

Panel on the Nonprofit Sector

Convened by INDEPENDENT SECTOR

Work Group Recommendations to the Panel on the Nonprofit Sector Posted for Public Comment January 26, 2005

#6: Financial Audits and Reviews

Background:

Two Work Groups, the Governance and Fiduciary Responsibility Work Group and the Transparency and Financial Accountability Work Group, addressed the following Statement of Problem regarding requirements for audits and reviews of the financial statements of charitable organizations. The Expert Advisory Group comments on both Groups' recommendations are provided at the end of this document.

Financial audits provide an external party's validation of the financial condition of a public charity and foundation. A lack of financial accountability and transparency has contributed to governance failures in some charitable organizations. There is currently no federal statute mandating whether or when a nonprofit organization should be subject to an outside audit or review. The Senate Finance Committee staff has proposed that an exempt organization with over \$250,000 in gross receipts be required to have an independent audit of its financial statements, including certification regarding the organization's exposure to the unrelated business income tax. The Senate Finance Committee staff further proposes that if an organization's gross receipts exceed \$100,000 but are not more than \$250,000, its financial statements must be reviewed by a certified public accountant.

Regulators' concerns over potential for fraud have led to proposals requiring nonprofits to rotate audit firms and/or partners every five years to achieve a "fresh look" at an organization's financial procedures. The Senate Finance Committee staff proposes that charitable organizations be required to use a new auditor at least every five years.

I. Governance and Fiduciary Responsibility Work Group Recommendation

A. Statement of Problem

See background statement at the beginning of this document.

B. Recommendations

Every public charity with gross revenues of \$2 million or more (not counting funds for which a governmental entity requires an accounting) and every private foundation with assets of \$10 million or more should be required by law to prepare financial statements in accordance with generally accepted accounting principles and have such financial

Note: These recommendations have not yet been reviewed by the Panel on the Nonprofit Sector. They will be part of the deliberations by the Panel as it prepares its interim report.

statements audited by an independent certified public accountant in accordance with generally accepted auditing standards.

The Work Group recommends that rotation of either audit firm or lead partner within an audit firm should not be required for charitable organizations.

C. Rationale

Preparing financial statements in accordance with generally accepted accounting principles and having an independent audit will likely increase the quality of an organization's financial information. The Work Group's proposed thresholds of \$2 million in non-governmental revenues for public charities and \$10 million in assets for private foundations represent an attempt to balance the anticipated costs of compliance with an audit requirement against the associated benefits to the organization, regulators and the public. Data from the National Center for Charitable Statistics indicates that the public charity threshold will likely result in audit coverage of a significant portion of all annual revenues reported by public charities.¹ While the vast majority of charitable assets would be covered by the audit requirement, smaller organizations that lack the resources to engage an outside auditor would not be burdened by the requirement. Many organizations that would be affected by the requirement already are subject to state audit requirements, which are generally triggered at thresholds below the proposed \$2 million in non-governmental revenues.

On the question of audit firm or lead partner rotation, the Work Group noted that in many locations there are relatively few accountants qualified to work with charitable organizations and the firms that do work with charitable organizations are typically not large. Thus a rotation requirement would be impractical to impose and would likely have little to no benefit compared to the cost.

D. Other Considerations

Some members of the Work Group felt that the costs associated with the audit requirement might be much greater than anticipated, that an audit requirement would not necessarily result in benefits to the organization which would outweigh the costs, and that a federal tax benefit might offset audit costs. Several members of the Work Group, however, believe that the cost of an external audit should be borne by the organization as part of its duty to be accountable and the Work Group reached no consensus on the issue.

¹ The same is likely true for private foundations.

II. Transparency and Financial Accountability Work Group Recommendations

A. Statement of Problem

See background statement at the beginning of this document. In addition, the Work Group considered the Senate Finance Committee staff proposal that tax-exempt organizations be required to have their Form 990 reviewed by an independent auditor for conformity to established Form 990 filing standards and that the auditor's report be attached to the Form 990.

B. Recommendations

1. The Work Group generally agreed that every public charity and private foundation with gross receipts of \$500,000 or more should be required to prepare financial statements in accordance with generally accepted accounting principles and have such financial statements audited by an independent certified public accountant in accordance with generally accepted audit standards. Organizations whose gross receipts exceed \$250,000 but are not more than \$500,000 should be required to prepare financial statements in accordance with generally accepted accounting principles and have such financial statements reviewed by a certified public accountant. There should not be a financial audit or review requirement for organizations with annual receipts of \$250,000 or less.
2. Current certification requirements for tax preparers of the Form 990 and the Form 990-T are sufficient, and additional requirements for certification by an independent auditor should not be enacted.
3. Boards of charitable organizations should be encouraged as a "best practice" to regularly monitor the auditor relationship for effectiveness, expertise, and independence, and change firms when performance is deficient. Charitable organizations should not be required to rotate audit firms/partners on a fixed schedule.

C. Rationale

Charitable organizations that receive over \$500,000 in federal funds in a given year are currently required under OMB A-133 to have their financial statements audited. State requirements have varying thresholds and various bases for measurement. The Work Group generally believes that a clear federal standard would simplify compliance for organizations that operate in more than one state, but some members believe that the decision to have financial statements audited should be left to the discretion of boards of directors, which are in a better position to evaluate the cost-benefit of an audit for their organizations.

Audit requirements for such organizations would require additional expense without necessarily producing a corresponding benefit to the organization or to the public. Organizations with annual revenues under \$500,000 may rely on volunteer or part-time accountants to prepare financial information and the Form 990. Financial reviews are less

rigorous (and therefore less expensive) than an audit, and could provide a more cost-effective alternative for those organizations.

Organizations that have unrelated business income are required to file Form 990-T to determine tax liability. While auditors take unrelated business income into account as part of an audit, they do not examine unrelated business income unless the amount is “material.” Further extension of requirements for auditing unrelated business income would add significantly to the cost of audits for charitable organizations.

In signing Form 990, the preparer swears that the return is true, correct and complete. Standards for filing a Form 990 do exist in the extensive IRS instructions, and a preparer’s certification that the return is prepared in keeping with the accounting methods the organization follows for financial reporting purposes. Directing the development of specific standards to allow for a CPA to attest to the accuracy of the Form 990 preparation would be duplicative. Additional certification, particularly if imposed in addition to required financial audits that must be publicly disclosed, would be unnecessary.

A mandatory rotation system would do more harm than good. The auditor’s ability to analyze financial activity increases incrementally each year as knowledge of an organization’s accounting and internal control systems accumulates. Rotation discards valuable knowledge useful in performing a rigorous audit. An American Institute of Certified Public Accountants study shows that “audit failures” are three times more likely to occur during the first two years of an audit engagement. Time spent by both the auditors and organization personnel is increased by auditor rotation. Up to twice as much time may be spent during the first year or two of an audit engagement. Accounting firms now absorb much of this cost as an investment in long-term client relationships. The shortened time frame in which start-up time is recouped will place a costly burden on the nonprofit sector.

D. Other Considerations

Current accounting standards require related entities to prepare consolidated financial statements, while the IRS does not permit organizations to file a consolidated Form 990 without specific permission. Attaching audited financial statements to the Form 990 would require additional explanation or education for the public.

The Form 990 includes a reconciliation of revenues and expenses, which is readily available to the public. Work Group members expressed concern that due to differences in accounting and tax reporting, the Revenues, Expenses and Changes in Net Assets and Statement of Functional Expenses of the Form 990 can look quite different from these financial statements, due to differences in accounting and tax reporting.

III. Expert Advisory Group Comments

The Expert Advisory Group agreed that accuracy of financial statements and 990 filings is crucial to organization transparency, and that audits and reviews by independent CPAs can help improve the accuracy and consistency of these documents across the sector. However, there must be clearer accounting standards for nonprofit financial and management reporting so that financial statements would provide organization managers and directors, as well as regulators and the public, with a more appropriate and consistent substantive picture of an organization's financial operations and practices.

The Financial Accounting Standards Board (FASB) standards currently applied to charitable organizations are frequently inappropriate. The Expert Advisory Group recommends that the Work Groups consider in Phase II recommending the establishment of a new organization for tax-exempt organization accounting standards similar to the Public Company Accounting Oversight Board called for in Section 101 of the Sarbanes-Oxley Act of 2002. The new entity would frame new accounting and audit rules appropriate to the charitable nonprofit sector.

The Expert Advisory Group does not advise taking a blanket position opposing rotation of audit firms and partners. Such rotation might be appropriate, especially for larger organizations, and could be helpful in identifying fraudulent practices and mismanagement of funds.

The Expert Advisory Group emphasized the importance of establishing a system of internal controls appropriate to the organization's size, functions, and structure. For example, larger organizations should consider conducting anti-fraud audits.

The Expert Advisory Group believes there is a need for stronger disclosure standards and requirements for auditors regarding reportable events and a central reporting entity where auditors would be required to report reportable events. The Expert Advisory Group requests that the Work Groups consider defining when and what auditors should be required to disclose and to whom during Phase II of this project.