Philanthropy under the Microscope: A Cost-Benefit Analysis of Small Nonprofits Conducting Financial Statement Audits

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Abstract

External audits are conducted by Certified Public Accountants (CPAs) and ensure the reliability of financial reporting and internal controls of a given organization. Publicly traded corporations are required by the Securities and Exchange Commission (SEC) to conduct a yearly external audit. In addition, some large or government funded not-for-profits must produce audited financial statements upon request. If an organization is not required to conduct an audit, it may still choose to undergo an independent audit. Among those that may voluntarily conduct an audit are small nonprofit organizations. Due to the unique characteristics of small nonprofits, some elements of an external audit may not be feasible; however, there are still advantages provided by this independent evaluation. The decision to conduct or not conduct a voluntary external audit requires the analysis of the engagement's costs and benefits. The intent of this paper is to present a cost-benefit analysis related to the observable costs, expenses and advantages of conducting an audit within a nonprofit organization.

Keywords: nonprofit, audit, cost-benefit analysis

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The role and services of a Certified Public Accountant (CPA) are in many ways essential to the success of large public corporations. Accountants provide consulting services, tax expertise, and financial statement review in the form of external audits. These external audits are required by the United States Securities and Exchange Commission (SEC) for all publicly traded companies. By verifying the reliability of a company's financial reporting, audits affect the sustainability of the market and investors' confidence in the efficient and responsible management of the company's resources. Due to the temptation for executives to misrepresent earnings and the company's financial position in order to alter the appearance of performance within a given period, there have been cases of falsified financial statements and resulting misinformed investment decisions by creditors and shareholders (Floch, 2004). Public companies have an obligation to use the resources of their investors with prudence and to be transparent with the results of those efforts. A CPA's responsibility in an independent audit is to attest to the proper record keeping of these resources and activities.

Like for-profit public corporations, nonprofit organizations also have a responsibility to appropriately utilize the funds and donations they receive from those who agree with the cause and/or purpose of the organization. Some nonprofits even receive funds from local, state and federal governments, so there is an even greater concern regarding the utilization of resources. For this reason, some nonprofits are required by law to conduct yearly independent audits (AICPA, 2010). Yet, while external audits can ensure proper internal controls and the faithful representation of financial statements, a small nonprofit must carefully weigh the costs and benefits associated with the process.

The purpose of this thesis will be to look closely at the observable costs and benefits of conducting an audit within a nonprofit organization. Three particular costs of an external audit will be discussed. These are related to the topic of internal control evaluation, the direct audit fee, and the cost of employee's time devoted to audit preparation. In contrast, the benefits of an external audit include the potential to strengthen internal control, improve donor opinion and confidence, maintain fiduciary responsibilities and financial transparency, and promote an increased attention to compliance requirements.

Along with weighing the costs and benefits of a full audit, nonprofits can also consider what alternatives may afford them the same or better outcomes when observing donor and government agency support. Authorities within the nonprofit sector suggest that techniques known as financial reviews and compilations may be acceptable verification of a nonprofits financial records (AICPA, 2015). The distinctions and benefits of these options will be explained in the course of the paper as well. Finally, other suggestions for improving the clarity of audit requirements and standards for nonprofits will be presented as part of the discussion. In all, this analysis will present the many faceted considerations of nonprofit management with respect to the external audit decision.

Community and Economic Impact of Nonprofits

In order to understand the necessity of evaluating the financial practices of nonprofit organizations, one must to understand how substantial their impact is on various communities in the United States and the economy as a whole. According to a study published by the Urban Institute, approximately 1.41 million nonprofits were registered with the IRS in 2013; and in 2014, individuals, foundations and businesses participated in charitable giving in excess of $358 million (McKeever, 2015). Of those that were required to file a Form 990 informational tax return with the IRS in 2013, revenues of $2.26 trillion and assets of $5.17 trillion were reported. Overall, the nonprofit sector contributed 5.4% of the United States' gross domestic product (GDP). All of these statistics show that the nonprofit sector represents a significant part of the country's economy as well as everyday life for many Americans.

This is further seen through the information provided by the National Center for Charitable Statistics, which states that a quarter of all Americans over the age of 16 participate in some form of volunteer work through a registered nonprofit and these organizations make up around nine percent of all wages and salaries paid in the United States (2015). The vast community and economic impact of nonprofits should require a certain level of accountability on the part of management and board members. In order for this impact to continue, Julie Floch (2004), a CPA and nonprofit expert, suggested that "the trust that the nonprofit world is seeking can only come with the confidence that an active and vigilant regulation process provides" (p. 6). Independent opinions, such as annual audits, are one possible form of regulation and check on the integrity of these organizations.

Background on Nonprofit Audits and Common Stakeholders

According to the National Council of Nonprofits (2017), a nonprofit organization is a group that is tax-exempt under the Internal Revenue Code Section 501(c). Twentynine different types of organizations can receive tax-exempt status under this section of the Internal Revenue Code (IRC), and they are granted this status based on the contributions they make to the communities around them. Depending on the nature of the nonprofits' work, some may be eligible to receive federal and local funding in the form of grants to support their services and programs. For this reason, some nonprofits are required by law to undergo a yearly external audit. While state and local requirements may vary, there is a defined threshold for organizations receiving federal funding that would be subject to this obligation.

The most recent legislation which governs tax-exempt organizations needing an external audit is the "Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards," which was released by the Office of Management and Budget in December, 2013. In summary, this publication, also called the Uniform Guidance (2013) for short, requires that any organization expending more than $750,000 in federal funds must conduct an external compliance audit. Along with this federal legislation, states and municipalities may have similar requirements at varying thresholds. An auditor's responsibility when performing a compliance audit is to obtain sufficient audit evidence in order to express an opinion regarding whether an entity has materially conformed to the compliance requirements of a particular grant that they are receiving. The auditor is also responsible for identifying any additional audit or reporting requirements specified by the governmental audit agreement which binds the organization (AICPA, 2010).

Most compliance audits will be performed in conjunction with a financial statement audit due to the connection between financial stability and meeting grant conditions. These audits are not voluntary and are often allowable expenses under the grant received (Uniform Administrative Requirements, Cost principles, and Audit Requirements for Federal Awards, 2013). This means that once grants in excess of a particular threshold have been accepted, management no longer has the option to consider whether an audit is or is not desirable, but it also means they are not responsible for directing internal funds to cover the cost of the external audit. It is now just a mandated necessity.

When an organization is not subject to the federal, state or local compliance and financial statement audit requirements, the decision of whether or not to conduct an audit takes on a completely new dimension. Many stakeholders are involved with the operation of any kind of nonprofit, and their requests and concerns are important in this decision process. The organization’s board of directors wants to ensure that the financial data and reporting methods of the organization will allow for the continued operation of the group, individual donors desire to see their gifts being used to successfully accomplish the intended missions, which they felt drawn to support, and members of an organization need to know that their support and effort is being well managed (Carlson, 2011). Finally, while a nonprofit may not be operated with the intention of generating a return for owners, it must still be run like a business, and many lenders or funding groups could call for evidence of financial sustainability and accountability before extending assets to an organization. Each of these stakeholders have different limits, parameters, and thresholds for determining the point at which they consider an audit necessary.

Nonprofits and their respective leaders are generally considered to be benevolent and trustworthy due to the altruistic causes they represent. However, in an article on the integrity of nonprofit organizations, Julie Floch (2004) pointed out the historical evidence that nonprofits can be subject to the same temptations of for-profit entities. Unfortunately, a dishonest attempt to improve the appearance of financial reports may come as the result of “a misguided effort to devote more resources to a mission…to mislead a donor, grantor, the public, or the regulators as to how its funds are being used… [or] for the personal enrichment of an officer or employee” (Floch, 2004, p. 4). Despite the good intentions of nonprofits, it is reasonable for the public to demand a similar level of professionalism and compliance with applicable laws as would be expected from a public company. In fact, it could be argued that nonprofits be held to a higher standard given their missions to promote benevolence and societal improvement (National Council of Nonprofits, 2017). One way to accomplish this check on general philanthropy and professional associations is through the independent judgement and assertions of a CPA. These are provided by conducting a financial statement audit which will essentially place the daily operations of the nonprofit under a stringent, yet practical microscope. These factors and stakeholders are what make the analysis of the following costs and benefits relevant and necessary.

Costs

In some cases, a stakeholder may prefer that an audit not be pursued. This is because of the fear that the costs of performing an audit will divert funds away from the direct purpose of the organization. If resources are spent on administrative matters such as an audit, less resources are available to provide the services and charity for which an organization’s stakeholders chose to support the entity. For many small organizations, resources are extremely limited and are constantly on the brink of being overextended.

This is why an evaluation of the costs associated with an audit is an important task for nonprofit management.

Internal Control Evaluation

The first cost topic involves the evaluation of internal controls. One of the biggest values and most heavily emphasized purposes of obtaining a CPA's professional opinion is having someone from outside the organization comment on the efficiency and effectiveness of internal controls. Beginning with the Sarbanes-Oxley Act of 2002 (SOX), this became a mandatory assessment for public companies. However, the costs of completing this evaluation can be vast. One study estimated that for smaller companies, the cost of complying with SOX Section 404, which details the internal control audit, was on average $2.2 million (Krishnan, Rama, & Zhang, 2008). While the companies that reported these costs may still be significantly larger than many nonprofits, it still demonstrates the magnitude of resources that must be devoted to ensuring proper internal controls exist. Additionally, the researchers pointed out that the total costs are largely impacted by the cost of initial setup for technology or procedures that are deemed lacking through the process. For small nonprofits with limited resources, it may be difficult to convince mission-minded donors that this is a necessary expenditure.

Another concern with the rigorous evaluation of internal controls is the element that requires the separation of duties. The personnel base of some nonprofit organizations is too small for the detailed separation of duties that are required within public companies or among common recommendations. In a study titled "Addressing Problems with the Segregation of Duties in Smaller Companies" (Gramling, Dana, & Ye, 2010), researchers identified 116 small companies with average revenues of around $81,000. These companies had all indicated in their management report on internal controls that there was a material weakness in the area of segregation of duties. Of these companies, 90 attributed the problem to not enough people. The lack of personnel is a challenge for smaller nonprofits who tend to keep administrative staff as minimal as possible. According to Gramling, Dana, and Ye (2010), compensating controls such as management oversight, rotation of duties, and using third-party service providers are options for overcoming the risks of a lack of separation of duties, yet effective internal controls may not be achieved consistent with the high standards that CPAs must recommend according to their own professionalism.

The management of nonprofit organizations must always consider what can be done to improve internal controls and therefore the safeguarding of assets, but they are also responsible for spending contributions in a way that is productive (Bell & Zimmerman, 2007). If one of the primary methods and purposes of a full external audit is to evaluate the internal controls of an entity, the potentially non-existent or limited separation of duties could lead to a negative audit opinion, frustrated employees, or a fruitless expense. Also, if there is already a strong emphasis on integrity and ethics within the organization, the cost of reviewing and establishing extensive internal controls may exceed the benefit. Perhaps a financial statement review, which will be discussed later in detail, may be appropriate in this case.

Audit Fees

The next cost is a more common consideration for all audits. The audit fees charged by the public accounting firm or CPA that completes the evaluation can be a substantial expenses for businesses and nonprofits alike. Some nonprofit managers and stakeholders are hesitant to commission an audit because they believe they may not be able to realistically afford the steep prices of a full audit (Bell & Zimmerman, 2007). The in-depth testing and evaluation that goes into an external audit usually contributes to the substantial fee. A news report released by Financial Executives International (2016) revealed that public companies paid on average $6.5 million for audit fees in 2015. While this number is significantly lower for nonprofits at an average of $159,844 and a median of $84,625, these numbers can cause anxiety for leaders and may lead to a substantial amount of spending for the organization.

Many factors are considered when determining an audit fee. Understanding what auditors look for when setting engagement prices may influence a nonprofit’s inclination toward conducting an audit. According to Tang and Li (2014), there are six major characteristics that drive audit fees: auditor size, reputation, industry specialization, client size, complexity, and litigation risk. For increases in most of these factors, there is a strong positive correlation with higher audit fees.

For nonprofits, one area that is particularly relevant is industry specialization. While auditors that have specializations may cost more in general, some argue that hiring a firm which specializes in the firm’s industry, such as nonprofit, may result in reduced expenses (Hadzima, 2005). Choosing a firm that is comfortable and experienced in nonprofit audits decreases the amount of effort required to complete the engagement, and therefore, audit fees may be lower. This is because most auditors, like other professional service providers, bill their clients based on the hours required to perform the service (Hadzima, 2005). If an accounting firm’s staff is more experienced with nonprofits, the engagement will require less hours worked, and thus a lower audit fee (Tang & Li, 2014).

The same explanation is true for some of the other factors. Larger nonprofits and those involved with complex operations may need to be wary of higher audit fees.

Engaging a large audit firm may provide the advantage of a wider knowledge base or even convenience, depending on location, but nonprofits need to recognize the increase in cost that comes with hiring a large firm. Furthermore, when a regional firm is the most convenient option, there is the risk that limited knowledge of nonprofit organizations could lead to lengthy audits and expensive fees. The cost of audit fees is one element of an audit that can vary greatly, and so the decision of whether to conduct an audit will be affected differently by this factor depending on the nature of available CPA firms as well as the characteristics, size, and complexity of a nonprofit. This means that it is necessary for all firms to responsibly evaluate the direct expense of an audit and whether it is a wise use of the organization’s funds. Nevertheless, it is important to realize that there can be flexibility in this area, and this should eliminate some intimidation caused by the misguided impressions of unreasonably priced audit services.

Time Cost

The final cost, and perhaps one of the largest, is the time it takes employees to prepare for and assist with an audit. This is time lost on other projects and routine tasks. External audits require a significant amount of involvement from the organization’s financial and secretarial staff. First, key individuals must schedule and attend meetings where plans for communicating with auditors and preparing required documents are discussed (National Council of Nonprofits, 2013). Auditors will request that documents including bank statements, account reconciliations, company handbooks, payroll records, trial balances, expense schedules, etc. be prepared before audit field work even begins

(Cardello, 2016). The process of collecting and organizing all of the requested materials can take days away from an employee or manager's regular assignments. Once field work begins, managers must be available to answer questions about unclear documentation and unusual account variances. Other employees may be called upon to participate in fraud interviews or provide additional information to the auditors. All of these tasks can add up and result in a substantial loss of typical productivity (Dennis, 2000).

Unlike for-profit companies who are most concerned with an efficient employee base for the sake of keeping human resource expenses low, a nonprofit organization, which generally has a philanthropic or service minded purpose, could sacrifice providing meaningful services to its benefactors if time is wasted. Due to the abstract nature of this expense and the lack of physical cash outlay, it is difficult to quantify a dollar amount that represents the cost of employees' time. However, opportunity costs must always be considered, and it is no different in the case of deciding whether a nonprofit can afford an external audit. The decision makers of the organization must answer the question of whether its employees can handle the burden of audit work on top of their essential job functions, keeping in mind that overwhelmed, underappreciated or unproductive human resources can severely impact a firm's ability to prosper.

All costs can vary in significance based on the nature of each nonprofit, but the concern for using resources wisely makes each of the above costs relevant to the discussion of whether or not to hire external auditors. The unique structure or challenge of internal controls, limited funds to cover substantial audit fees, and the risk of lost time are the most common costs facing nonprofit organizations that wish to engage in an external audit.

Benefits

After weighing the costs of completing an external financial statement audit within a nonprofit, it follows that the associated benefits also be presented. The benefits of an audit can be very broad and numerous as is made clear through the wide use of audits by regulating bodies to demonstrate the reliability of an entity's financials. These benefits include an independent, unbiased opinion, a thorough review of things which are material to users, and a concise report which indicates the findings of the certified professional. However, in this particular analysis, it is more beneficial to observe the benefits that better relate to the previously mentioned costs, which would prevent an organization from choosing to participate in an audit.

Improved Internal Control

The first benefit of an external opinion to consider has already been identified as a potential cost: internal control. While the expenses mentioned previously are valid and reasonable, arguments on both sides of this topic will be presented. Internal controls are an important part of operating a successful organization, and effective controls over assets and record keeping are important to those who are entrusting those assets (Gramling, Dana, & Ye, 2010). Charitable donors and grantors may wish to receive more substantial evidence that controls are not only in place, but that they are being performed as prescribed.

As cited earlier, Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) includes substantial requirements for the review of a public company's internal controls, but Iyer and Watkins (2008) acknowledged that this has been a large expense for these companies. In their article about nonprofits adopting the measures of SOX (2008), Iyer and Watkins sought to evaluate the benefits that the Act may provide to nonprofits as well as to what extent nonprofits are already adopting the measures of the statute. When conducting their research, they found that 78% of nonprofits already had a formal mechanism for assessing existing internal controls, and 61% responded that the group's internal or external auditors issued a separate report on internal controls. However, very few of these had made these policies based on the release of SOX. This demonstrates the importance that nonprofits already place on internal controls. This presents the possibility that when comparing nonprofits, a large grantor may choose an organization with strong internal control and an independent opinion on their effectiveness over an organization that has avoided well-documented and tested internal controls. The competition for funds is one motivator for having an external opinion in this area.

If a nonprofit does not already have strong internal controls established, an external CPA may be able to provide useful recommendations in this area. Auditors are specifically trained in the area of evaluating and developing internal controls for the purpose of reducing the risk of fraud and material misstatement. The American Institute of Certified Public Accountants (AICPA) mentions in its Core Competency Framework (2017) that one of the key functional competencies of an accounting professional is the ability to analyze risk and find ways to control that risk. While the independence of an auditor prohibits him from directly designing or implementing internal controls for an organization, he could identify areas of key weakness and present resolutions for management to work toward. The benefit of this professional knowledge could potentially prevent fraud and misstatement from occurring in the future which leads to the next benefit of an external audit.

Donor Opinion and Confidence

Next, an unqualified, or clean, audit opinion may improve donors' opinions of and confidence in an organization, therefore providing a potential increase in contribution revenue. According to Gittler and Ryan (2011), nonprofits experience frequent criticism "for having weak internal controls due to understaffing, poor training, and lack of segregation of duties." Moreover, they mentioned that the availability of charitable funds has a tendency to decrease as the country experiences economic downturns. This means that nonprofits experience greater competition amongst themselves when raising the funds they need to carry out their mission. By conducting a yearly audit, nonprofits are more easily able to demonstrate to current and potential donors that funds are being used efficiently and appropriately. Even in times of economic prosperity, donors and grantors want to be sure that their gift is being put to good use. Because a nonprofit's income is based solely on the reputation it has for executing its mission, it is essential that they be able to prove the responsible use of funds given to this end. While an audit may not accomplish this entirely, it is a step in the right direction.

Another source of donor confidence is third party reviews of nonprofits. Charity watchdogs exist to advise donors about how efficiently a charity will use donations received and alert them to any potential abuses of gifts. These watchdog groups will also rate organizations according to certain criteria which they believe contribute to the previously mentioned characteristics. According to the National Council of Nonprofits (2017), one of these criteria that these watch groups consider when creating their ratings is whether a nonprofit has an annual independent audit. If the lack of an annual audit causes the nonprofit to receive a lower rating, conscientious donors may be more hesitant to supply funds. On the other hand, a positive rating increases confidence and could result in new donors or increases in the amounts given by existing donors as they see that their money is being used wisely.

Management's Fiduciary Responsibility and Financial Transparency

Another benefit to obtaining an external audit is an audit's ability to aid management in maintaining its fiduciary responsibility to the organization and promote financial transparency with stakeholders. As managers and directors of a nonprofit, individuals are charged with what is known as fiduciary responsibilities. According to Cornell University's legal dictionary, fiduciary responsibilities include the duties of care, loyalty, good faith, confidentiality, prudence, and disclosure (Temchenko, 2016). The first three duties are most applicable to nonprofits and the decision about whether or not to conduct an audit. These require that a manager take sufficient efforts to obtain all material information before making a decision, place the organizations interests before selfish interests, and refrain from doing anything which may jeopardize the organization. Attention to each of these responsibilities would be embodied by the choice to submit the organization to external review in the form of an external financial statement audit, and to then subsequently present the results to the donors and constituents.

The duty of disclosure describes the responsibility of directors to inform stakeholders of all facts and circumstances with honestly and clarity (Temchenko, 2016). For nonprofits, disclosure by way of financial transparency is particularly important. Grantors and communities want to be assured that a nonprofit is using its funds to further the mission that it claims to support. According to Carlson (2011), "the expected level of nonprofit transparency is often well beyond the minimum required by state laws" (para.

10). This means that even though an organization may not meet state thresholds requiring an audit, the need to maintain financial transparency in the eyes of the public goes beyond what the law requires (Financial Transparency, 2017).

Many nonprofit organizations have noble intentions and admirable missions, but it is not uncommon for the leaders of such groups to place these goals above maintaining reliable books (Floch, 2004). While this does not necessarily mean there is anything wrong with the financial position of the firm, it can lead to uncertainties for those who are not involved with daily internal activities. For this reason, an external audit may provide confirmation of healthy spending as well as awareness to negligent expenditures. The expert opinion of a CPA regarding the financial integrity of a nonprofit's finances is a valuable advantage offered by an independent audit.

Attention to Compliance Requirements

A final benefit of a voluntary yearly audit is to ensure compliance with regulations. Compliance is a key term for nonprofits that are receiving federal grants for specific programs and projects. When an organization applies for and accepts a grant, they become responsible for complying with the relevant disclosure, recordkeeping, expense, and legal specifications laid out by the grant documents. One requirement that may be included in a grant agreement is a mandatory financial statement audit (AICPA, 2010). If this is the case, completing an external audit may not be an option, but the benefit provided is enhanced. By choosing to meet the audit requirement, an organization may have the ability to accept and utilize funds that would not otherwise be available.

By contrast, a nonprofit may also have reasons for not accepting a grant that relate to the performance of an audit. While a nonprofit may not be currently subject to a mandatory federal or state compliance audit, they may still be receiving some amount of government funds. For an organization that already conducts a *voluntary* annual financial statement audit, they may choose not to accept a new grant or additional grant because the results of the current audit imply the imminent possibility of a mandated compliance audit. A legal obligation to complete a compliance audit would occur if total federal funds expensed crosses the currently designated threshold of $750,000 (Uniform Administrative Requirements, Cost principles, and Audit Requirements for Federal Awards, 2013). A CPA is able to expertly calculate how close an organization is to this edge. Costs of a compliance audit are similar to costs of a financial statement audit and have already been discussed as reasons management may wish to avoid an audit. Over and above the costs associated with a compliance audit, the meticulous recordkeeping that is often required by grant agreements can also be expensive. A yearly financial statement audit can provide the benefit of ensuring that an organization does not unknowingly cross the threshold that would trigger a mandatory audit or accept a grant that would create expenses which would severely impact their financial stability position.

Alternatives to an Audit

The discussion among management regarding whether to complete or not complete an independent audit of the organization's financial statements may not always lead to clear benefits beyond costs or vice versa. Sometimes the conversation about providing confidence in the integrity of the nonprofit's operations and reporting may include the option for either a financial statement review or a CPA-provided compilation. These are two alternatives that may be more appealing to small nonprofits that are concerned about limited resources. In some cases, the availability of these options may eliminate a full external financial statement audit from the discussion. In other cases where a careful analysis of the costs and benefits is pursued and the costs appear to outweigh the benefits for a particular group, management should be made aware that there are other assertions that may provide similarly desired benefits with significantly less costs. In addition, there are other methods for reasonably pacifying stakeholders' concerns about the reliability of a nonprofits financial management and organizational stability.

Financial Statement Reviews

According to the Nonprofit Audit Guide (National Council of Nonprofits, 2015), a financial statement review has goals similar to an independent audit. A review seeks to determine that the financial statements are consistent with generally accepted accounting principles (GAAP), but it is not conducted with the same degree of investigation and analysis as an audit. During a review, the auditor does not test the nonprofit's internal controls. This is important to note when the costs associated with this area are a key concern for the association.

The AICPA's "Guide to Financial Statement Services: Compilation, Review and Audit" publication (2015) recommends that a company choose the service of a CPA-performed review when lenders and other outside parties need a basic level of assurance in order to provide the company with larger or more complex levels of financing and credit. The CPA still issues a formal report in accordance with the assurance obligations of a financial statement review, and this can be valuable to both internal and external stakeholders. However, it is important to note that this type of engagement only provides limited assurance regarding the accuracy and reliability of financial information.

Nevertheless, this outside opinion may allow the organization to grow both by attracting new funds and donors, while still keeping administrative costs low.

Financial Statement Compilations

A financial statement compilation is completed with even less effort and detail than a review. As part of a compilation, an independent CPA organizes the entity's financial information and formats it into statements compliant with GAAP (AICPA, 2015). This option has several advantages. First, by having an external accounting professional prepare financial statements on a regular basis, it may be possible to avoid the need to keep a highly experienced bookkeeper on staff. With financial statements put together in a standard format, it would be easy to provide these to potential lenders and grantors. Second, the National Council of Nonprofits (2015) points out that a professional eye may be able to quickly catch any irregularities or need for special disclosure. Finally, and uniquely attractive to the extremely small organization, a compilation has a significantly lower cost than even an independent review. Yet, a compilation provides no professional assurance as to the accuracy or reliability of the financial information provided, while a review offers at least limited assurance. The AICPA (2015) recommends that this option is best for entities that are seeking low levels of financing or wish to invoke confidence with outside parties due to the organization's association with a CPA.

Assurance without a CPA's services

Bell and Zimmerman (2007) point out that there are several ways that nonprofits can generate donor and constituent confidence, ensure compliance with accounting standards, and prevent fraud without purchasing an audit. By selecting financial managers with strong reputations for integrity and knowledge, nonprofits can be clearer about financial conditions and objectives. Other initiatives such as preparing timely and accurate IRS Form 990s, providing an annual report via the organization's website, carefully tracking restricted contributions, and developing annual budgets can ease the worries of donors and constituents. Similarly, proper treasurer selection and an emphasis of financial literacy for top management can ensure proper attention is paid to accounting standards. If these are not realistically possible, a nonprofit may look into contracting for the monthly services of an outside bookkeeper who has nonprofit accounting experience. Finally, preventing fraud must come first and foremost through the establishment of an organizational culture which is committed to ethical behavior. By executing each of these practices, an organization may satisfy the needs of the auditing process without the added expense that comes with an annual external audit.

Nonprofit Audit Standards

Along with providing management with relevant information regarding the costs and benefits of an audit, it is important to ensure clarity among related legislation. Like any area of accounting, the standards relating to nonprofit audits are always changing. As discussed early in this thesis, some nonprofits are required by external stakeholders to have a financial statement or compliance audit performed annually. First, a qualitative obligation looks at the specific state of operation for an organization. The National Council of Nonprofits' website breaks down these requirements by each individual state for the convenience of nonprofit executives and decision makers. According to the Council's website, in the state of Virginia, "a nonprofit organization with gross annual revenue of $1 million or more may be required to provide an audited financial statement prepared by an independent CPA." Furthermore, if the organization falls into a range of revenue between $750,000 and the $1 million threshold, the requirement is reduced to a financial review conducted by an accountant (National Council of Nonprofits). By contrast, a charitable organization in the state of Maryland would be required to undergo an audit of the financial statements if gross income from charitable contributions exceeds the $500,000 threshold, and a review is required if revenue falls into a $200,000 to $500,000 range. Even with just two examples, it is easy to see that the requirements for a financial audit can vary greatly.

While the previous examples demonstrate the changes to obligations by state, they also highlight the degree to which the quantitative amount of total revenue can affect the need for a financial audit. By observing just two variables which can affect the need for an audit, it is easy to see how this can become confusing and frustrating to nonprofit financial executives who are eager to follow applicable laws, yet also interested in focusing on the larger mission of the organization.

The Uniform Grant Guidance mentioned previously was released by the Office of Management and Budget in December 2013, and it is the most significant reporting update for organizations receiving federal grants since the Single Audit Act of 1984. With the new guidance, an organization must now receive $750,000 or more in federal funds in order to meet or exceed the threshold at which an audit would be required. This increase from the prior $500,000 threshold is estimated to reduce the number of organizations requiring an audit by 5,000 (Floch, 2004). According to the Uniform Guidance's summary statement, the overall purpose of the update is to streamline the reporting requirements for nonprofits undergoing compliance audits (Director of the

OMB, 2013). While this guidance refers more specifically to compliance audits, its goal of reducing the number of groups impacted as well as simplifying reporting requirements could be an influence on state policies. Just as many states adopted regulation similar to the Sarbanes-Oxley Act for nonprofits (Iyer & Watkins, 2008), they may consider adapting current state regulations requiring financial statement audits to be more in line with federal compliance requirements. This has the potential to relieve some of the burden placed by some states on smaller nonprofits.

The National Council for Nonprofits has created a Nonprofit Audit Guide "to provide charitable nonprofits with the tools they need to make informed decisions about independent audits" (2013). It includes information explaining what an audit is, lists details of federal and state laws, suggests alternatives to an audit, and presents research supporting why an audit is advantageous. This guide is a great resource for nonprofits wanting quickly discover whether they are legally required to complete an audit or not, and it is a significant improvement in clarifying the responsibilities of nonprofits with regards to audit standards.

Nonprofit organizations make up a large portion of the United States' social and economic environment, and their health and reliability is important. Many organizations provide necessary services, guidance, and charity to society. Helping to maintain their existence by assuring they are financially sound is vital, but it is also important to avoid placing them under unrealistic requirements in order to achieve this. In addition, many individuals take pride in making contributions to various charitable and meaningful organizations. It is the right of these donors to know that the resources they are bestowing are being used in a way that corresponds to the interpreted mission of the organization.

For these reasons, an analysis of the relevant costs and benefits to small nonprofit organizations that arise from independent, external audits is significant.

In summary, substantial arguments support both the costs and benefits of an audit of nonprofit financial statements. One cost is the effort and difficulties involved with evaluating internal controls in a small, nonprofit environment. This particular cost has a correlating benefit seen in the probability that an outside expert would be able to make recommendations for improvement of internal controls or provide necessary, independent evaluation of insufficient segregation of duties and other control issues. Depending on the specific size, nature, and culture of an organization, the costs or benefits may outweigh the other. The remaining costs include the direct audit fees and the employee time that must be dedicated to participating in an audit. Both of these can require substantial resources from a nonprofit and may hinder activities related to the nonprofit's service or philanthropic mission. The additional benefits presented included improving donor opinion and confidence and maintaining management's fiduciary responsibilities, financial transparency, and attention to compliance requirements. All of these are reasons that motivate nonprofits that currently choose to perform an audit, and the same reasons may also cause an organization to do so in the future.

In conclusion, management and board members must combine the individual characteristics of their organization with the presented costs and benefits to come to a responsible decision. The differences in stakeholders, revenue levels, geographic location, and organizational purposes make it difficult to establish a best practice maxim for all nonprofits. While there are clear and measurable benefits to performing an external financial statement audit, this performance consequentially results in demands on the organization's resources that decision makers have a responsibility to utilize appropriately. A careful analysis of relevant costs and benefits is good practice for making sure this responsibility is properly taken.

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