Lawyers Alliance FOR NEW YORK

Connecting Lawyers, Nonprofits, and Communities

July 11, 2023

Audit Committees of New York Nonprofits

A nonprofit organization bears responsibility towards its stakeholders, including donors and the individuals who rely on the organization's resources. It is a basic expectation of these stakeholders that organizations safeguard charitable assets and prudently and appropriately use their funds – whether acquired through donations, grants, membership fees, or otherwise. The audit function of a nonprofit goes hand in hand with this accountability to stakeholders, and it serves as one of the vital checks and balances of nonprofit governance. This function may be carried out by the full Board or, in many nonprofits, the audit committee.

This Legal Alert will discuss the basic legal requirements concerning audit committees for New York nonprofits and certain related best practices that organizations should consider adopting to ensure efficient and effective audit governance.

The Audit Committee

Section 712-a of the Not-for-Profit Corporation Law (the N-PCL) sets forth guardrails regarding preparation of financial statements and the related audit oversight and establishes the concept of the audit committee. Specifically, Section 712-a provides that unless the board of an organization performs such governance function, New York nonprofits are required to form an audit committee comprised of "independent directors"[1] for this purpose.

Audit Committee Responsibilities

The responsibilities of an audit committee are to assist the board by providing oversight of (i) the quality and integrity of annual financial statements; (ii) compliance with legal and regulatory requirements applicable to the organization's finances; (iii) the performance of the organization's internal accounting and financial controls, including risk management processes; and (iv) the independent auditors' qualification, independence and performance.

Financial Statements

New York nonprofits are, with limited exceptions, required to submit financial statements to both the IRS and the Charities Bureau of the New York State Attorney General's Office (the "Charities Bureau")[2], subject to the revenue thresholds described below. Organizations must submit these financial statements to the IRS on Form 990 and to the Charities Bureau on Form CHAR500 (New York's Annual Filing for Charitable Organizations).

[1] See Section 712-a of the N-PCL.

[2] In general, most organizations that solicit charitable contributions in New York are required to register with the Charities Bureau in accordance with Article 7-A of New York Executive Law. However, Section 172-a of the Executive Law exempts certain organizations from registration, including religious organizations.

Nonprofit organizations that are required to file an annual financial report with the Charities Bureau must submit either an unaudited financial report, a "review report" prepared by an independent auditor,[3] or audit report prepared by an independent auditor,[4,5] depending on their gross annual revenue: [6]

Gross Annual Revenue[7]	**Must File**
$250,000 or less	Unaudited financial report
Greater than $250,000 but less than $ 1 million	Financial report with review report of independent auditor
More than $1 million	Financial report with financial statement audited by independent auditor

Independent Auditors

Under the N-PCL, if applicable to the nonprofit, the audit committee is required to (a) retain or renew the retention of an independent auditor to conduct the annual financial statement audit; (b) review with the auditor the results of the audit; and (c) review the auditor's communications to the audit committee, including in any management letter[8], resulting from the audit.[9]

For nonprofits that had or expect to have annual revenues in excess of $1 million, certain additional audit oversight responsibilities are required, including:[10]

- review with the auditor the scope and planning of the audit prior to the audit's commencement;
- upon completion of the audit, review and discuss with the auditor:
    - any material risks and weaknesses in internal controls identified by the auditor;

[3] Exec. Law § 172-b

[4] A review provides limited assurance on an organization's financial statements. During a review, inquiries and analytical procedures present a reasonable basis for expressing limited assurance that no material modifications to the financial statements are necessary; they are in conformity with generally accepted accounting principles. While this review report meets the minimum requirement, many nonprofits nonetheless decide to obtain a full audit report as a best practice.

[5] An audit provides the highest level of assurance on an organization's financial statements. An audit provides assurance that an organization's financial statements are free of material misstatement and are fairly presented based upon the application of generally accepted accounting principles. It includes confirmation with outside parties, testing selected transactions by examining supporting documents, completing physical inspections and observations, and considering and evaluating the internal control system of the organization.

[6] See https://lawyersalliance.org/userFiles/uploads/legal_alerts/New_York_Charities_Filing_Requirements_Legal_Alert.pdf (Update on What to File with the New York CHAR 500, Including When New Audit Thresholds Take Effect)

[7] Gross Annual Revenue includes all revenue and support received in the preceding year, including money received as a result of contributions, grants, fees and other sources of revenue.

[8] A management letter is a letter prepared by an auditor which serves to identify areas of deficiency in operations, procedures and/or internal controls that the nonprofit may want to improve, redesign or resolve.

[9] See Section 712-a(a) of the N-PCL.

[10] See Section 712-a(b) of the N-PCL.

    - any restrictions on the scope of the auditor's activities or access to requested information;
    - any significant disagreements between the auditor and management; and
    - the adequacy of the corporation's accounting and financial reporting processes
- annual review and consideration of the performance and independence of the auditor.

The Audit Committee and the Auditor

The audit committee of a nonprofit that is required to file an audit with its form CHAR500 (see threshold discussion above) must engage an independent certified public accountant to conduct its annual financial statement audit. In addition to reviewing and endorsing financial statements, the auditor will communicate with the audit committee with respect to any internal control or other material issues identified related to the processing of financial information of the nonprofit. Audit committee members should be prepared to communicate with the auditor and management, to ask the appropriate questions so that it can properly review and evaluate the auditor's findings. As noted above, the audit committee should also (even if not required) to evaluate the performance of the auditor and the audit process, and a strong relationship with the auditor is an important component of this evaluation.

Other Roles and Responsibilities of the Audit Committee

In addition to their primary responsibilities discussed above, audit committees are often the default choice when boards must delegate responsibility for administering key corporate policies and procedures. In particular, for many organizations, audit committees play key roles in administering conflict of interest and whistleblower policies.

Conflict of Interest Policy

The N-PCL requires every New York nonprofit to adopt a conflict of interest policy applicable to, among others, directors and officers. The purpose of a conflict of interest policy is to avoid improper financial transactions that are not in an organization's best interest. In addition to the provisions required by the N-PLC, well-drafted policies include clear practices for monitoring proposed or ongoing transactions and dealing with potential or actual conflicts. They also designate the governing body or committee that both reviews actual conflicts and considers whether a conflict exists for a given fact pattern. Typically, such review is delegated to the audit committee, assuming review is not conducted by the full board. For additional information on Conflict of Interest Policies, please see our Legal Alerts dedicated to this topic.[11]

Whistleblower Policy

A nonprofit organization incorporated in New York must have a whistleblower policy if its annual revenue is more than $1 million and it has at least 20 employees. Even smaller nonprofits who do not meet these

---

11

https://lawyersalliance.org/userFiles/uploads/legal_alerts/Conflict_of_Interest_Policies_Legal_Alert_June_2019_FINAL.pdf (Legal Alert: Conflict of Interest Policies)

https://lawyersalliance.org/userFiles/uploads/news/pdfs/Nonprofit_Revitalization_Act_FAQs.pdf (New York Nonprofit Revitalization Act of 2013 -- Frequently Asked Questions). See Section titled "Conflict of Interest Policy" beginning on page 9.

thresholds may nonetheless wish to have such a policy in order to comply with contract obligations or for risk management purposes. Whistleblower policies must designate a specific director, officer or employee to administer the policy, who must then report to a chosen governing body – typically the audit committee or the full board. For additional information on Whistleblower Policies, please see our Legal Alerts dedicated to this topic.[12]

Additional Responsibilities

The Charities Bureau has also issued guidance ("AG Guidance") on additional responsibilities to be handled by the audit committee (or, if one does not exist, the board)[13]. The Audit Committee should:

- maintain detailed minutes or other records of meetings of the committee;
- ensure proper federal and state tax compliance, including timely tax filings;
- review internal and financial controls on a regular basis;
- refine the processes for risk identification and assessment, including detailed risk response plans;
- monitor legal matters that could impact reputation, financial health and required reporting;
- institute and oversee special investigatory work as needed, and assure responses to investigations; and
- periodically review the organization's insurance coverage and determine if adequate.

Appointing the Audit Committee

Nonprofits should take care when choosing which directors will serve on the audit committee. In addition to the requirement that all directors must be independent (discussed in further detail below), the board may also consider the financial literacy of directors, and ideally at least one (if not multiple) directors serving on the audit committee should be sophisticated concerning financial reporting and accounting. Although members of the audit committee must be independent directors of the organization, the audit committee is free to seek advice from non-members (short of non-members participating in formal voting or deliberation, which is prohibited).

Independent directors

Per AG Guidance, the audit provisions of the N-PCL were intended to require "a nonprofit's review of its auditor's report to be independent of management and to be conducted by individuals who have no financial interest in the nonprofit and whose families have no such interest." As a result, only independent directors are permitted to participate in any board or committee deliberations or voting relating to audits.

N-PCL § 102(a)(21) sets forth a precise definition of who may be considered an "independent director". Generally (and subject to certain stated exceptions and clarifications), an independent director is a

---

[12] See
https://lawyersalliance.org/userFiles/uploads/legal_alerts/New_Law_Whistleblower_Anti_Retaliation_Legal_Alert.pdf (New Law Imposes Broader Whistleblower Anti-Retaliation Obligations
on New York Employers)
https://lawyersalliance.org/userFiles/uploads/news/pdfs/Nonprofit_Revitalization_Act_FAQs.pdf (New York Nonprofit Revitalization Act of 2013 -- Frequently Asked Questions). See Section titled "Whistleblower Policy" beginning on page 24.

[13] See "Audit Committee Requirements And Responsibilities Under New York's Not-For-Profit Corporation Law As Amended Through 2017" at https://ag.ny.gov/sites/default/files/regulatory-documents/AuditCommittees.pdf

director who (i) is not and was not recently an officer or employee of the nonprofit, or an immediate family member of such an officer or employee; (ii) has not received, and does not have a relative who has recently received, more than $10,000 in direct compensation from the nonprofit; (iii) has no material business or financial relationship with the nonprofit (including through a relative); and (iv) is not and does not have a relative who is a current owner, director, employee or officer of the nonprofit's outside auditor. For the full and comprehensive definition of "independent director, please refer to N-PCL § 102(a)(21) in its entirety.

The board should make reasonable efforts to determine whether a director is independent and should adopt procedures for making such determination, including obtaining the relevant information through annual disclosure questionnaires collected from directors. For additional helpful information and hypotheticals on who may be considered an "independent director", please refer to our Legal Alert titled "New York Nonprofit Revitalization Act of 2013 -- Frequently Asked Questions".[14]

Number of Audit Committee members

The N-PCL does not provide a specific minimum or maximum number of audit committee members, but in general, the N-PCL requires that board committees contain at least 3 members.

Frequently Asked Questions:

Q: Must my nonprofit organization have an audit committee?

As noted above, the N-PCL permits the board of an organization to perform audit governance and therefore a separate audit committee is not strictly required. If performed by the board itself, only independent directors are permitted to participate in formal deliberations. Whether an audit committee would be advisable or useful will vary between nonprofits as the needs of each organization are unique and no solution is one-size-fits all. For example, organizations with complex financial arrangements or significant financial resources would likely benefit significantly from the creation of an audit committee. On the other hand, small organizations with limited funds or a simple financial structure may decide it would be more efficient and effective to place audit oversight with the board.

Q: What is an audit committee charter – and does my audit committee need one?

Organizations with audit committees should adopt a charter that specifies (i) the structure of the committee (*i.e.*, number of members, designation of a committee chair and appointment, removal and resignation procedures); (ii) committee meeting procedure; and (iii) detailed duties and authority of the audit committee. Although the duties required of the audit committee may vary depending on where an organization falls within the thresholds discussed above, relevant charter provisions may discuss procedures for (a) reviewing the work of the auditor and annual filings (*e.g.*, financial statements, any auditor management letter, IRS Form 990, *etc.*); (b) evaluating the organization's relationship with its auditor; (c) reviewing the integrity of the organization's financial reporting process; and (d) regularly reporting its review and findings to the board. Given the audit committee's oversight role as a critical eye

[14] https://lawyersalliance.org/userFiles/uploads/news/pdfs/Nonprofit_Revitalization_Act_FAQs.pdf (New York Nonprofit Revitalization Act of 2013 -- Frequently Asked Questions). See Section titled "Independent Directors" beginning on page 13.

towards organizational weaknesses, many committee charters include broad authority to study or investigate any matter of interest or concern which the committee in its discretion deems appropriate.

Q: What is the difference between an audit committee and a finance committee?

The role of an audit committee may be quite different from that of a finance committee. For a typical finance committee, the principal tasks include the approval and monitoring of an organization's budget and financial results and setting long term financial goals for an organization. Finance committee members must be adept at communicating to the organization's board the overall financial health of the company. In contrast, the audit committee views the organization's financial reporting, disclosure, compliance, internal controls and risk processes from a critical perspective to understand and assess organizational weaknesses.

Note that while historically, it was not uncommon for smaller nonprofits to delegate audit and finance responsibilities to one committee, this may no longer considered industry best practice. In fact, some practitioners interpret the N-PCL as requiring a separate committee whose function is to oversee the audit process, and the AG Guidance specifically provides, "management, who are responsible for developing and maintaining financial controls, should not also be involved in the Audit Committee's performance of its duties..."

This alert is meant to provide general information only, not legal advice. If you have any questions about this alert please contact Ciarra Chavarria at cchavarria@lawyersalliance.org or visit our website at www.lawyersalliance.org for further information. To become a client, visit www.lawyersalliance.org/becoming-a-client.

For his assistance in preparing this Legal Alert, Lawyers Alliance would like to thank Jonny Gelfand, an extern attorney from the Skadden, Arps, Slate, Meagher & Flom law firm.

Lawyers Alliance for New York is the leading provider of business and transactional legal services for nonprofit organizations and social enterprises that are improving the quality of life in New York City neighborhoods. Our network of pro bono lawyers from law firms and corporations and staff of experienced attorneys collaborate to deliver expert corporate, tax, real estate, employment, intellectual property, and other legal services to community organizations. By connecting lawyers, nonprofits, and communities, Lawyers Alliance for New York helps nonprofits to provide housing, stimulate economic opportunity, improve urban health and education, promote community arts, and operate and advocate for vital programs that benefit low-income New Yorkers of all ages.