

# Absent the Audit: How Small Nonprofits Can Demonstrate Accountability Without One

by Jeanne Bell and Steve Zimmerman

IN THE ONGOING DEBATE AT THE state and federal levels about how best to regulate public charities, a recurring question has been, “At what annual budget size should nonprofits obtain an audit of their year-end financial statements?” In 2005, Independent Sector’s *Panel on the Nonprofit Sector* recommended to Congress that federal law be changed to require exempt organizations with annual revenues exceeding \$1 million to have their financial statements audited by an independent CPA, and further, that organizations with annual revenues of \$250,000 to \$1 million have their statements reviewed by an independent accountant. In California, where the Nonprofit Integrity Act took effect in 2006, nonprofit advocates rallied passionately against early drafts of the law that would have required audits of nonprofits with annual revenues of \$500,000, arguing that the expense of annual audits was an undue burden for small nonprofits. In the end, the Act’s audit threshold was a far more generous \$2 million in annual non-governmental revenues. Eighteen states now require nonprofits of a certain annual revenue size to submit audits if they solicit funds from their state’s residents, though the revenue threshold varies

considerably from state to state. Meanwhile, watchdog groups and standards-setting entities continue to vary in their answers to the audit question. The Wise Giving Alliance has a \$250,000 annual revenue threshold, while the Standards of Excellence Institute’s threshold is \$300,000.

With such diversity of opinion among experts and regulators alike, it is no wonder that executives and board members of community-based nonprofits are confused about when to begin having their statements audited. Moreover, with the audit proving to be a ubiquitous element of accountability legislation and recommended self-regulation, how should those community-based organizations that don’t get an annual audit otherwise demonstrate their fiscal responsibility?

First, staff and board leadership must recognize pragmatically what an audit does—and does not do—for a small nonprofit. An audit is an outside CPA’s professional opinion on the material accuracy of an organization’s year-end financial statements. An audit has nothing to do with financial strategy or organizational sustainability—a fact that too many nonprofit staff and board members overlook. An organization’s own financial statements, which mini-

mally include a balance sheet and an income statement, are first and foremost internal management tools. Even small organizations of \$50,000 to \$250,000 should produce internal financial statements for staff and board on a quarterly basis; larger groups should do so monthly. With the complexity and unpredictability of nonprofit income and the small margin upon which most community-based groups survive, timely analysis of accurate financial statements is both essential and totally independent of the audit issue.

The benefits to a community-based nonprofit of purchasing an annual audit of its year-end financial statements fall into three categories:

*Generate Donor and Constituent Confidence.* From a pure return on investment perspective, perhaps the greatest benefit to a nonprofit of purchasing an annual audit is the ability to provide copies of it to prospective major donors and institutional funders. An unqualified audit is a universal indicator (though hardly a guarantee) that an organization is investing in its financial management and that the financial statements it is including with its proposal are likely to be accurate. Beyond donors, the audit is a symbol (though, again, hardly a guarantee) of an organi-

## Absent the Audit: Strategies for Accountability

| Challenge                                               | Strategies                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                   |
|---------------------------------------------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Generating Donor/Constituent Confidence                 | <ul style="list-style-type: none"> <li>• Involve the volunteer treasurer in response to constituent inquiries</li> <li>• Ensure Form 990 is done well and submitted on time</li> <li>• Post PDFs of last three Form 990s on Web site</li> <li>• Distribute an inexpensive annual report to the community</li> <li>• Track restricted contributions fanatically</li> <li>• Develop a well-formatted, high level annual budget for public consumption</li> <li>• Consider purchasing a review by an independent CPA</li> </ul> |
| Ensuring Compliance with Nonprofit Accounting Standards | <ul style="list-style-type: none"> <li>• Recruit an experienced nonprofit CFO or executive director as treasurer</li> <li>• Contract with an expert nonprofit bookkeeper</li> <li>• Prioritize financial literacy and professional development at staff and board levels</li> </ul>                                                                                                                                                                                                                                          |
| Preventing and Catching Fraud                           | <ul style="list-style-type: none"> <li>• Engage staff, contractors, and board to ensure segregation of financial duties</li> <li>• Develop and follow simple accounting policies and procedures</li> <li>• Actively maintain a culture of financial ethics and transparency</li> </ul>                                                                                                                                                                                                                                       |

zation's broad constituency, including the media and watchdog groups, that the organization is committed to fiscal accountability.

*Ensure Compliance with Accounting Standards.* Board and staff leadership benefit from an audit done by a CPA who has current knowledge of nonprofit accounting standards in that such CPAs can help move an organization towards best financial management practices. Particularly in cases where the bookkeeper is new to nonprofit accounting, the audit process can educate her or him on advanced topics such as fund accounting and grants tracking. Further, even amongst experienced nonprofit finance staff, knowing that they will have to defend accounting

judgments to an auditor at year-end sustains a kind of accounting discipline, or rigor, throughout the year.

*Prevent or Catch Fraud.* This benefit is perhaps the most commonly overstated. In fact, an annual audit is only a small *potential* element of a sound system of internal controls. One need only reflect on the major corporate scandals that continue to make the news to recognize that the audit process does not always prevent or catch fraudulent activity. Certainly, the prospect of an audit may play a deterrent function, but a determined staff person or volunteer can find ways to steal from a nonprofit that an auditor, who may be onsite testing for two days each year, will not detect.

If these are the primary benefits of purchasing an annual audit, how does a nonprofit that elects not to purchase one meet these same objectives? Let's assume that the Young Artists Network (YAN) is a small community-based nonprofit founded in California six years ago to connect and support young people hoping to build a career in the arts; it has five paid staff members and annual revenues of \$405,000. Without the *requirement* of an audit by the state or any of YAN's funders, the board of directors has not deemed it necessary to invest \$10,000 of their barely-break-even budget in an annual audit. Still, the board and executive director definitely want to generate donor and constituent confidence, ensure compliance with nonprofit accounting standards, and prevent fraud.

*Generating Donor and Constituent Confidence without an Audit.* There are six things YAN can do to inspire financial confidence among donors and constituents. First, it can establish and maintain an active board finance committee with a strong treasurer who can speak fluently about the financial condition of the organization. When an executive director can include a board member in responses to constituent inquiry, it sends a message of financial oversight and transparency to the community.

Second, the treasurer and the executive director can work together to ensure that YAN's IRS Form 990 is done well and submitted on time each year. Without an audit, many funders and constituents will rely on the Form 990 to assess the organization's financial status. The Form 990 is due four and a half months after the close of an organization's fiscal year. Since YAN's fiscal year is January through December, staff and board should ensure that its Form 990 is submitted by May 15th or that it requests an extension from the IRS (Form 8868). To demonstrate transparency, YAN can put PDFs of its last three Form 990s on its Web site.

Third, YAN can produce an inexpensive annual report to the community summarizing the impacts it had over the previous year as well as the sources and uses of its funds. If thoughtfully written and presented, the annual report need not be a fancy production to effectively communicate YAN's sense of mission and financial accountability to its constituents. In demonstrating impact and accountability, an annual report is an effective marketing and donor cultivation vehicle, even though these are not its explicit intents.

Fourth, YAN staff can be fanatical about tracking restricted contributions. In the end, most major donors and funders want to be assured that their funds are used as they intended them to be. Before YAN takes a penny of restricted money, it should set up adequate systems for identifying expenses as satisfying those agreements. At a minimum, a well-structured and maintained Excel workbook that keeps a running balance on each major restricted funding source is essential.

Fifth, YAN staff can develop a summarized version of its board-approved annual budget for public consumption. Many donors and funders ask for an annual budget before they commit funds. YAN can consolidate its income and expense categories for a clean, high-level look at its financial plan for the year. With reduced line items, there will be room on the page for a short narrative about the budget's assumptions and desired programmatic outcomes. Such a document demonstrates that YAN understands the nature of outside constituents' financial questions—as opposed to staff and board's—and is responsive with an informative, digestible presentation.

Finally, YAN may elect to engage an outside CPA in a *financial statement review*, rather than a full-blown audit. Less expensive and time-intensive for YAN staff, a review does not include onsite testing and therefore does not conclude with an auditor's "opinion"—

a technical term for the CPA's expert judgment as to whether the financial statements prepared by the organization were prepared in accordance with accepted accounting principles. Instead, based on limited document review and communications with staff and/or board, the review report's objective is to give limited assurance that no significant modifications to the financial statements are needed to make them conform to accepted accounting principles. For roughly half the price of an audit, YAN would have a CPA-prepared document to share with constituents, albeit one with less "bite."

*Ensuring Compliance with Accounting Standards Without an Audit.* Like many small community-based nonprofits, YAN's volume of financial activity does not warrant a full-time staff accountant or CFO. And, like most founding executive directors, YAN's leader is not fluent in accounting, much less the specifics of nonprofit accounting standards. Still, ensuring best financial practices is essential, and YAN has several strategies it can employ. First, the aforementioned strong treasurer is a great opportunity to bring a volunteer with nonprofit finance skills into the organization's inner circle. Too many nonprofits look to general business people and bank employees as ideal treasurers; instead, YAN can recruit an experienced CFO or executive director of a larger nonprofit in its community. There is great utility for a small nonprofit in having a treasurer who knows how nonprofits actually work financially.

Next, YAN can contract for monthly services with a bookkeeper who is a nonprofit accounting expert. This independent contractor can not only prepare monthly financial statements in accordance with accounting standards, but also serve as a teacher and coach to YAN administrative staff who may be growing into a finance role. YAN's executive director might consider paying to have the expert bookkeeper on site for

several hours a week to deepen the coaching and oversight impact and ensure greater accessibility for answering staff and board questions throughout the month.

Finally, YAN's executive director and board chair can explicitly and consistently prioritize financial literacy at the staff and board levels. This might include doing annual orientations to YAN's budget and financial statements at staff and board meetings, inviting a local expert to do a training for staff and board, and/or paying for staff and volunteers to attend finance workshops or conference sessions. More fundamentally, YAN's staff and board leadership can insist upon dual bottom line thinking—managing for mission impact *and* financial sustainability at all times—rather than allowing outdated program-versus-finance cultures to persist. The more that staff and volunteers have a holistic view of the programmatic and financial aspects of their organizations, the more likely they are to shepherd the organization to a place of best practice.

*Preventing or Catching Fraud Without an Audit.* The primary ways that organizations prevent fraud, regardless of budget size, are in segregating financial duties and creating a culture of financial ethics and transparency. The only difference for small nonprofits like YAN is that having enough people among whom to segregate financial duties is a greater challenge. By engaging the office manager for accounting clerk functions, the contract bookkeeper for review, reconciliation, and statement preparation, and both the executive director and the treasurer for review and signatures, YAN can effectively prevent one person from having unchecked access to its resources. Requiring dual signatures on large checks and having the payroll company send the payroll report of all funds distributed directly to the volunteer treasurer are two ways that YAN can segregate duties. With lots of non-

profit experience between them, YAN's treasurer and contract bookkeeper can help the organization document these and other simple accounting policies and procedures that ensure adequate internal controls.

It is the job of the organization's leaders—both staff and volunteer—to establish and maintain a culture of financial transparency. At its essence, this is about how carefully we collect and share financial information with a broad array of internal and external stakeholders. As a founding leader whose passions are in programmatic work, YAN's executive has to consciously reflect on what attitudes and practices about money she is modeling for her staff and board.

A fundamental assumption of the auditing process is that the organization has the capacity—be it achieved through its staff or through a combination of staff, contractors, and volunteers—to produce its own year-end financial statements in accordance with generally accepted accounting principles. Small and emerging organizations that intend to accomplish their intended impacts with paid staff and scaled up organizational structures have to work up to this capacity, just as they have to work up to the *financial* capacity to afford an audit. (Those that intend to be all volunteer or very small indefinitely may never desire audit-readiness.) The strategies outlined above will not only position an organization as serious about financial accountability and transparency, they are also necessary steps in the journey towards sufficient financial capacity to warrant an annual audit.

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