September 2014
Updated July 2017

Tax-Exempt Organizations Alert: Audit Committees and Audit Committee Charters

The Internal Revenue Service (IRS) places great emphasis on nonprofit governance, including the board of directors' role in overseeing the financial affairs of nonprofit organizations. This focus on board oversight is reflected in IRS Form 990, the annual information return that tax-exempt organizations with annual receipts of $200,000 of more must file with the IRS. One question on Form 990 is whether the nonprofit has a committee of the board overseeing the audit process.

While an audit is not required for federal tax-exemption, the IRS is interested in ensuring that all tax-exempt organizations have enhanced financial oversight. Therefore, organizations should seriously consider having an audit committee to assist in such oversight.

Moreover, organizations that do not have their books and records audited by an independent auditor should strongly consider doing so. In fact, many states require tax-exempt organizations with gross receipts in excess of specific dollar thresholds to have an annual audit by an independent auditor for charitable solicitation registration purposes.

In addition to creating an audit committee, every tax-exempt organization should draft and adopt an audit committee charter to facilitate the creation of its audit committee and to ensure the committee's continued functioning. Even an organization that already has a functioning audit committee should consider adopting a charter, if it has not already done so, to increase transparency and to clarify the audit committee's duties.

What is an Audit Committee?

An audit committee is tasked with overseeing the review and audit of the organization's books and records, financial reporting, and compliance reporting. The audit committee's duties generally include reviewing the work of the chief financial officer, as well as selecting the independent external auditor, reviewing the independent auditor's work, and (if necessary) dismissing the independent auditor.

The audit committee should consist exclusively of board members. The two main requirements for an effective audit committee are:

- Financial expertise, and
- Independence from management.

Financial Expertise

The audit committee must have enough financial expertise among its members to conduct meaningful review of the organization's financial statements and the work of the independent, external auditor. A single committee member may have this expertise, or the various members may have complementary skills and experience that, in combination, enable the committee to fulfill its purpose. The committee must not rely on the organization's chief financial officer or independent auditor to conduct the committee's oversight duties.

Independence from Management

The audit committee is generally charged with overseeing the officers and managers of the organization in their financial duties. For this reason, the committee must be able to review and investigate matters within its purview without the influence of officers, managers, or employees of the organization.

To achieve this independence, the audit committee should report only to the board, and should conduct its reviews and meetings in private. The committee members or their family members and close business associates should not have any financial interest in the organization and should not themselves be compensated by the organization.

What is an Audit Committee Charter?

An audit committee charter is a document, adopted by the board, describing the purpose of the audit committee and laying out the committee's powers and responsibilities. (A sample of an audit committee charter is attached to this alert.)

The charter should state how members of the committee are to be selected, the frequency of the committee's meetings, and other governance matters concerning the committee.

The main purposes of an audit committee charter are to:

- Ensure that the committee will have the necessary financial expertise and independence to achieve its purposes;
- Give the members of the committee a roadmap for how to approach their tasks; and
- Instill and maintain a level of transparency regarding the committee's functions and position in the organization.

Additional Resources

You may find the following information helpful in reviewing your organization's recordkeeping policies:

- IRS, *Form 990, Schedules and Instructions* https://www.irs.gov/charities-non-profits/annual-reporting-and-filing

- Independent Sector, *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* (2015) https://www.independentsector.org/wp-content/uploads/2016/11/Principles2015-Web-1.pdf

- The American Institute of Certified Public Accountants Audit Committee Toolkit: Not-for-Profit Organizations, *Resources for Audit Committees* http://www.mcconnelljones.com/PDF/NFP%20Audit%20Toolkit.pdf

- National Council of Nonprofit Associations, *Board's Role & Audit Committees* https://www.councilofnonprofits.org/nonprofit-audit-guide/board-role-audit-committee

---

This communication is provided by Orrick Herrington & Sutcliffe LLP and the D.C. Bar Pro Bono Center as a public service solely for informational purposes, without any representation that it is accurate or complete. It does not constitute legal advice, and should not be construed as such. It does not create an attorney-client relationship between the recipient and any other person, or an offer to create such a relationship. This communication contains information that is current as of the date it is written. However, laws change, and as a result the information may no longer be timely. Consult an attorney if you have questions regarding the contents of this communication.

September 2014
Updated July 2017

The following Model Audit Committee Charter is a sample document for nonprofit organizations incorporated in the District of Columbia only. It is presented only as a guide, to assist organizations in drafting their own charters and intended only for corporations seeking to qualify as tax-exempt organizations under Section 501(c)(3) of the Internal Revenue Code. This sample is provided only for informational purposes and does not provide specific legal advice for any individual situation. Some or all of this document may not be appropriate for your organization. The sample also reflects the provisions of the Internal Revenue Code and the laws of the District of Columbia as of the date it is written. However, laws change. Only an attorney with knowledge of your particular situation can provide the legal assistance you need. Your organization should meet with an appropriate advisor to assist in drafting a charter that will address any relevant state law audit committee requirements, which may be more specific than those addressed in the model charter.

Model Audit Committee Charter

THIS CHARTER OF THE AUDIT COMMITTEE of the Board of Directors (the "Board") of _____ (the "Organization") has been duly approved and adopted by the Board this _____ day of _____, _____.

Membership

The members of the Audit Committee shall be appointed by the Board. In selecting members, the Board will strive to include in the Audit Committee at all times at least one member with sufficient financial expertise to fulfill the responsibilities and perform the review of financial records and reports as described in this Charter. The Audit Committee shall consist only of members of the Board.

The members of the Audit Committee shall not include any of the following: the Chair of the Board, Executive Director, Chief Executive Officer; Treasurer, Chief Financial Officer, or Controller, or any paid employee of the Organization. No member of the Audit Committee shall receive payments from or have any material financial interest in the Organization or in any entity doing business with the Organization and shall not be a spouse, sibling, parent, child, grandparent or grandchild of any individual who is an employee or receives payments from the Organization or has a material financial interest in the Organization or any entity doing business with the Organization or a spouse of any such persons.

The Finance Committee of the Board (if any) shall be separate from the Audit Committee. Members of the Finance Committee may serve on the Audit Committee; however the chairperson of the Audit Committee may not be a member of the Finance Committee and members of the Finance Committee shall constitute less than one-half of the membership of the Audit Committee.

Compensation

The members of the Audit Committee shall serve without compensation, but they may be reimbursed for out-of-pocket expenses incurred while serving on the Audit Committee, in accordance with the Organization's written reimbursement policy.

September 2014
Updated July 2017

Meetings

The Audit Committee shall meet as frequently as circumstances dictate, but not less than two times annually. The Board shall name a chairperson of the Audit Committee, who shall prepare and/or approve an agenda in advance of each meeting. A majority of the members of the Audit Committee shall constitute a quorum. The Audit Committee shall maintain minutes or other records of meetings and activities of the Audit Committee.

Portions of each meeting with the Organization's independent external auditors shall be held without any members of management present. Meetings of the Audit Committee may be held in person or by telephone at the discretion of the chairperson of the Audit Committee.

The Audit Committee shall, through its chairperson, report to the Board following the meetings of the Audit Committee, addressing such matters as may be related to the Audit Committee's functions and responsibilities.

Responsibilities of the Audit Committee

The Audit Committee:

- Shall be responsible for recommending to the Board the retention and termination of the Organization's independent, external auditor.
- May negotiate the compensation of the independent auditor on behalf of the Board.
- Shall confer with the Organization's independent auditor to satisfy the Audit Committee members that the financial affairs of the Organization are in order.
- Shall review and determine whether to accept the audited financial statements prepared and submitted by the independent auditor.
- Shall have the power to approve or reject any non-audit services (including tax services or financial advice) proposed to be performed by the independent auditing firm.
- Shall assure that any non-audit services provided by the independent auditing firm conform with standards for auditor independence required under relevant law and regulations.
- Shall establish written procedures whereby employees can confidentially and anonymously submit to the Audit Committee concerns or issues regarding the Organization's accounting, compliance, or auditing matters.

The Audit Committee is not responsible for preparing financial statements on behalf of the Organization or performing the Organization's audits, and its members are not the Organization's auditors and do not certify the Organization's financial statements. These functions are to be performed by the Organization's management and independent auditor.

The Audit Committee shall perform such other functions as are required by law, the Organization's Articles of Incorporation or Bylaws, or the Board.

September 2014
Updated July 2017

Review of Financial Statements

Prior to the release or filing thereof, the Audit Committee shall review the Organization's audited financial statements. The Audit Committee shall specifically review:

- With management and the independent external auditor, their processes for assessment of material misstatements, identification of the notable risk areas, and their response to those risks.

- With management and the independent auditor, the Organization's annual financial statements and related footnotes.

- The independent auditor's audit of and report on the financial statements and compliance with laws and regulations.

- With the independent auditor, any additions or changes in auditing or accounting principles suggested by the independent auditor or the Organization's management.

- With the independent auditor, the internal control, compliance and management letters provided by the independent auditor and the Organization's response.

- The independent auditor's qualitative judgment about the appropriateness, and not just the acceptability, of accounting principles, use of estimates, basis for determining the amounts of estimates, and financial disclosures.

- With the independent auditor, any significant difficulties or disputes with management encountered during the course of the audit.

- Any material financial or non-financial arrangements of the Organization that do not appear on the financial statements of the Organization and their related risks.

- With management and the independent auditor, the effect of regulatory and accounting initiatives as well as accounting principles and their alternatives that have a significant effect on the Organization's financial statements.

- Any transactions or dealings with parties related to the Organization that are significant in size or involve terms or other aspects that differ from those that would likely be negotiated with independent parties, or that are relevant to an understanding of the Organization's financial statements.

- Any other matters related to the annual Organization audit.

Audit Committee Charter

The Audit Committee shall review and reassess annually the adequacy of this Audit Committee Charter and recommend any changes to the Board.