A. INTRODUCTION AND OVERVIEW

The Audit Committee met on March 29, 2005 with Tom McIlrath, Treasurer, and Michael Stephens, Controller, and with Don Phillips, Engagement Partner, and Greg Plotts, Manager, of the audit firm PricewaterhouseCoopers (PWC). At this meeting, PWC’s Audit Report for the year ending December 31, 2004 was examined and discussed. Following the general discussion with the above-named persons, the Audit Committee then met with just Don Phillips and Gary Plotts. The PWC auditors then departed. Next, the Committee, along with Tom McIlrath and Michael Stephens, met with Bob Kelly and Tracy Alinger to hear Business Continuity Plans for APS at College Park and APS Editorial Office. Then we met in Executive Session followed by a meeting with Tom McIlrath, and lastly with both Tom McIlrath and Michael Stephens. The present report covers the entire 2004 calendar year. The Committee wishes to extend its thanks to Tom McIlrath and Michael Stephens for their cooperation and assistance in meeting the responsibilities of the Audit Committee.

The Audit Committee was provided with:

- The 3/8/05 PWC Report titled "APS Financial Statements, Supplemental Information and Reports of Independent Auditors for the Year Ended 12/31/04".
- The PWC Report to the Audit Committee, dated 3/29/05.
- The 4/16/04 Report of the 2004 Audit Committee to the Council.
- The APS Audit Committee Charter, dated 3/14/05, describing the Committee's major functions, background, duties and responsibilities.
- APS Report on Sarbanes-Oxley Gap Analysis.
- APS Report on Whistleblower.

Prior to the meeting, the treasurer and controller provided the Audit Committee with:

- An e-mail of AIP’s response to the Committee’s request for AIP to perform a SAS 70 audit to be given to APS.
- A Report on Audit Firm Rotation by AIP members.
- A Background Paper on Post Retirement Benefits prepared by the Treasurer and Controller.

Finally, the Committee Chair provided the Committee, the Treasurer and Controller with

- A National Survey of Retiree Health Coverage.

In addition to the formal audit issues other topics were discussed, as described below.
B. THE AUDIT REPORT

During the Committee's meeting with Don Phillips and Greg Plotts, Mr. Phillips stated: (i) the APS financial statements are prepared in accordance with generally accepted accounting principles; and (ii) the fiscal condition of the APS is sound and very healthy, in the sense that: (a) it has no long term debt; (b) its liquid assets are a significant fraction of its total assets; and (c) there were good increases in the Society’s net assets which were driven primarily by increases in the stock market.

_The Audit Committee sees no reason to disagree with these statements by Mr. Phillips, but see also paragraph E.7 below._

C. FOLLOW-UP ON THE 2004 AUDIT COMMITTEE RECOMMENDATIONS AND FINDINGS (Comments of the current Audit Committee are in italics)

1. We recommend that PWC's Report of Independent Accountants for the year ending 12/31/03 be accepted.

_Council accepted report._

2. We recommend that the APS retain PWC as the audit firm for the new fiscal year ending 12/31/04. The desirability of re-bidding audit responsibility should be reassessed after receipt of PWC's audit report for the new fiscal year.

_PWC was retained._

3. We find, on the basis of the audit by PWC and our discussions that there are no outstanding issues of material importance in the financial affairs of the APS, except as discussed in C-7.

_No follow-up required, but see C.7 below._

4. We request that the audit be provided to the Committee as early as possible before the Committee meets. We also note that the 2005 Council Meeting, when the Audit Report will be presented, is two weeks earlier than this year.

_The draft information was presented to the committee in a more timely manner._

5. We recommend that the Audit Committee be expanded to four members who will serve four year terms. The member in his/her third year will serve as Chair. At present, the Chair is only in his/her second year and should have more experience to be a more effective chair. We believe the auditors, Tom McIlrath and Michael Stephens concur in this recommendation.

_This recommendation requires a change in the By-Laws of the Society. Management is in the process of making this change._
6. We find that the Business Continuity Plans at the Editorial Office and at College Park are continuing to develop in an excellent manner, with well thought out future expansions. A major effort has been made to provide several back up locations so there would be continuity of service should something happen at Ridge. We were delighted to hear from Bob Kelly that this back up had been tested at ten US libraries which were connected to Ridge, in which they were switched from Ridge to another location without their library personnel even knowing a switch had occurred. This successful switch is a major achievement. The Ridge Office is to be commended on its successful trial of the switch of on-line activity from one location to another.

*Business Continuity Plans continue to be in good order.*

7. Long-term retiree health care, which presently amounts to 20% of total liabilities, remains an increasing financial obligation fraught with long-term uncertainty. During the year 2003, this liability grew to $6,138,436 from $5,089,554 on December 31, 2002. The Committee feels the APS Executive Board should be concerned about the long-term, retiree health care commitment. A better understanding of the driving forces behind this issue are needed to develop clearer perspectives and possible solutions. This will require in-depth analysis of the actuarial procedures in formulating the liabilities. We recommend that the Society, under the leadership of the Treasurer, address this issue by examining how its present benefits package compares with the packages offered by other comparable not-for-profit organizations concentrating on not-for-profit organizations whose salary structures are similar to the APS's and doing an in-depth analysis of the actuarial procedures. We believe the Auditors will help in this regard.

*In 2004, Thomas McIlrath worked with the actuaries to determine modifications to the current program. This is an on-going issue and will be addressed by the Audit Committee in E7 below and by the Budget Committee.*

8. We felt the need to be involved from the beginning of the Audit process. This next year the Audit Committee will meet by phone with the Auditors and APS Management before they start the process to provide input for the Audit. This move is with the concurrence of Tom McIlrath and Michael Stephens.

*Committee met with the Auditors by conference call on December 3, 2004.*

9. To carry out its work, we believe that the Audit Committee needs to be provided with quarterly financial reports. Tom McIlrath and Michael Stephens have agreed to provide this information. In addition, any serious reports of financial mismanagement, as identified in new procedures to be put in place, are to be reported immediately to the Audit Committee.

*Quarterly reports are now being supplied to the Audit Committee via email.*

10. We believe this gap analysis recommendation of PWC's should be seriously considered by the Society.
A Gap Analysis regarding the Sarbanes-Oxley Act was performed by management.

11. We recommend the APS develop a formal procedure of reporting and addressing questionable or known business activities or those that are known to be illegal or inappropriate. The procedure should include informing the Audit Committee immediately of any serious accusations. We believe the new procedure can be conveniently incorporated into the existing APS policy statement on Workplace Harassment, Discrimination and Violence or be a stand alone procedure as management chooses.

A Whistleblower Policy has been developed but not yet communicated to the employees.

12. The Committee (with one recusal to avoid any possible conflict of interest) urges APS to request AIP to do a SAS 70 Report that would be given to APS.

AIP declined to do a SAS 70. While the Committee understands the reluctance of AIP to do a SAS 70 Report, the Committee urges AIP to reconsider.

D. STATEMENTS BY PWC ABOUT THE AUDIT FOR YEAR ENDING 12/31/04

The following statements appear in the PWC Report to Management of the APS dated March 8, 2005:

1. Continue to Improve Procedures Relating to Accounting for Pledges and Gifts

During 2004, APS began to prepare a reconciliation of the Development Department records of gifts to the gifts recorded in the general ledger on a quarterly basis. From these reconciliations, several pledges from prior years were identified that were not initially recorded as contribution revenue in the general ledger. Therefore, gift revenue was recognized in the year of payment rather than in the year the pledge was made by the donor.

APS should continue to focus on improving the record keeping and analysis associated with pledges receivable to ensure that they are being recorded, reviewed, and accounted for completely and accurately. We recommend increasing the frequency of the reconciliation between Development records and the general ledger from a quarterly to a monthly basis. All adjustments should be communicated timely amongst the departments to ensure their individual records are accurate. We also recommend formal guidelines should be developed to govern the treatment of gifts, especially for gifts where donor documentation is ambiguous or incomplete.

Management's Response: Management is continuing to improve the procedures. Since the audit, reconciliements have been done on a monthly basis.

Audit Committee's Response: We believe management has responded appropriately to the recommendation.
2. Establish Formal Policies and Procedures to Review Collectibility of Pledges Receivable

We noted that an analysis to determine an allowance on pledges receivable is not being performed. Since pledges receivable should be recorded at net realizable value, establishing a reasonable allowance for these amounts is an integral part of accurate financial reporting.

A best practice for developing a reasonable allowance is to track the organization’s actual collection history to develop an appropriate allowance. Therefore, we recommend the following be implemented to strive for a historically based calculation of the allowance:

- Prepare a formal aging of the pledge receivable balances
- Perform a trend analysis review that utilizes historical collection data and write-off experience
- Develop formal policies and procedures to reserve for pledges which have been specifically identified as at-risk, as well as for the inherent collectibility risk on pledges due in future period.

Management's Response: Management will examine the age of its pledges and establish a reserve for uncollectible pledges.

Audit Committee's Response: We recommend that APS develop a plan to carry out the Auditor’s recommendations.

3. Recognize Bequests on a Timely Basis

During 2004, APS was the beneficiary of a bequest from the estate of Mrs. M. Hildred Blewett. This trust was not recorded during the year, as APS was waiting to hear from the trustee regarding the will clearing probate. Upon inquiry of the trustee, we noted that the will was declared valid and cleared probate before December 31, 2004. Generally accepted accounting principles requires not-for-profit organizations to recognize the revenue and the related receivable from a beneficial interest in an estate when the probate court declares the will valid and the amount to be received can be reasonably estimated.

We recommend that APS closely monitor any known cases where it has been named as the beneficiary in an estate and recognize the revenue in accordance with generally accepted accounting principles.

Management's Response: This was a very complicated bequest from an estate located in Canada. In the process, management has gained a better understanding of how to monitor such bequests and how to recognize the revenue in accordance with generally accepted accounting principles.

Audit Committee's Response: The Committee believes the proper procedures are now understood and will be followed.
4. Establish Procedures to Ensure Accrual of All Federal Expenditures

During our audit, we noted approximately $75,000 of 2004 expenditures related to subrecipients of Federal Grants were not properly accrued in the financial statements. We understand that certain subrecipients are typically slow to bill for the expenses related to the grants and, therefore, APS is accounting for these expenditures on the cash basis.

We recommend that APS recognize all Federal expenditures related to subrecipients based on the accrual method of accounting. This may require APS to develop specific procedures or estimates to capture expenses incurred by certain subrecipients. Such practices will help ensure that all expenses are recorded in the period when the expense actually occurred.

Management’s Response: Management will perform accruals for Federal expenditures related to subrecipients. APS will also bill Federal agencies based on the accrual method of accounting.

Audit Committee's Response: The Committee concurs with Management’s response.

5. Strengthen Password Parameters

During our review, we noted:

A. The password settings currently configured in the Lawson Financial system – web based are as follows:
   - Passwords are not set to expire;
   - The system does not lock-out user accounts after a specified number of failed login attempts;
   - No minimum password length; and
   - Password complexity is not enforced – (alpha numeric, special character).

B. The password settings currently configured in the Association Anywhere – Oracle web based Membership Subscription system are as follows:
   - Passwords are not set to expire;
   - The system does not lock-out user accounts after a specified number of failed login attempts or periods of inactivity;
   - Minimum password length - 5 characters; and
   - Password complexity is not enforced – (alpha numeric, special character).

These configurations are not consistent with industry best practices for strong security parameters. Accordingly, we recommend that Management reevaluate current Lawson Financial and Association Anywhere password parameters and adopt industry best practices to strengthen security over information systems and data.

Management’s Response: Management is investigating the best way to increase password security.
Audit Committee’s Response: We believe Management understands the issues and is proceeding accordingly.

E. RECOMMENDATIONS AND FINDINGS OF THIS AUDIT COMMITTEE REPORT TO COUNCIL

1. We recommend that PCW’s Report of Independent Accounts for the year ending 12/31/04 be accepted.

2. We recommend that the APS retain PWC as the audit firm for the new fiscal year ending 12/31/05. The desirability of re-bidding audit responsibility should be reassessed after receipt of PWC's audit report for the new fiscal year. However, we expect the same recommendation next year because a new Treasurer will be hired in 2006. It will be helpful for the new Treasurer to be working with someone familiar with APS.

3. We find, on the basis of the audit by PWC and our discussions, that there are no outstanding issues of material importance in the financial affairs of the APS, except in regards to Post Retirement Health Benefits described below.

4. We are pleased that steps are being taken to implement our recommendation that the Audit Committee be expanded to four members who will serve four year terms. The member in his/her third year will serve as Chair.

   This was done.

5. We recommend that the Audit Committee be expanded to four members who will serve four year terms. The member in his/her third year will serve as Chair. At present, the Chair is only in his/her second year and should have more experience to be a more effective chair. We believe the auditors, Tom McIlrath and Michael Stephens concur in this recommendation.

   We commend both officers for their excellent work.

6. We are pleased with the excellent job Mike Stephens did in a gap analysis regarding compliance with the provision of Sarbanes-Oxley. There was only one area identified in which the future APS could have a problem, Section 407 of Title IV-Enhanced Financial Disclosure:

   Section 407 requires public companies to disclose whether or not, and if not, the reasons therefore, the audit committee is comprised of at least 1 member who is a financial expert. A financial expert is one who has (1) and understanding of generally accepted accounting principles and financial statements, (2) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves, (3) experience preparing, auditing, analyzing, or evaluating financial statements
that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the company’s financial statements, or experience actively supervising one or more persons engaged in such activities, (4) an understanding of internal controls and procedures for financial report, and (5) an understanding of audit committee functions.

7. **(A). Definition of issue.** The Committee expressed its concern to the Council the last two years about the rapidly increasing liability for post-retirement medical benefits for employees. This year this issue received considerable attention by the Committee. The auditors concurred with the Audit Committee that this is the greatest threat to the long term financial well being of the society.

In the financial statements, the liabilities for post-retired medical benefits have been the following:

- $3,409,738 December 31, 2000
- $4,247,857 December 31, 2001
- $5,089,554 December 31, 2002
- $6,138,436 December 31, 2003
- $7,250,581 December 31, 2004

In four years, this liability has more than doubled and is approaching the total cost of salaries which was $11,846,000 in 2004.

Quoting the Background Paper on Post Retirement Benefits prepared by Tom McIlrath:

Post Retirement benefits are handled differently from other compensation. Post Retirement benefits are actually paid out only after an employee has retired. However, accounting rules require that we recognize this future charge over the employee’s years of service at APS. An actuarial estimate is made of the costs for providing health care benefits during the period after an employee has retired. This total cost (or more properly, the present value of the funds necessary to cover future costs) is divided by an estimate of the number of working years of the employee, and a charge is made each year to the Society for the anticipated costs.

In contrast to other benefits which are subtracted from Society assets, Post Retirement benefits do not represent current payments, and they are thus treated by an addition to the APS liabilities. However, Post retirement benefits have exactly the same effect on the Net Assets of the Society as do Salaries and other benefits.
This issue is in reality likely much worse than the above figures would estimate for our future liabilities. This is because government regulations set the increases in medical costs which are used in the calculations for the future costs. The assumptions are 10.5% increase in medical costs in year one decreasing to 5.5% in year six and constant after that. This is to be compared with increases of the order of 15% a year for a number of past years with similar increases expected per year over the next five to ten years. It also does not factor in any increasing life expectancy which could further increase the liability and cost. Even at the yearly increases used, this liability will exceed salaries in less than five years.

This is a major national problem as stressed in a recent article in Business Finance entitled “Exit Strategies for Retiree Health Plans.”

Providing fully subsidized retiree health benefits is no longer tenable… Retiree health benefits are yet another piece of the historic industrial landscape that will soon slip over the horizon. The plans have long outlived their original purpose as a tool to help regulate turnover, but they continue to generate huge liabilities for the companies that provide them. Employers are aggressively seeking strategies for shedding plans that were once considered a critical part of the retirement benefit package.

‘As each year passes, retiree medical coverage becomes more rare at U.S. companies,’ notes Steven J. Friedman, chairperson of the employee benefits practice group at the New York City office of Littler Mendelson, a labor employment law firm headquartered in San Francisco. ‘Companies are getting crushed by the mounting costs of health care. For active employees, employers’ costs are quite high; for retirees, employers’ costs are devastating.’

Our auditor’s stressed that APS must do strategic overall planning and not just look at immediate tactical solutions to address the threat posed by the rapidly increasing liability for post retirement medical benefits.

Clearly this benefit has been part of the employee’s compensation. However, it is not clear that APS employees are fully aware of this benefit or the long term liability APS is assuming on their behalf. Most employees, it seems, are not as concerned about benefits they will receive after retirement. This is evidenced by the fact that APS dropped the requirement that employees put in 2.5% of their salary in order to receive the APS 10% contribution when too many people did not join the retirement plan because of the 2.5% requirement even though they received a 10% bonus when they did.

**Summary of Issues**

The cost of health care benefits for retirees is a real component of the compensation of APS employees and a real long-term, rapidly escalating liability for APS. In particular,
effects of this component of compensation on the “bottom line” of APS are the same as, for example, the salaries actually paid to employees.

**Principles of Solution**

In our view, it is necessary for management, Compensation Committees, Presidential Line, etc., to consider these benefits and their costs, as they determine the appropriate compensation for APS employees and the long-term financial health of the organization. Financial analysis, projections and financial reports to Council and Executive Board must, of course, show the total cost of compensation including the projected increase in retirement benefits. An overall strategic plan needs to be developed.

**Recommendation**

The Audit Committee recommends that Management, the Budget and Compensation Committees and the Executive Committee begin to work together immediately to develop a strategic plan to address this problem.

8. The Committee recommends that the Audit Committee Chair convey its deliberations on the issue of Post Retirement Benefits directly to the Budget Committee at its next meeting.

9. The Committee continues to feel that APS needs AIP to do a SAS 70 Report. We recommend that APS agree to pay a prorated share of the cost (or up to 50% of the cost).