

Time for an audit?

Guess who was among the most vocal supporters of the Illinois legislation that recently raised the audit threshold for charitable organizations that receive annual contributions from \$150,000 to \$300,000? It was the Illinois Society of CPAs.

In a letter to Gov. Pat Quinn, the society's President and CEO Elaine Weiss said hiring auditors causes some small charities "to expend their precious resources that would otherwise be used in providing charitable services to those in need."

Missouri is among the 25 states that do not have statutory audit requirements. But like Illinois, states with requirements have been busy increasing their thresholds. In Connecticut, the threshold recently increased from \$200,000 to \$500,000. Michigan's new audit threshold is likewise \$500,000. In May, Minnesota Gov. Tim Pawlenty signed legislation that sets his state's threshold at \$750,000 in total revenue, up from \$300,000.

While there are many misconceptions about audits, a "clean" audit conducted by an independent certified public accountant (CPA) often serves as a "seal of approval" that the nonprofit is handling its finances in a responsible manner.

New Hampshire and Georgia now require audits at \$1 million in annual revenues. And the California Non-Profit Integrity Act of 2004, which was passed in the wake of the federal Sarbanes-Oxley legislation, requires organizations with non-governmental revenue of \$2 million or more to have an independent audit.

In this age of accountability and transparency, do these higher thresholds

seem counterintuitive?

This issue of *Arts Law Memo* describes the thinking behind the trend, outlines why reviews (a less expensive option) may be a good option for midsized arts organizations, explains how small organizations can demonstrate financial accountability and offers some practical advice for organizations that do engage auditors.

BENEFITS

While there are many misconceptions about audits, a "clean" audit conducted by an independent certified public accountant (CPA) often serves as a "seal of approval" that the nonprofit is handling its finances in a responsible manner.

So exactly what is an audit and what isn't it? Audits are not designed to test all transactions, provide assurance of the organization's ability to continue as a going concern or detect embezzlement. Rather, an audit is a series of procedures used to form an opinion on the fairness of the presentation of an organization's financial statements.

An audit contains standard financial information (generally covering two fiscal years), footnotes and the all-important opinion letter. Generally, auditors also provide a separate management letter, which usually addresses internal controls or other matters of interest to the board of directors.

There are many good reasons to have an audit. Among them are:

- An audit ensures that financial records are being kept in accordance with generally accepted accounting principles (GAAP). This term has a specific meaning — it describes the widely accepted rules and procedures established and communicated by the Financial Accounting Standards Board (FASB), an independent board of professionals.

- An audit gives the board and staff useful insight from a trained outsider who can provide professional advice on a variety of business matters.

Published by the St. Louis Volunteer Lawyers and Accountants for the Arts (VLAA), Arts Law Memo is distributed, free of charge, to more than 850 Missouri and Southwestern Illinois arts organizations, VLAA volunteers and corporate sponsors.

VLAA helps artists and arts organizations solve and avoid legal and accounting problems by:

- Making referrals to lawyers and accountants;
- Mediating arts-related disputes;
- Publishing Arts Law Memo and concise how-to guides;
- Sponsoring seminars and public forums;
- Arranging for guest speakers;
- Maintaining a reference library;
- Operating an arts space clearinghouse;
- Supplying model contracts and other arts law and business materials;
- Conducting and disseminating research;
- Contributing articles to publications;
- Collaborating on arts advocacy initiatives; and
- Providing access to the national volunteer lawyers for the arts network.

This issue was written by VLAA Executive Director Sue Greenberg. Special thanks to Judy Murphy, partner, RubinBrown.

This publication is distributed with the understanding that VLAA is not engaged in rendering legal or accounting counsel. We urge you to seek professional services to address your specific needs.



St. Louis Volunteer Lawyers and Accountants for the Arts

6128 Delmar, St. Louis, MO 63112
314/863-6930
FAX 314/863-6932
vlaa@stlrac.org
www.vlaa.org

- An audit can provide some protection against fraud by improving internal controls and other financial management practices.

- An audit helps the board, which is typically made up of members who are focused on the organization's mission, programs and fundraising challenges, fulfill its fiduciary responsibilities.

- An audit generates confidence and credibility; it is a useful fundraising and public relations tool.

- An audit reinforces the organization's internal commitment to best practices and promotes year-round accounting diligence.

- An audit may be required by state law, grantmakers, lenders, bylaws or accrediting associations.

RISING COSTS

Audits are expensive and getting more so. New standards affecting the way auditing firms assess the risk of material misstatements in financial statements went into effect in 2007.

The additional scrutiny takes more time and more time has significantly increased fees — 10 percent or more. By some estimates, an audit for an organization with revenue under \$500,000 could range anywhere from \$7,500 to \$20,000. For an organization with \$250,000 in revenue, an audit could consume as much as 4 percent of its annual budget. This expense is hard to justify.

Common sense prompted some states to take corrective action. In Connecticut, for example, the society of CPAs and the state's Council for Philanthropy supported the wisdom of saving an estimated 500 nonprofits \$3 million in audit fees by raising the legal requirement for audits to \$500,000.

According to Gov. M. Jodi Rell, the "bill provides financial relief to smaller charities and helps to ensure that more of the dollars raised are spent on the charity itself rather than on a costly audit."

SIZE MATTERS

But beyond state capitols, the perennial question, "At what budget size should an organization obtain an audit?" remains a thorny question. Unfortunately, for some organizations,

the answer is not simple.

Experts say that an audit is both unnecessary and imprudent for organizations with budgets of \$100,000 or less. At the other end of the spectrum, \$300,000 is the new trigger point in Illinois. The threshold is \$500,000 or higher in other states.

While there is no federal requirement mandating audits of charitable organizations, OMB Circular A-133 requires an annual audit for organizations that receive \$500,000 or more in federal grants.

When the IRS weighs in on the size equation, \$200,000 appears to be a critical figure: Beginning in tax year 2010, organizations with \$200,000 in gross receipts and/or \$500,000 in assets will be required to file the new, very detailed Form 990 (smaller organizations will file the less cumbersome Form 990-EZ or Form 990-N).

Absent a legal obligation or definitive standards, midsized organizations may want to step back and ask who wants an audit and why.

Midsized organizations looking for additional trigger point guidance will find a variety of conflicting (and frustrating) non-governmental standards: the Better Business Bureau's Wise Giving Alliance threshold is \$250,000; the Standards of Excellence program, launched by the Maryland Association of Nonprofits in 1998 and replicated in seven states, sets the threshold at \$500,000; Independent Sector's blue ribbon Panel on the Nonprofit Sector recommended a \$1 million threshold.

REVIEW

Because it is useful to have financial statements reviewed by an independent accountant, some organizations are turning to a less expensive option — a review. Review fees typically range from half to two thirds of the cost of an

audit.

A review provides a significantly lower degree of assurance than an audit. It consists of a series of inquiries and analytical procedures to gain confidence in the financial statements. Instead of an opinion, the accountants provide what amounts to negative assurance that they are not aware of any material changes that should be made to the financial statements in order for them to be in conformity with GAAP.

Independent Sector recommends reviews for organizations with revenues of \$250,000 or more. The legislation that raised Maryland's audit threshold from \$200,000 to \$500,000 also raised the review threshold from \$100,000 to \$200,000.

Organizations considering moving from an audit to a review should be aware that switching back and forth will not save money.

An independent accountant may provide a third level of service — a compilation, which is limited to presenting financial statements in a standard, readable format. The accountant does not audit or review the statements and, therefore, does not express any opinion on their veracity.

New or very small organizations that are applying for their first grants may want a compilation.

FUNDAMENTAL QUESTIONS

Absent a legal obligation or definitive standards, midsized organizations may want to step back and ask who wants an audit and why.

Is it a board member who lacks confidence in the staff's ability to keep the books or is worried about organizational sustainability? An audit may not be the most appropriate way to address these concerns.

Instead, consider recruiting a treasurer with nonprofit accounting skills (like a CFO or executive director of a larger nonprofit), contracting with an outside bookkeeper with nonprofit expertise, developing short- and long-term financial strategies and making financial literacy a professional development priority.

These are just a few of the suggestions offered in "Absent the

Audit: How Small Nonprofits Can Demonstrate Accountability Without One” (see page 4).

Is the organization growing? Financial accountability and transparency are key elements in building overall organization capacity, so a review can be an excellent stepping-stone.

In addition, the organization should be planning now by establishing an active board finance committee, electing a strong treasurer, working to correct any weaknesses in its internal control systems and budgeting for the more expensive full-blown audit.

Donors want assurance that the organization is complying with the terms of the grant or gift — that money was used for the intended purpose.

Does a donor or potential grantmaker require an audit? A review may suffice. Would IRS Form 990 be acceptable? The new form actually provides more information about the organization, including governance and compensation practices, than an audit.

Above all, donors want assurance that the organization is complying with the terms of the grant or gift — that money was used for the intended purpose. Bookkeeping systems should be set up to segregate restricted funds and to easily report grant or project related expenses.

An accountant can lend credence by providing an affordable audit-type service known as Agreed Upon Procedures (AUP). In Missouri, organizations that are part of the Neighborhood Assistance Program (NAP) tax credit program frequently utilize this service in lieu of a full-blown audit.

Still stymied? Seek the advice of a CPA, lawyer, nonprofit association or service organization.

Audit Tips

- Know when your organization needs an audit and budget accordingly.
- Appoint an audit committee and articulate its responsibilities.
- Requests for proposals should be sent to three firms with nonprofit expertise so you can compare services and costs. Consider re-bidding on a regular basis and changing auditors (or audit partners) every five years.
- Be aware that the first year with a new auditor will be more expensive.
- Avoid engaging the auditor to provide non-auditing services aside from preparing IRS Form 990 and other permissible services.
- Small CPA firms usually offer the most competitive prices. But larger firms may be willing to match those fees as a friendly gesture to a board member or out of civic responsibility. Some firms offer "off peak" rates, typically in the summer months.
- Use the audit as an opportunity to educate the entire board about the financial health of your organization.

Audit Committees

One of the key provisions of the Sarbanes-Oxley Act of 2002 is the requirement that publicly traded companies form an independent audit committee that is responsible for oversight of the organization's financial statements and accounting practices. While not required by law, audit committees are being embraced by the nonprofit sector as a best practice.

The concept of an audit committee is not new. Wall Street first endorsed the concept more than 50 years ago. What is new is that audit committees are being held to a much higher standard emphasizing independence and financial expertise. To be an effective independent overseer on behalf of the entire board, the committee must position itself between management and the external auditors. This organizational structure allows the audit committee to question management's judgments about financial reporting matters and to suggest improvements in its internal control systems.

In order for an audit committee to function properly, it should be separate from the finance committee and made up of members who are independent of the day-to-day management of the organization. At least one member should be a financial expert, and the other members should be financially literate, including knowledge of nonprofit financial standards. If the board does not have sufficient financial literacy, the audit committee may include non-voting advisors.

A sample description of audit committee roles and responsibilities, provided courtesy of Nonprofit Risk Management Center (www.nonprofitrisk.org), is posted on VLAA's Web site (www.vlaa.org). For more information on audits, download *The Audit Process*, published by CPAs for Public Interest (www.cpaspi.org) or *The AICPA Audit Committee Toolkit: Not-for-Profit Organizations* (www.aicpa.org/audcommctr/toolkitsnpo/homepage.htm).

Absent an Audit: Demonstrating Accountability

Generating Donor/Constituent Confidence

- Establish and maintain an active board finance committee with a strong treasurer
- Ensure IRS Form 990 is done well and submitted on time
- Post PDFs of last three Form 990s on website
- Distribute an inexpensive annual report to the community
- Track restricted funds fanatically
- Develop a well-formatted, high level annual budget for public consumption
- Consider purchasing a review by an independent CPA

Ensuring Compliance with Nonprofit Accounting Standards

- Recruit an experienced nonprofit CFO or executive director as treasurer
- Contract with an expert nonprofit bookkeeper
- Prioritize financial literacy and professional development at the staff and board levels

Preventing and Catching Fraud

- Engage staff, contractors and board to ensure segregation of financial duties
- Develop and follow simple accounting policies and procedures
- Actively maintain a culture of financial ethics and transparency

Source: Absent the Audit: How Small Nonprofits Can Demonstrate Accountability Without One by Jeanne Bell and Steve Zimmerman (The Nonprofit Quarterly, Spring 2007)



W H I T A K E R F O U N D A T I O N

Publication of *Arts Law Memo* is made possible by grants from the Whitaker Foundation; Regional Arts Commission; the Illinois Arts Council, a state agency; and the Missouri Arts Council, a state agency.