



Quality Financial Reporting

*What is
the board's
responsibility?*

by Dan Busby, ECFA Vice-President

Boards of nonprofits are legally responsible for overseeing the organization's financial management. Since nonprofits receive tax-exempt status by state and federal agencies to fulfill public needs, the board's obligations go well beyond its organization's members, constituents, beneficiaries or clients.

An important part of serving the public trust is fulfilling the important stewardship roles of protecting financial and nonfinancial assets, and managing current income properly to fulfill exempt purposes.

Although a ministry's management has the primary responsibility for the organization's financial management and reporting, the board of directors is ultimately responsible for the process. Outside auditors also play an important role as well.

ECFA believes that board oversight can be carried out by the full board or a committee consisting of a majority of independent members (Standard 2). The committee could be delegated the responsibility to engage the auditors, although the board generally reserves this authority for itself.

So how can a board be sure it is exercising adequate due diligence with respect to its financial responsibilities? Consider the following steps:

- **Review your conflict of interest policy.** A conflict of interest policy (and related

questionnaire completed by the board and key staff members) helps ensure that a ministry fulfills its charitable purposes. According to the IRS, a solid conflict of interest policy should include the following provisions: disclosure of financial interests, procedures for determining whether the financial interest may result in a conflict of interest, procedures for addressing a conflict of interest, and procedures for communicating the policy to appropriate parties.

Although some "conflict of interest" arrangements with board members or senior management and their related parties can seem to be in the best interest of the organization, the best policy is to avoid conflicts of interest altogether. When a board member or senior management is on more than one side of a transaction, regardless of their integrity and motives, they may not be able to fulfill their governance or management roles as fully and effectively as they would without such a conflict.

- **Establish an audit committee.** Although ECFA Standards permit the audit review function to be handled by the full board, an audit committee is highly recommended for most mid-size to large ministries. Committee roles should include:

- Understanding financial and operating risks of the organization.

- Understanding internal controls designed to mitigate those risks.

- Recommending to the board the selection of the independent audit firm.

- Evaluating the performance of the independent auditors.

- Evaluating the performance of management in fulfilling financial management and reporting responsibilities.

The committee, not ministry management, should take the lead in determining the selection, compensation terms and, if necessary, replacement of the outside auditor—generally subject to board approval.

The outside auditor is ultimately accountable to the board of directors and the audit committee of the organization.

“The outside auditor needs to have an open, candid dialogue with the audit committee.”

- **Establish a charter for the committee.** It is essential that the audit committee have a written charter to define the boundaries of the committee. The charter should state the committee's responsibilities, composition, roles, purpose, and agenda.

- **Select qualified individuals for the audit committee.** Unless the audit review function is handled by the full board, ECFA Standard 2 requires the committee to consist of a majority of independent members. Ideally, there should be at least three members, all of whom are independent. In addition to being independent, committee members should be selected on the basis of availability, prior

experience, objectivity, and aptitude for reading and understanding financial management issues and reporting.

Members of the audit committee are generally considered independent if they have no relationship to the organization that may interfere with the exercise of their independence from staff and the organization. Examples of relationships that would often impair independence include:

- A director being employed or who has a close family member employed by the ministry (or any of its affiliates) for the current year or in recent years.

“The audit committee is the fulcrum of the financial reporting function.”

- A director (or their business or related party) accepting any compensation from the ministry or any of its affiliates.

• **Select the “right” audit firm.** Obtaining the services of the “right” audit firm is a prerequisite to quality financial reporting. Which auditor is the “right” one for your ministry? Only your board can determine this. But it should be a firm that is knowledgeable about your ministry’s specific type and field of operations. Its principals and others who will serve your ministry should have all the necessary credentials and related experience.

While management can make auditor recommendations, the board should make the decision to select or retain the audit firm. The primary responsibility of the auditor is to the board. Management should not select auditors to audit the work of management.

• **Review the independence and objectivity of your auditor.**

The board should be certain that the auditors are independent and objective in performing their duties. It should identify any threats to their objectivity and analyze the significance of such threats. Objectivity does not require the auditor to be completely free of all the factors that might affect the ability to make unbiased audit decisions, but only free from those that rise to the level of compromising that ability.

Factors that may pose threats to objectivity include: self-interest (auditor acts in his or her own emotional, financial, or other personal self-interest), self-review (auditor audits his or her own work or the work of a colleague), familiarity (auditor is influenced by a close relationship with an audit client), and intimidation (auditor is being, or believes that he or she is being, coerced by an audit client or by another interested party).

• **Analyze the financial statements.** Because the financial statements are the primary and, often, only means of communication about a ministry’s financial performance, it is critical for the audit committee to understand their content. Management may wish to provide the committee with a written analysis of the financial statements, including computation of key financial indicators and comments on noteworthy trends and patterns.


• **Understand the management letter.** The management letter issued by the auditors is a confidential document intended to serve the board and management. It should contain information about any reportable conditions and material weaknesses

identified during the audit. These are conditions that are of significant concern because the internal controls or financial reporting processes may not protect the interests of the organization or assure proper financial reporting.

In addition, a management letter should contain findings and recommendations about other issues, such as less significant internal controls, financial and tax matters, and any other issues that may improve the operations.

• **Meet with the auditors.** The audit committee should meet with management (including the internal auditors, if any) and the independent auditors at least once a year. And the auditors should feel free to call the audit committee chair if material issues arise between scheduled meetings.

It is also important for the committee and the auditors to meet privately and directly. Auditors and audit committees need to have a frank dialogue about the ministry’s financial reporting operations. One way auditors and audit committees can ensure a candid and open discussion is to meet without any ministry management or staff present—perhaps at the end of regularly scheduled committee meetings or on a separate occasion.

At a time when boards are increasingly being reminded of their fiduciary responsibility, it is important for boards to adopt comprehensive practices to ensure the quality of the ministry’s financial reporting. 

Reprinted from
FOCUS on Accountability