REPORT OF THE 2002 AUDIT COMMITTEE TO THE COUNCIL
OF THE AMERICAN PHYSICAL SOCIETY
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A. INTRODUCTION AND OVERVIEW

The Audit Committee met on October 7, 2002 with Tom McIlrath, Treasurer and Michael
Stephens, Controller, and with Donald Phillips, Partner and Amy Hargrett, Manager, of the audit
firm PricewaterhouseCoopers (PWC). At this meeting, the Audit Report of Pricewaterhouse-
Coopers for the fiscal year ending June 30, 2002 was examined and discussed. The Committee
also met with Tracy Alinger, APS Director of Headquarters Information Technology and Bob
Kelly, APS Director of Journal Information Systems, to review the APS College Park Business
Continuity Plan and the APS Editorial Office Business Continuity Plan. Following the general
discussion, the Audit Committee first met in executive session, then met with Donald Phillips
and Amy Hargrett in separate session, then met separately with Tom McIlrath, and lastly met
separately with both Tom McIlrath and Michael Stephens. 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, and to Tracy Alinger and Bob Kelly for presentation of
the business continuity plans.

The Audit Committee was provided with:

- The Audited APS Financial Statements for FY 2002 and 2001, together with the Report of
  Independent Accountants dated 9/20/02.
- The PWC Report to the Audit Committee dated October 7, 2002.
- The APS charge to the Audit Committee dated 4/19/2002.
- The APS Editorial Office Business Continuity Plan.

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

B. THE AUDIT REPORT

As noted by the audit firm PricewaterhouseCoopers (see the "PWC Report to the Audit
Committee", the "Audited APS Financial Statements for FY 2002 and 2001" and the "Report of
Independent Accountants dated 9/20/02"), the APS is in compliance with standard auditing
requirements and the fiscal condition of the APS is sound and in accord with reasonable
requirements for not-for-profit organizations.

*The Audit Committee agrees with this conclusion.*
C. FOLLOW-UP ON THE RECOMMENDATIONS OF THE 2001 AUDIT COMMITTEE
(Comments of the current Audit Committee are in Italics)

1. We recommend that the FY 2001 Independent Auditor’s Report prepared by Price-waterhouseCoopers be accepted.

Council accepted report.

2. We find, on the basis of the audit by PWC and our discussions that there are no outstanding issues of importance in the financial affairs of the APS.

No follow-up required.

3. We recommend that the APS retain PricewaterhouseCoopers as the audit firm for FY 2002 and through the six-month transition period to the new calendar fiscal year. The possibility of re-bidding audit responsibility should be reassessed in spring 2003 and every year after that.

PWC was retained.

D. STATEMENTS BY PWC ABOUT THE FY 2002 AUDIT (Comments in Italics)

The following statements appear in the "PWC Report to Management of the APS dated September, 2002":

1. Consider Implementing Action Steps of the Corporate Reform Agenda

Recently, President Bush unveiled his “Comprehensive Corporate Reform Agenda,” which contained a number of proposals directed at increasing public confidence in U. S. finance markets by strengthening the “corporate responsibility” of publicly traded companies. In addition, Congress recently enacted the Sarbanes-Oxley Act of 2002, which is intended to bring about fundamental changes in how audit committees, management and auditors carry out their respective responsibilities and interact with each other. Although targeted at curbing abuses by publicly traded businesses, it is foreseeable that a number of these proposals will be extended in one manner or another to not-for-profit organizations in the future. Such an extension is foreseen due to:

- The public disclosure requirements already imposed on not-for-profit organizations.
- The perceived need to create parity among organizations that should be held accountable to the general public.
- The accountability of not-for-profits to the general public due to their tax-exempt status.

Not-for-profit organizations’ best outlook is to become aware of the changes in the for-profit community and to assess which changes, if any, should be implemented as a best practice for purposes of public perception and heightened accountability.
We recommend that the Committee and management become familiar with the changing regulations and assess what action steps APS should take to promote clear, independent and transparent reporting. Some of the potential actions may include:

- Establishing an ad-hoc sub-committee to stay abreast of regulations and the impact to APS;
- Adopting internal accounting controls and accounting practices that will facilitate the ability of the Executive Officer and Treasurer to personally vouch of the organization’s financial statements;
- Assessing the independence of directors, outside auditors, and outside advisors carefully and, if necessary, taking measures to reduce conflicts of interest;
- Establishing or assessing the independence of the dedicated audit committee, nominating committee, and compensation committee;
- Requiring the audit committee to possess financial management or accounting practices;
- Adopting clear record retention policies;
- Evaluating governance policies and procedures and strengthening the Committee’s understanding of fiduciary duties; and
- Evaluating the need for an internal audit function.

Management’s Response: Management will consider the action steps of the Corporate Reform Agenda. Initial steps will be taken to address issues raised to date and the policies will evolve as the demands of the Corporate Reform Agenda evolve.

Audit Committee’s Response: *We find that the APS is well run financially. This is corroborated by the independent external audit. We are especially pleased with the role that Michael Stephens plays in this process. The auditing function is working well; accounting practices are changing however. As for the recommendations of PWC relative to the Sarbanes-Oxley Act of 2002, many of the suggested action steps are not germane to the APS in our opinion. We recommend management consider all these recommendations, but implement only those that it deems useful.*

2. Establish Formal Policies and Procedures to Monitor Grant Sub-recipients

The Society has not established formal policies or procedures to monitor sub-recipients of federal grants under the provisions of OMB Circular A-133. APS is responsible for ensuring all grant expenditures including those expensed by sub-recipients are in compliance with the federal grant requirements. Without formal policies and procedures in place to monitor sub-recipients expenditures, APS increases its risk of non-compliance that could result in the retraction of funds as well as hinder future grant proposals.

We recommend that APS establish formal policies and procedures to monitor sub-recipients. These policies and procedures should include the following:

- Review of invoices remitted by the sub-recipients prior to reimbursement of expenses by APS to the sub-recipients;
• Review of the indirect cost rates utilized by the sub-recipients prior to reimbursement of expenditures by APS to the sub-recipients;
• Review of the sub-recipient’s A-133 report on an annual basis as outlined in the sub-contract between APS and the sub-recipient;

In addition, APS should ensure individuals responsible for the grant administration process have sufficient knowledge of the OMB Circular A-133 compliance requirements and provisions and ensure continuous training regarding subsequent revisions. As the organization expands its federal grant application process and receives additional federal funding, it is imperative that the necessary control procedures are put into place to meet the minimum objectives of an internal control structure as described in the OMB Circular A-133 Compliance Supplement.

Management’s Response: Management will consider establishing formal policies and procedures to monitor grant sub-recipients. In conjunction, procedures for grant principal investigators to follow will be formalized and distributed.

Audit Committee’s Response: The Audit Committee urges management to seek modifications of the required APS grant procedures pertaining to managing federal grant sub-recipients, for instance to investigate the possibility of direct grants to sub-recipients under an APS umbrella grant.

For good business practice, management should institute a procedure whereby the Treasurer signs off on all grant proposals.

In response to direct questions from the Audit Committee, PWC’s representatives stated that they found no unresolved issues in their audit.

E. BUSINESS CONTINUITY PLANNING

The Audit Committee reviewed the business continuity plans of College Park and the APS editorial office. We find those business continuity plans well thought out; although improvements doubtless can be found, we are pleased with management’s efforts in this important function.

F. SUMMARY OF RECOMMENDATIONS AND FINDINGS OF THE FY 2002 AUDIT COMMITTEE TO COUNCIL

1) We recommend that the FY 2002 Independent Auditor’s Report prepared by PricewaterhouseCoopers be accepted.
2) 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.
3) Long-term retiree health care, which presently amounts to 20% of total liabilities, is an increasing financial obligation fraught with long-term uncertainty. The Audit Committee expresses its concern. We recommend that the APS examine ways to limit the growth of this liability.
4) We find the business continuity plans of College Park and the APS Editorial Office (Ridge) well thought out; although improvements doubtless can be found, we are pleased with management’s efforts in this important function.

5) Market uncertainties play a large role in the net assets of the APS. The Audit Committee observes that it has no responsibilities in the investment strategies of the APS. The Audit Committee believes that the Council would be well served by receiving direct reports from the Investment Committee.