



AUDIT COMMITTEE INSTITUTE

Strengthening Governance and Accountability in the Not-for-Profit Sector

Audit Committee Roundtable Highlights—Fall 2004

KPMG



KPMG's Audit Committee Institute

Communicating with Audit Committees Since 1999

KPMG's Audit Committee Institute (ACI) has been communicating with audit committees since our formation in 1999. Our programs have allowed us to meet personally with thousands of directors and officers. ACI's initiatives include semiannual roundtables, publication of *Audit Committee Quarterly*, conference and board presentations, a toll-free hotline, periodic distribution of time-sensitive information, and our Web site, www.kpmg.com/aci.

ACI's Web site, which hosts audit committee tools and information, has been highly rated by directors and officers. The site's resources include additional information on topics discussed in *Audit Committee Quarterly*, published articles from ACI, regulatory and technical content, audit committee "hot topics," and additional resources.

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KPMG's Audit Committee Insights

Register for KPMG's *Audit Committee Insights*

KPMG LLP (U.S.) recently launched a biweekly electronic publication to help audit committee members, executives, and others stay up to date on the ever-increasing volume of news, opinions, research, and trends related to corporate governance and the role of the audit committee. KPMG's *Audit Committee Insights* contains relevant articles selected from hundreds of sources on such topics as financial reporting, audit committee surveys, shareholder issues, and items in the news. It also features articles offering KPMG's commentary, perspectives, and insights on key issues, leveraging the knowledge gained through KPMG's Audit Committee Institute. Registration for this complimentary electronic publication is available at www.kpmginsights.com.

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Introduction

Financial scandals in recent years have placed the governance practices of all boards—including those of not-for-profit organizations—under unprecedented scrutiny. Although exempt from most Sarbanes-Oxley (S-O) and related regulatory reforms, not-for-profits nevertheless face both mounting pressure from internal and external parties to reexamine their governance oversight practices in a world of elevated public expectations and the potential for increased regulatory attention. The most vocal proponents of strengthening governance oversight for not-for-profit organizations may be board members themselves—those concerned about potential reputational damage or personal liability resulting from their association with an organization involved in a scandal and accused of lax governance oversight.

Questions being asked throughout the not-for-profit community and by stakeholders include: Are the board’s oversight capabilities and commitment sufficient? Does it make sense to voluntarily adopt any elements of S-O? How are other not-for-profit boards reacting to the corporate governance reforms impacting public companies? Are not-for-profits prepared for potential S-O-like mandates in the future? What controls are in place to mitigate potential risks and strengthen financial reporting? How do boards evaluate the integrity of management?

While integrity is a critical asset for success in any setting, because of reliance on voluntary support, public trust and reputation are even more vital to ensuring continued success in the not-for-profit world. Given the speed at which “bad news” now travels, integrity—and the board’s ability to assess and support that integrity—has never been more vital.

Open Dialogue Guided by Distinguished Panels

ACI's roundtable discussions—held in New York City, Rochester, Philadelphia, and Washington, D.C., through December 2004—were led by distinguished panels of professionals representing a variety of viewpoints from the not-for-profit sector, including representatives from higher education, charitable, healthcare, and advocacy organizations.

ACI's Roundtable Format

ACI roundtables are structured to encourage dialogue among audience members and panels comprising board members, managers, corporate counsel, internal audit executives, and others supporting the audit committee process. A moderator introduces topics, with the panel members and attendees providing the discussion content. The interactive format engages the audience to drive the direction of the discussion.

To help audit committee and other board members of not-for-profit organizations navigate the rapidly changing corporate governance landscape, KPMG's Audit Committee Institute (ACI) hosted a roundtable series entitled "Strengthening Governance and Accountability in the Not-for-Profit Sector." Guided by luminaries in corporate governance and professionals from the not-for-profit sector, the roundtables facilitated a dialogue among an array of leading organizations. The following is an overview of issues discussed during the roundtables, as well as key panel and participant insights and approaches that not-for-profit boards and audit committees are considering as they respond to increasing expectations for enhanced oversight.

Key Roundtable Findings and Insights

Our roundtable discussions elicited a range of insights and emerging trends around the challenges and opportunities presented by an evolving governance environment, including:

- The spotlight on governance has prompted most larger not-for-profits, and many others as well, to undertake certain S-O-like initiatives on a voluntary basis.
- The not-for-profit's ability to attract and retain support hinges increasingly on its reputation—often more so than even the effectiveness of its programs (which are often difficult for donors to evaluate).
- Given the heightened expectations regarding the reliability of financial information in the public domain, many boards and audit committees are reassessing their roles and responsibilities.
- Recognizing their emerging role in overseeing the organization's enterprise-wide risks, some boards are assigning this responsibility to their audit committees (or other standing committees of the board).

Attention Turns to Not-for-Profits

While most legislative, regulatory, and media attention has been focused on governance reforms affecting public companies, the not-for-profit sector has also been caught in the wake of Enron, WorldCom, and other corporate financial reporting scandals. With proposals emerging at the federal and state levels to address the effectiveness of oversight in the not-for-profit world, many organizations are undertaking—or accelerating—initiatives to evaluate and voluntarily strengthen their governance practices.

Reactions by Interested Parties

- Various states are considering—and California has enacted—legislative proposals aimed at improving accountability and transparency in the not-for-profit sector.
- The National Association of College and University Business Officers issued its NACUBO Advisory Report, *The Sarbanes-Oxley Act of 2002: Recommendations for Higher Education* (November 2003).
- BoardSource and Independent Sector jointly issued *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* (December 2003).
- Senate Finance Chair Charles Grassley held public hearings on charity oversight (June 2004) and reform, and indicated his intention to propose legislation in 2005.

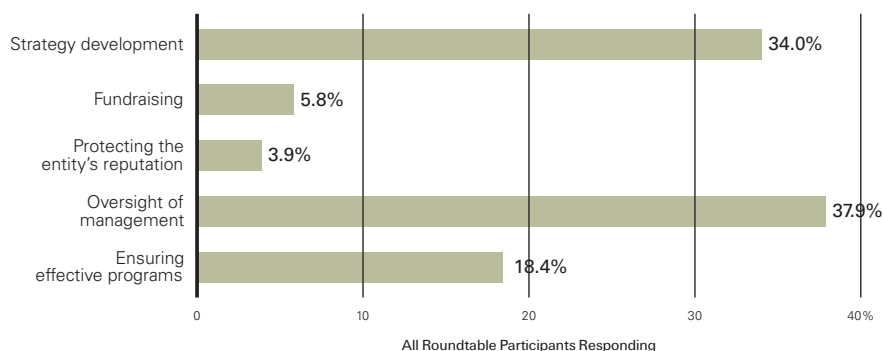
“Not-for-profit board members have learned that their charitable motivations to serve will not shelter them from criticism when governance fails.”

—Roundtable participant

Higher Hurdles, Lower Tolerance

Perceptions that board oversight of not-for-profit organizations is less demanding—or, as one panelist recently put it, “governance lite”—belie the complex forces faced by many mission-based organizations. Carrying out the obligations of a board member in the not-for-profit world—subject to an array of discerning constituents, and based on performance goals that may be difficult to define or measure—is arguably more challenging than an equivalent role in the for-profit world.

What is the most important task of the not-for-profit board today?



Source: KPMG International

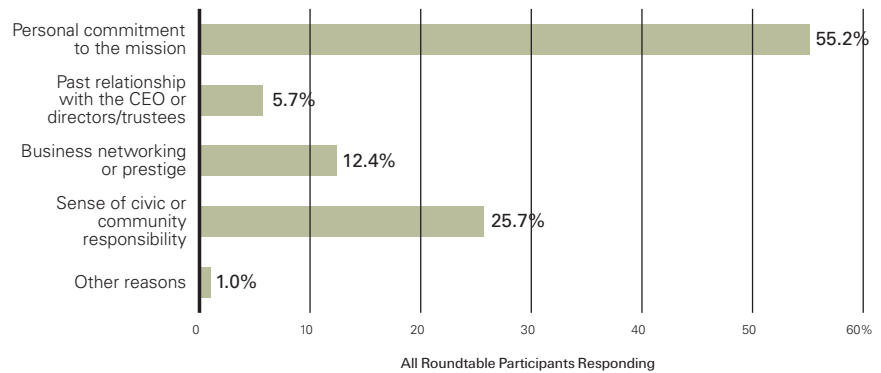
More than 70 percent of respondents said they believe the board’s most important tasks are either oversight of management (38 percent) or strategy development (34 percent). While board members may have been recruited for specific skills or perspectives, each must recognize the broader responsibilities to their fiduciary duties of care and loyalty.

Given these challenges, why do so many prominent individuals give generously of their time to serve on not-for-profit boards? According to those surveyed at the ACI roundtables, most cite their dedication to a specific cause and a desire to “give back” to their communities.

**Accountable to Whom?
The Various Constituencies of the Not-for-Profit**



What do you perceive as the number-one motivation of directors/trustees serving your board today?



Source: KPMG International

An overwhelming majority of respondents—more than 80 percent—cited a “personal commitment to the organization’s mission” or a “sense of civic responsibility” as the primary motivation for serving on not-for-profit boards.

When Not-for-Profits Encounter Trouble

As some charitable organizations have experienced firsthand, giving often comes far easier to donors than forgiving. Unlike in the commercial sector—where, in spite of even well-publicized scandals, underlying product demand often will continue to drive consumer purchases—management or governance failings within a not-for-profit can have long-lasting, even fatal, consequences. Whether from outright misuse of funds, apparent extravagance, or conflicts of interest, lapses in oversight can quickly damage the not-for-profit’s ability to attract and maintain voluntary support.

“The bottom-line test is a simple question: ‘Could this embarrass us?’”

—Roundtable panelist

Conflicts of interest—real or perceived—can create an impression that board members are leveraging their position for personal gain. While many transactions between directors and their organizations can be both legal and beneficial to the organization, boards must be sensitive to these transactions and disclose them in a transparent manner to avoid even the perception of self-dealing.

The Board’s Evolving Role: Benign Guidance or Engaged Oversight?

“Boards tend to look only where management shines the light.”

—Roundtable panelist

It is becoming clearer that not-for-profit board members must accept that their role has moved beyond that of adviser or mere benefactor. To carry out their fiduciary duty of care, board members must ask probing questions and, when appropriate, challenge the answers they receive. Establishing a culture of constructive dialogue within the board is essential to securing the information necessary to act as effective stewards of the organization’s mission. In short, ignorance is *not* bliss; in today’s governance environment, ignorance is *risk*. Boards need to take action to help ensure that the information required to govern is available on a timely basis, and they must have the wherewithal to challenge, probe, and question constructively and appropriately.

Different Approaches, One Objective

In assessing their effectiveness, not-for-profit boards are increasingly considering the background and experience of individual directors and trustees as well as their organization’s leadership culture. Colleges and universities, for example, have long followed a shared-governance model with faculty often having an important role in setting policy. Member-organization governance is typically established by a subset of elected members serving for fixed terms. Human service organizations frequently structure their boards around national or local community leaders, depending on the span of geography they serve. While these models can vary dramatically in form, all should share in substance the objective of furthering the organization’s mission while protecting its integrity and reputation.

The most successful boards tend to be those that are comfortable questioning management on matters affecting reputation and other overarching risks—without becoming “over-involved” and, in effect, taking on management’s responsibilities. Indeed, as boards take on a bigger role in overseeing the organization’s risks, finding an appropriate “line” between engaged oversight and “over-involvement” becomes an important consideration in helping to ensure the board’s effectiveness.

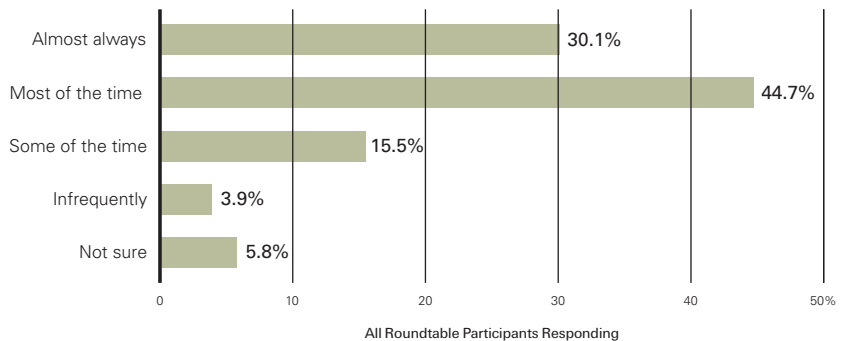
Considering the Board’s Effectiveness

In today’s evolving governance environment, boards should consider fundamental questions that underlie their organization’s effectiveness:

- Why is our mission still relevant today?
- What choices has management made to align available resources with current goals?
- On what basis are we confident that the “tone at the top” helps to ensure that unethical choices will not be tolerated?

More than 25 percent of roundtable participants believed their directors/trustees would be uncomfortable or have “real difficulty” answering these questions.

Does your board currently provide the level of oversight appropriate to protect your institution?



Source: KPMG International

Approximately one quarter of respondents said their board achieves an appropriate level of oversight only “some of the time” or “infrequently,” or were “not sure.”

A Balanced Approach to Oversight



“...boards need to create a culture in which trust, respect, candor, and open, constructive dissent are the norms.”

Margot Cairnes
Boardrooms That Work

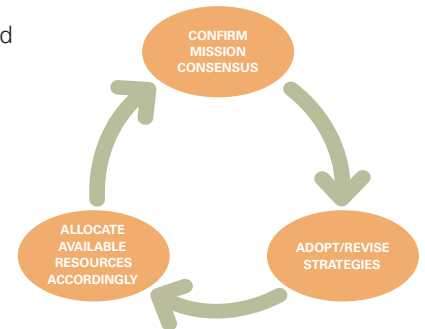
“The audit committee is rapidly becoming the risk committee.”

—Roundtable participant

Many roundtable participants suggested that the definition of “appropriate oversight” remains elusive, with views varying significantly. The challenge many noted is to be engaged enough to provide “appropriate oversight” without taking on the role of management.

An effective oversight process is a dynamic cycle—with each step derived from, and guided by, the previous one.

Effective Oversight Process



Risk: Driving the Future Agenda?

Beyond consideration of the specific governance practices, certifications, and disclosures required under S-O, many not-for-profit boards also are engaging in a more robust discussion of risk—including the organization’s major financial risk exposures.

New York Stock Exchange listing standards now require audit committees of public companies to discuss management’s policies with respect to risk assessment and risk management, although they are not required to be the sole governance body overseeing risk assessment and management.

In some instances—particularly among larger not-for-profits—the audit committee’s oversight role is evolving to encompass an evaluation of management’s risk assessment and mitigation processes. Whether such a role makes sense for the audit committee depends in part on how the roles of the board as a whole or other standing committees are defined by the entity.

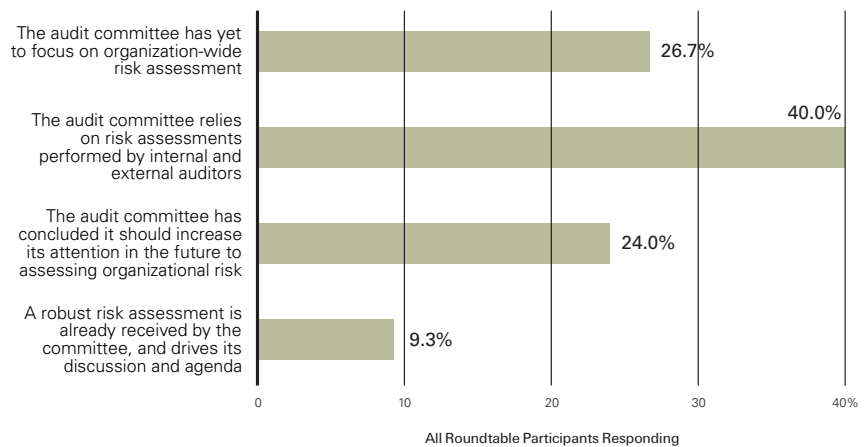
Boards are taking different approaches in this area, and a consensus has not yet emerged. Some boards do not see organization-wide risks as within the purview of the audit committee, whose oversight role continues to be more narrowly focused on financial reporting and internal control. Others see real value in the audit committee focusing on all major risks—whether financial, operational, or strategic.

For those audit committees that have a role in oversight of organization-wide risks, certain key questions need to be considered:

- Are there systems in place for measuring and monitoring risk?
- Are “risk owners” identified and engaged?
- Does everyone understand his or her role and responsibility for managing risk?
- Does the organization’s approach to risk management permeate the culture of the entity?

As expectations of the audit committee increase, boards are being confronted by questions of the appropriate limits of the committee's role. Though there is general consensus that oversight has become more important, the extent to which such oversight is vested in the audit committee will differ among even well-run organizations. Clearly, however, the post-S-O environment presents an assortment of oversight issues that many boards are delegating to the audit committee.

Has risk assessment become a driver of the audit committee's agenda?



Source: KPMG International

Fewer than 10 percent of roundtable participants said organizational risk drives their audit committee's discussion and agenda. A majority (approximately 65 percent) said their audit committee either relies on risk assessments performed by the internal or external auditors or has yet to focus on organization-wide risk.

Considering the Audit Committee's Role in the Post-S-O Environment

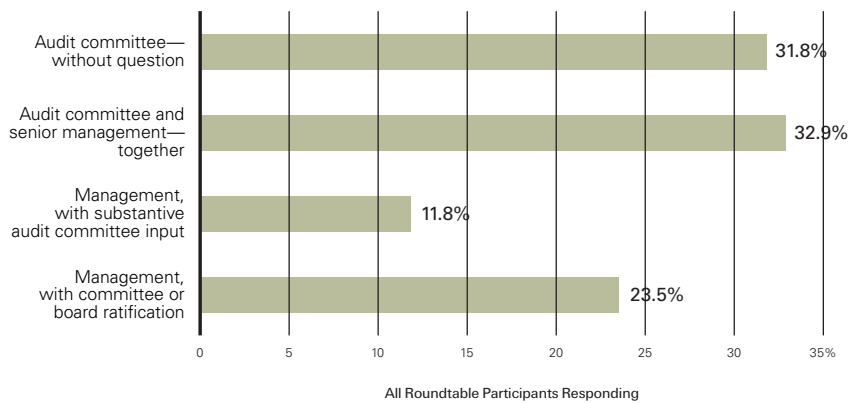
The raft of post-Enron regulatory reforms—including S-O, SEC regulations, and stock exchange listing standards—has dramatically elevated the visibility of the audit committee in both the business and not-for-profit worlds. As reflected by roundtable participants, audit committees are playing an increasingly prominent role in considering, implementing, and monitoring key elements of corporate governance enhancements and reforms—from auditor independence to “whistleblower” policies to “financial expertise” of committee members.

Oversight of Auditors

Audit committees in the not-for-profit sector are, in many cases, beginning to take on a more direct role in the hiring, evaluation, and compensation of internal and external auditors. The audit committee's—and, indeed, the full board's—overarching

objective should be to help ensure that the audit function has the resources, independence, skills, and stature to both identify and effectively communicate issues to the committee in a timely manner.

Who makes the decision in your organization to hire or retain the independent auditor?

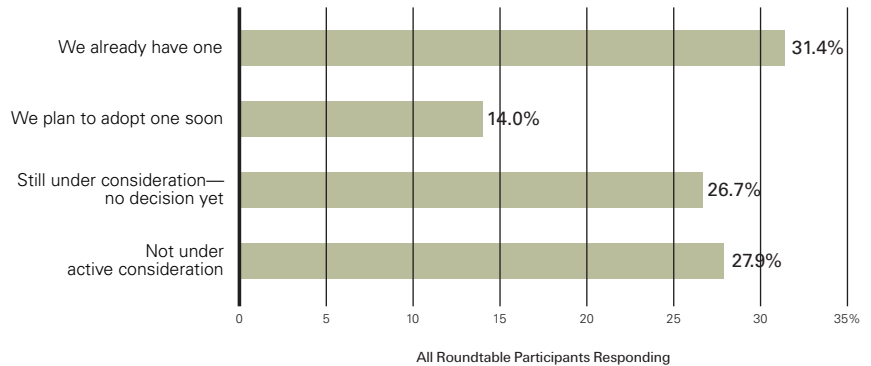


Source: KPMG International

While there has been a clear shift toward greater audit committee involvement in the oversight of auditor relationships, only one in three respondents indicated that their audit committee “without question” controls decisions on hiring and retaining the independent auditor. Approximately 23 percent said this decision is made by management, with audit committee or board ratification.

“Whistleblower” Policies

To provide employees and others with an avenue to communicate complaints regarding ethics, integrity, internal controls, and accounting or auditing matters, the final SEC rule implementing S-O requires “whistleblower” policies ensuring that all employees have confidential means to report concerns regarding auditing, accounting, and internal control issues. A significant number of organizations in the not-for-profit sector have responded to increasing evidence that such mechanisms may be among the best ways to uncover questionable acts or outright fraud. Although many not-for-profits have had some protocol for reporting wrongdoing in the past, these processes may not have been well publicized, in some cases did not adequately protect anonymity, and may not have been structured to help ensure that substantive matters reached the appropriate parties—including the audit committee. This is beginning to change.

Do you have, or intend to adopt, a formal “whistleblower” complaint process?

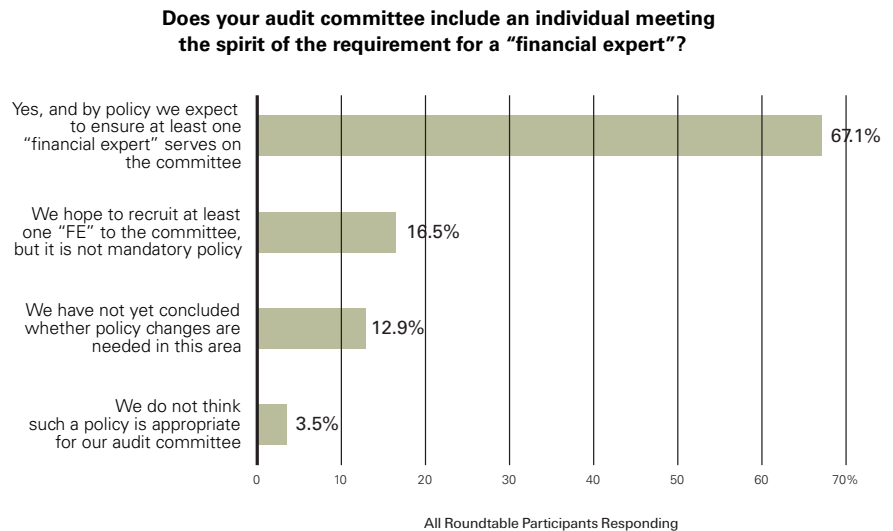
Source: KPMG International

Approximately 45 percent of those surveyed said they either have a whistleblower communications process in place or have active plans to establish one—representing a significant increase in the adoption of this process in the not-for-profit world. Those implementing such processes are taking a variety of approaches; some are using internal resources and others external service providers as a means to capture complaints and concerns.

“Audit Committee Financial Expert”

To enhance the audit committee’s ability to effectively consider the potential financial reporting impact of complex accounting and disclosure issues, many not-for-profits are considering designating one member of the committee as a “financial expert.” Final S-O regulations mandate that public companies disclose whether their audit committee includes such a designated “expert,” and if not, why not.

While an “audit committee financial expert” can serve as a valuable resource, to date many not-for-profit boards have been reluctant to single out or “designate” an individual. Some committees are taking the position that they will instead more carefully consider the financial acumen of the audit committee *as a whole* in evaluating candidates to fill vacancies. Beyond the designation of a single “expert,” many not-for-profit boards are expecting *all* audit committee members to have a basic understanding of financial reporting (defined as “financial literacy” by the listing standards of the public stock exchanges). Most roundtable participants nonetheless believe their organizations are trying to meet the “spirit” of having appropriate “expertise” on the audit committee. Discussion surrounding this issue, however, suggests a wide range of perceptions as to the level of “financial expertise” necessary to meet stakeholder expectations.



Source: KPMG International

Although most respondents (67 percent) indicated that their audit committee includes an individual who meets the “spirit” of the requirement for an “audit committee financial expert,” the backgrounds that not-for-profits deem to be responsive to that spirit appear to vary widely.

Audit Committee Charters

A number of not-for-profit organizations still lack formal, well-defined charters for their audit committees—or existing charters have not been “dusted off” and critically reviewed and updated in many years. The audit committee’s emerging prominence is bringing the importance of the charter back into focus.

Some not-for-profit organizations take the position that an audit committee charter is unnecessary—believing that sufficient guidance as to the purpose and role of each standing committee is provided in the bylaws. In many cases bylaws may be too general for this purpose. Audit committee charters, while widely varied in scope and level of detail, typically reinforce the bylaws but go further in specifying responsibilities and ongoing activities to be carried out by the committee. Many not-for-profit organizations have now developed and approved well-thought-out charters—and have shown a willingness to share them with others. As a result, various models are readily available and can be easily refined to the needs of nearly any size organization.

Assessment of Internal Control over Financial Reporting

It is well publicized that public companies have struggled with and been frustrated by the massive undertaking necessary to complete the required internal control assessments under S-O section 404. Very few not-for-profit organizations, however, have volunteered to undertake this element of the reform, though many are actively considering the pros and cons of improving internal control documentation and conducting some level of internal control assessment.

Compliance with section 404 is no simple undertaking. The first-year implementation has strained the resources of even the largest public companies as well as the entire audit profession. Public companies have leveraged both their internal and external audit resources to face the significant hurdles and costs in meeting the law's requirements and deadlines. It is not surprising that two thirds of roundtable participants said their organizations had not yet considered a project to enhance internal control documentation—or had considered it but have not taken steps to commence work. Only one roundtable participant indicated that his organization intended to assess internal control over financial reporting and also intended to request an independent auditors' report similar to the requirements of S-O 404.

There are certainly benefits to be gained by many not-for-profit organizations from a detailed evaluation and documentation of controls—such as the identification of unnecessary or duplicate controls and areas for improvement as well as insights about the organization's processes and risks. Organizations will have to weigh the potential costs and benefits of an internal controls assessment and consider the extent and urgency of such a project within the context of its risks and the evolving expectations of its sponsors.

Conclusion: Keys to Strengthening Governance

Based on our roundtable discussions and other KPMG observations in the corporate governance arena, we see the most effective boards in the not-for-profit sector viewing enhanced governance as a means to both protect their reputation and, in some instances, to differentiate themselves competitively. This is where “added value” may exist in the governance conversation for some organizations—especially those institutions facing constant public scrutiny and an increasingly harsh “24x7” media world.

Clearly, some leading practices are now evident. Whether voluntarily adopting elements of S-O or accelerating other corporate governance initiatives, the most effective not-for-profit boards in the post-Enron world will be those that:

- Recognize the vital importance of integrity and transparency in financial reporting and corporate governance—and establish a framework that supports both
- Have the knowledge and independence to challenge management’s assertions in a constructive dialogue to better facilitate a robust discussion of organizational risks
- Strike the right balance between the extremes of “cheerleading from the sidelines” and over-involvement by “stepping into management’s shoes”
- Facilitate and constantly reassess the “tone at the top” as the organization’s first defense of its reputation

Enhancing governance can lead to better-managed organizations and greater confidence among donors and other stakeholders.

Given the broad diversity of goals, resources, cultures, and stakeholders in the not-for-profit world, different organizations will require different approaches to governance oversight. Clearly, one size will never fit all. We believe, however, that by considering the fundamentals of good governance in the multi-constituent environment of the not-for-profit organization, boards can enhance their ability to protect the organization’s reputation and, as a result, continue to attract and retain the support necessary to fulfill its mission.

The Benefits of Effective Governance



Selected other publications from KPMG's Audit Committee Institute:

- *Strengthening Governance and Accountability: Higher Education, Charities, and Other Not-for-Profit Organizations*
- *Corporate Governance Reforms: Implications for Not-for-Profit Healthcare: Audit Committee Roundtable Highlights—Spring 2004*
- *Oversight of Auditors: Audit Committee Roundtable Highlights—Spring 2004*
- *Fraud Risk Considerations: Audit Committee Roundtable Workshop—Spring 2004*
- *Audit Committee Oversight of Taxes and Other Issues: Audit Committee Roundtable Highlights—Fall 2003*
- *Building a Framework for Effective Audit Committee Oversight: Audit Committee Roundtable Highlights—Spring 2003*

These and additional ACI publications are available at www.kpmg.com/aci.

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