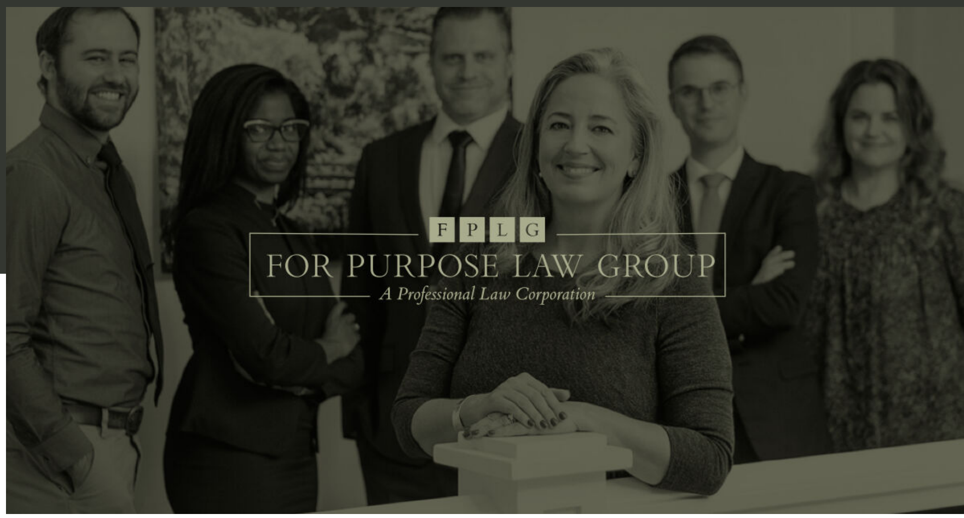
NONPROFITS: CALIFORNIA ATTORNEY GENERAL

Do We Need to Have a CPA Audit Our Books?

06.21.17 | Linda J. Rosenthal, JD



Many small- to mid-sized 501(c)(3) organizations are often confused about their accounting and reporting duties. They may hear or read about an "independent audit" and wonder what that means and if it necessarily applies to them.

The simple answer is:

- The IRS rules for charities do not include a requirement for an "independent audit";
- Some states require them in certain circumstances; and
- Some grantors may ask for one.

What is an Independent Audit?

First things first. Let's pin down the definition of an "independent audit." Generally, it is "an examination of the financial records, accounts, business transactions, accounting practices, and internal controls of a charitable nonprofit by an 'independent auditor.'"

"'Independent' refers to an auditor/CPA who is not an employee" but "instead is retained through a contract for services."

This independent professional "reviews the organization's financial statements to determine whether they adhere to "generally accepted accounting principles" (GAAP)." Created by the Financial Accounting Standards Board (FASB), they are not law, but they carry significant weight. If GAAP are not followed, the auditor must note that fact.

There must be a report issued "to the board of directors expressing a professional opinion about the organization's financial practices; specifically, whether the financial statements: 'fairly present the financial position of the organization" without any inaccuracies or material misrepresentations.'"

> *There are four types of reports that an auditor could issue: 'Unqualified Opinion' (this is the type of audit you hope for); 'Qualified Opinion' which signals that the auditors found one or two situations where the nonprofit is not following GAAP, or that the organization is following GAAP in most cases although perhaps not all, but overall there is not a material misstatement of any financial position(s); 'Adverse Opinion' (which signals that the auditors found a material misstatement or that overall the organization is not conforming to GAAP); or a 'Disclaimer of Opinion' report. Either one of the first two reports is preferable to either the adverse opinion or a disclaimer report. The Disclaimer report essentially signals: 'Something prevented us from forming an opinion, therefore we refuse to do so.' Receiving an Adverse Opinion or Disclaimer of Opinion can have a serious negative impact on efforts to obtain funding for your organization.*

Independent Audit Requirements for CA Charities

The Council on Nonprofits has a helpful guide for each state's requirement, if any, for an independent audit. About one-third of all states require nonprofits of a certain annual revenue size to be audited if they solicit funds from their state's residents. The revenue thresholds vary from state to state."

California's statute on independent audits is the Nonprofit Integrity Act of 2004, California Government Code section 12586(e)(1). It was enacted after the huge corporate scandals (e.g., Enron, Worldcom) of the early 2000s; federal and state officials reacted by imposing new rules and regulations on all corporations, including nonprofits.

Fortunately, the threshold of this requirement is high: It applies to any charitable corporation in California with gross annual revenue of $2 million or more *and* that is already required to file reports with the Attorney General. It must be prepared by an independent CPA.

Independent Audit Required by Certain Funders

Whether or not state law applying to a particular organization mandates an independent audit, certain government agencies or other grantors may require one. For instance, the "federal Office of Management and Budget (OMB) requires any nonprofit that spends more than a designated amount in federal funds in a year (whether directly or by passing the money on to other nonprofits) to obtain what is termed a 'single audit' to test for compliance with federal grants management standards." Some funders, including certain foundations, may require an independent audit; likewise, certain banks or other lenders may demand one.

Conclusion

It's good that an independent audit is not required in all cases because it's expensive. Even for a small nonprofit, the fee might be $5,000 to $10,000 – and audit fees for larger nonprofits in major urban areas can exceed $20,000.