process, separate from corporate compliance, by which interested parties may report concerns regarding financial, accounting and related potential irregularities. Such parallel processes must be closely coordinated with the General Counsel; there is great organizational risk to “siloing.”

10. Resources

The Audit Committee should have the resources and budget to engage third-party advisors and legal counsel (in addition to the independent auditor) as may be necessary. Except in extraordinary circumstances, these engagements should be in the name of the corporation even if the reporting relationship is with the Audit Committee.

Polling Question

For oversight, who should be apprised of all material issues found in the Auditor's Management Letter comments?

- A. General Counsel
- B. Corporate Compliance Officer
- C. All Members of the Board
- D. All of the above
- E. None of the above



Part III: A Recommended Legal-Based Action Plan for the Nonprofit Audit Committee

An Action Plan

For obvious and appropriate reasons, much is expected in terms of the oversight activity of the nonprofit Audit Committee. Thus, the Audit Committee may be well advised to consider the following steps, among others, to assure that its stewardship is consistent with the evolving standard of conduct:

An Action Plan (cont'd.)

1. Re-examine the Committee charter and scope of duties.
2. Closer focus on agendas with priority items emphasized by Chair.
3. Work with the Nominating Committee to assure proper membership composition and succession planning.
4. Consider periodic self-evaluation at committee level.
5. Review allocation of meeting time between discussion and questions (more) and presentations (less).

An Action Plan (cont'd.)

6. Focus on quality and clarity of meeting materials and committee information.
7. Consider periodic use of executive session practice.
8. Increase coordination with Legal and Compliance functions.
9. Reconsider the effectiveness of horizontal and vertical internal reporting relationships.

An Action Plan (cont'd.)

10. Increase the level of dialogue with the independent auditor.
11. Schedule regular committee general education sessions.
12. Increase management education on financial developments.
13. Constantly monitor potential for committee-level conflicts.
14. Re-evaluate the sufficiency of internal controls regarding fraud and embezzlement.

An Action Plan (cont'd.)

15. Monitor frequency of committee meetings and member attendance.

Consider what's working, what's not working, and what's falling through the cracks.

**Remember: From the Law’s Perspective,
the Audit Committee is Increasingly
“Where the Action Is” with Respect
to Nonprofit Governance**

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