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45 CFR §1607.1. Part 1607 is focused primarily on the composition of governing bodies. In particular, the regulation sets forth requirements (many based in statutory requirements) regarding the relative percentages of lawyers and clients who must comprise recipient boards, along with how such members are selected. 45 CFR §1607.3. There are also provisions relating to waiver of the composition requirements (§1607.6) and limitations on compensation to board members (§1607.5).

The regulation also provides some general requirements regarding the functions of the governing body:

- (a) A governing body shall have at least four meetings a year. A recipient shall give timely and reasonable prior public notice of all meetings, and all meetings shall be public except for those concerned with matters properly discussed in executive session in accordance with written policies adopted by the recipient's governing body.
- (b) In addition to other powers and responsibilities that may be provided for by State law, a governing body shall establish and enforce broad policies governing the operation of a recipient, but neither the governing body nor any member

then-current regulation did “not recognize that general authority” but that the Board thought “it should do so.” *Id.* Although the preamble to the final rule does not provide any further insight into the Board’s thinking on this matter, the preamble to the NPRM on this matter notes that the

Committee felt that the current regulatory language did not grant the governing body the general authority, for example, to hire and fire a program’s executive director and that there should be language that granted that authority.

59 Fed. Reg. 30885 (June 16, 1994) at p. 30888. We can only infer that by 1994, LSC had become more concerned with the regulation’s requirements regarding corporate governance and responsibility of a recipient board. Still, the amendment of the regulation in 1994 was to provide greater express responsibility and authority to governing bodies, but only in a general sense by acknowledging the board’s general responsibility and authority under the laws of the state in which the recipient was incorporated. LSC did not, apparently, see a need for LSC to *require* more of boards but rather only for LSC to *recognize* their inherent corporate authority.

*Non-profit Governance – Audit and Finance Committees – Current Corporate Standards*

As noted in the *Working Group Report*:

In recent years, the paradigm:

cost-effective methods for ensuring that the organization's financial resources are managed responsibly and effectively." A review of the Panel Report shows that the board's responsibilities for overseeing the audit process include:

- x Retaining and terminating the engagement of the independent auditor;
- x Reviewing the terms of the auditor's engagement at least every five years;
- x Overseeing the performance of the independent audit;
- x Conferring with the auditor to ensure that the affairs of the organization are in order;
- x Recommending approval of the annual audit report to the full board;
- x Overseeing policies and procedures for encouraging whistleblowers to report questionable accounting or auditing matters of the organization;
- x Approving any non-audit services performed by the auditing firm;
- x Reviewing adoption and implementation of internal financial controls through the audit process; and
- x Monitoring the organization's response to potentially illegal or unethical practices within the organization, including but not limited to fraudulent accounting.

**The Role of an Audit Committee.** No federal law addresses the role of audit

The AICPA points to the role of the audit committee in the prevention, deterrence, investigation, and discovery or detection of fraud. The members of the audit committee should understand their role of ensuring that the organization has antifraud programs and controls in place to help prevent fraud, and aid in its discovery if it does occur, to properly fulfill their fiduciary duties of monitoring the financial reporting process; overseeing the internal control system; overseeing the internal audit and independent public accounting functions; and reporting findings to the board of directors.

No federal law requires nonprofit organizations to establish separate audit committees although at least one state adopted legislation requiring that the board

Notwithstanding the above observation, the GAO recommended that the LSC Board “establish an *audit committee function* to provide oversight to LSC’s financial reporting and audit processes either through creating a separate audit committee or by rewriting the charter of its finance committee.” (emphasis added.) Thus, the GAO did not require that the LSC Board establish a separate audit committee, but gave an option of either establishing a separate audit committee or changing the functions of the finance committee.

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**Financial Expertise on Governing Body.** An important component of audit oversight includes having a person with financial expertise on the board of directors. The Panel Report, AICPA, and others recommend that at least one member of the governing body should have financial expertise, or access to financial expertise. The availability of financial expertise is helpful to the entire board, as well as to the finance committee and any audit committee. The Panel Report stated that “[c]haritable organizations should include individuals with some financial literacy on their board of directors in accordance with the laws of their state or as a matter of recommended practice.” We agree. We also note that only 26% of the replies to the survey stated that their boards have a member who is a CPA or has a degree in accounting.

The importance of the board possessing financial expertise is also stressed when a board has a separate audit committee. The AICPA lists several essential attributes of financial expertise and several questions that should be used to assess whether an individual audit committee member or the committee as a whole possesses these attributes. Additionally the AICPA lists several alternative approaches if no individual member of the audit committee possesses the attributes required, including developing a relationship with the chief financial officer of a similar organization, engaging a financial professional to assist the audit committee, and pursuing a training program for audit committee members to develop the necessary financial expertise.

*Working Group Report* at pp. 3-7

*LSC’s Survey of Recipients – Audit and Finance Committees and Fiscal Oversight Experience among LSC Recipient Legal Services Programs*

As reported in the *Working Group Report*:

LSC grantees are diverse in funding and size, as well as distinct in other delivery model characteristics and attributes. A recent survey of LSC grantees revealed that while the vast majority of boards of directors are directly engaged in financial oversight, including the audit function, a smaller number have separate audit committees. The functions of an audit committee are essential and grantee boards

are required to ensure that these financial oversight responsibilities are being met. However, in certain situations, those functions might be efficiently and effectively handled by the board's finance committee.

There were 141 responses to the survey of grantee executive directors and board chairs, 51% of the 274 possible replies. The results showed that:

80% of the replies stated that their boards have finance committees and 74% have audit committees. However, there was no clear indication from the responses that the finance and audit committees were separate and 77% (50 of

86% of the 51 programs applying in 2009 stated that they had an audit committee, however there was no indication as to whether the audit committee was separate or combined with the finance committee.

Taken together, the results of the survey and the review of funding applications submitted over the past two years demonstrate that the vast majority of grantee boards of directors are directly engaged in financial oversight, including being involved in audit committee functions, while a smaller number have separate audit committees.

*Working Group Report* at pp.2-3.

### ***Options***

#### *Option 1 – Take No Action by Regulation – Encourage Audit Committees as a Best Practice*

One option for the Board to consider would be to determine not to initiate a rulemaking (leaving Part 1607 as it is). The Board could select this option for procedural or substantive reasons.

The Board could elect to not engage in any substantive consideration of the matter at all in deference to the fact that the Board is in the midst of turnover. There are, currently, five nominees awaiting full Senate confirmation and another three whose nominations are still under consideration by the Senate Health, Education, Labor and Pensions Committee. With the coming change in Board membership, the Board could elect not to make any regulatory changes at this time, and instead to maintain the status quo pending the appointment of the new Board members. This would provide the greatest flexibility to the incoming Board members to adopt new policies of their own choosing with regard to this matter.<sup>3</sup>

On the other hand, given that there are still two positions for which nominations have not yet been made, that three of the nominees are still awaiting Committee action (let alone full Senate confirmation), and that the five nominations awaiting floor action continue to be subject to a hold, it is not at all clear when there will be a new Board (in whole or part) in place. Until such time as there is a new Board, the sitting Board members remain in place and have a continuing obligation to move the business of the Corporation forward. As such, there is a strong argument to be made that the current Board can and should move forward with substantive consideration and action on this issue.

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<sup>3</sup> Of course, a new Board could choose to engage in rulemaking anyway, even if this Board does act to amend the regulation.





these circumstances, a good argument can be made that adding a regulatory requirement to have an audit committee is unnecessary.

The imposition of an audit committee requirement would have no effect on the boards which already have audit committees. It is true that for those boards, complying with such a requirement would be easy. However, for those boards which do not have separate audit committees, such a requirement could be administratively burdensome particularly for boards with very small numbers of directors. Moreover since even the boards without separate audit committees report performing the functions of an audit committee, either through a joint audit/finance committee or at the full board level, the imposition of a committee requirement the lack of audit committees does not appear to be statistically correlated with a lack of effective fiscal oversight activity.

To the extent that the regulation did no more than require recipient boards to have audit committees, LSC would be easily able to check for compliance (if an audit committee exists, the

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4. Reviews the audited financial statements, management letter, and senior staff's response with staff and auditor;
  5. Regularly reviews and makes recommendations about investment policies;
  6. Coordinates board training on financial matters. Acts as liaison between full board and staff on fiscal matters.

#### Audit Committee

The audit committee's role, subject to any requirements of state law:

1. Hiring the auditor;
2. Setting the compensation of the auditor;
3. Overseeing the auditor's activities;
4. Setting rules and processes for complaints concerning:
  - a. Accounting practices
  - b. Internal control practices

recipient is in compliance, if not, it is not in compliance). However, merely having an audit committee is meaningless unless the audit committee

Alternatively, the Board could initiate a rulemaking and direct that it be conducted as a negotiated rulemaking. However, negotiated rulemakings are time, labor and cost intensive and generally reserved for issues where one is looking to make significant changes involving complex issues where a series of face-to-face negotiations will likely help the agency and the interested parties involved in the negotiation consider and work through a number of difficult factual and policy problems. Moreover, once the negotiated rulemaking is completed, LSC would still have to conduct a standard notice and comment rulemaking. The situation at hand does not appear to be a good candidate for a negotiated rulemaking.

As noted above, the best reason to require recipient boards to have freestanding audit committees would be to as a way to ensure that boards are engaged in close fiscal oversight of their organizations. Imposing such a requirement would appear to be appropriate if many or most recipients were not engaged in such activity, or were not doing an adequate job of such oversight. In that case, imposing a regulatory requirement could demonstrate to recipients the seriousness with which LSC takes such concerns

substantive standards for the work of such committees should be adopted. For example, should audit committees be required to be distinct from finance committees? Should audit committees include someone with specific financial expertise?<sup>6</sup> If so, should that expertise be someone on the Board, or would the use of a consultant or volunteer in this capacity be sufficient? Should the regulation specify the types of functions and activities LSC expects audit committees to be performing and if so, what are they? These are not necessarily simple questions and, given the diversity of LSC's recipients, the answers to some or all of these questions may differ for different recipients. This may suggest that the issues of concern to the Committee are neither sufficiently addressed by the simple imposition of an audit committee requirement nor susceptible of a standardized solution imposed by a one-size-fits-all regulation.

*Option 3 - Initiate a Rulemaking and Request the Development and Publication of an Advance Notice of Proposed Rulemaking*

Another option would be to initiate a rulemaking the Board could direct staff to develop and publish for comment an Advance Notice of Proposed Rulemaking (ANPRM). This action would be most appropriate if the Board was not yet convinced one way or another about the merits of imposing an audit committee requirement by regulation, yet wanted a formal, public way to obtain additional, broader input. An ANPRM often does not set forth specific proposed regulatory text changes, but instead often sets forth questions and policy options upon which it seeks comment that the agency may formally take under consideration. After receiving comment on an ANPRM, the Board would decide whether to proceed with the rulemaking and provide policy guidance for the development of an NPRM or whether to close the rulemaking without any further action. The advantage of this course is that it allows for additional input at the early stages of the Board's consideration of possible regulatory amendment. The disadvantage is that it does take longer than a traditional notice and comment rulemaking. However, in this case, since there is no statutory deadline against which LSC is working, taking additional time does not appear to present a significant problem. Also, depending on when the Senate acts on the various nominees, the development of an additional record could be of use to the new Board members if they inherit this issue.

If the Board were to favor this option, the questions the ANPRM should address would appear to be the ones set forth above: Should audit committees be required to be distinct from finance committees? Should audit committees include someone with specific financial expertise? If so, should that expertise be someone on the Board, or would the use of a consultant or volunteer in this capacity be sufficient? Should the regulation specify the types of functions

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<sup>6</sup> Alternatively, the board could consider requiring, in lieu of a separate audit committee, a recipient governing body to include a person with financial expertise (such as an accounting degree and/or CPA certification). Given the statutory requirements for board composition which leave recipients with few board positions which may be filled by non-lawyers or non-client eligible members, it may be difficult for recipients to be able to find qualified board members with financial expertise within the confines of the composition requirements. If the Board wished to

and activities LSC expects audit committees to be performing and if so, what are they? Should there be a waiver requirement? If so, what standards should apply to such a waiver process?