ABSENT THE AUDIT

BY STEVE ZIMMERMAN AND JEANNE BELL (OCTOBER 2012)

With so many different audit thresholds it is easy to understand why executives and board members of community-based nonprofits are confused about when to have their financial statements audited. Even more confusing, and perhaps lost in all the talk of accountability, is the purpose of audited financial statements, and whether there is a more cost-effective manner for community-based organizations that don't conduct an annual audit to 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 the financial viability and sustainability of the organization – a fact that too many nonprofit staff, board members and funders overlook. Many people believe that a clean audit opinion signifies financial health, when in reality a clean audit opinion merely states the financial statements accurately reflect the organization's true financial health – good or bad.

An organization's own financial statements, which minimally should 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, at least, a quarterly basis. With the complexity and unpredictability of nonprofit income and the small margin upon which community-based groups survive, timely analysis of accurate financial statements is both essential and totally independent of the audit issue. Whereas in the past many small organizations depended on the auditor to compile their financial statements, new auditing regulations no longer allow them to do so. Therefore, the financial statements must be put together by the organization.

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) to the organization'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 or in communities where there may not be enough expertise in nonprofit accounting, the audit process can be used to educate the board and staff on advanced topics such as restricted funds. 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 major corporate scandals like Enron to recognize that the audit process does not always prevent or catch fraudulent activity. Certainly, the prospect of an audit may serve 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. Even if they do detect the fraud, it will always happen after the fact.

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 $7-10,000 of their barely-breakeven 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 promote financial literacy among board and staff and 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. Beyond just the finance committee, however, financial literacy among the entire board and senior management is essential to lead in economic uncertainty. By promoting and investing in financial literacy among board and staff the organization is not only sending a signal of the importance of financial management, but providing the tools for financial leadership.

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 revised Form 990 needs to be reviewed by the entire board prior to submission and now includes more governance-related questions including questions such as how the board reviews and approves executive compensation. The board should spend time to make sure the Form 990 accurately reflects and explains the process it uses. To demonstrate transparency, YAN can post PDFs of its three most recent IRS Form 990's on its website.

Third, YAN can produce an inexpensive annual report to the community summarizing the impact 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 that can reinforce the nonprofit's commitment to financial transparency.

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 intended by the donor. Before YAN takes a penny of restricted money, it should set up adequate systems for identifying whether expenditures of restricted funds satisfy donor intent. At a minimum, a well-structured and maintained Excel workbook that keeps a running balance on each major restricted funding source, and documentation of how those funds are expended, 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 and eliminate any acronyms or jargon 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 objectives 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 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 or consider outsourcing their accounting to a financial firm with the expertise. These independent contractors and firms 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. The bookkeeper or representative from the accounting firm can also attend board meetings, answering questions as they arise. This solution may not only provide more in-depth accounting expertise, but also may be more cost-effective than having an audit or hiring your own accounting personnel.

Finally, as we mentioned earlier, 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, or paying for staff and volunteers to attend finance workshops, webinars 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. There is a deep connection between the programmatic impact and financial viability of an organization. The more that staff and volunteers have a holistic view of these aspects, the more likely they are to shepherd the organization with an orientation of sustainability.

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 treasurer for review and signatures, YAN can effectively prevent one person from having unchecked access to its resources. Having the payroll company send the payroll report of all funds distributed directly to the volunteer treasurer is one way that YAN can segregate duties on its largest expense item. With lots of nonprofit experience between them, YAN's treasurer and contract bookkeeper can help the organization document 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. Beyond the audit, though, she must ensure the board and staff have access to accurate and meaningful financial information from which to lead their organization and make strategic decisions for organizational sustainability.

As board and staff weigh allocations of precious revenue dollars and determine whether they need or should have an audit, they should consider all the factors listed above. The 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. The strategies outlined above will not only position an organization as serious about financial accountability and transparency absent an audit, they are also necessary steps in the journey towards sufficient financial capacity to warrant an audit.

Note: *The original article this is based on appeared in the Spring 2007 edition of The Nonprofit Quarterly.*

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