



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

The IRS has redesigned the Form 990, the annual information return that most tax-exempt organizations file with the IRS. The new form asks organizations if they meet certain best practices in nonprofit governance. In particular, as part of the redesigned form, the IRS is placing greater emphasis on the board of directors' role in overseeing the financial affairs of the nonprofit organization.

Specifically, the revised Form 990 will, beginning in 2009, require each tax-exempt organization to declare whether it has an audit committee. Moreover, many states require charities and other tax-exempt organizations to have audit committees for state tax-exemption or for charity registration purposes.

An audit committee is not a strict requirement for federal tax-exemption; however, given the IRS' increased interest in ensuring that all tax-exempt organizations have audit committees, every tax-exempt organization that does

not already have an audit committee should strongly consider creating one.

We also recommend that every tax-exempt organization 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 a committee tasked with overseeing the review and audit of the organization's books and records, financial reporting, and compliance reporting. The audit committee's duties should generally include reviewing the work of the chief financial officer, as well as selecting the external financial auditor, reviewing the external auditor's work, and (if necessary) dismissing the external auditor.

Although it is not necessary for the audit committee to consist exclusively of board members, it is usually recommended that all committee members be selected from the board. The two main requirements for an effective audit committee are (1) financial expertise and (2) independence from management.

1. 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 external auditor. There may be a single committee member with 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 external auditor to conduct the committee's oversight duties.

2. 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 interference from the 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 officers, managers, or employees of 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. The charter may 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 (1) ensure that the committee will have the necessary financial expertise and independence to achieve its purposes, (2) give the members of the committee a roadmap for how to approach their tasks, and (3) instill and maintain a level of transparency regarding the committee's functions and position in the organization.

The attached Model Audit Committee Charter is presented only as a guide, to assist organizations in drafting their own charters. The model charter is drafted to be generally applicable; however, it should not be adopted as is. Any organization that wishes to use the model charter in adopting its own audit committee charter should tailor the model charter to the organization's particular structure and activities.

In addition, the 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.

Additional Resources

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

- *Redesigned Form 990, Schedules and Instructions.*
www.irs.gov/charities
- *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* (October 2007).

http://www.nonprofitpanel.org/seifreg/Principles_Guide.pdf

- *The American Institute of Certified Public Accountants Audit Committee Toolkit: Not-for-Profit Organizations.*
<http://www.aicpa.org/Audcommctr/toolkitsnpo/homepage.htm>
- *National Council of Nonprofit Associations: Financial Accountability and Audit Committees.*
<http://www.ncna.org/index.cfm?fuseaction=Page.viewPage&pageId=429>

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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 may include persons who are not members of the Board, but more than one-half of the members of the Audit Committee shall be members of the Board.

The members of the Audit Committee shall not include any of the following: the President, Director, or Chief Executive Officer; the 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, or child 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.

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.

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 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 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.

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 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.