When and How Do You Know Your Nonprofit Needs to Be Audited?

7 min read

Key Takeaways

- **How Much Can Legally Be Spent on Nonprofit Overhead Expenses?** Your overhead expenditures should be calculated by looking at the ratio or percent of overhead expenses compared to the nonprofit's total revenue or funds received.
- **The Importance of Choosing the Right Nonprofit Auditor:** When hiring an auditor for your nonprofit, it's essential that you choose someone who specializes in nonprofit accounting and auditing.
- **How to Be Audit-Ready at the End of the Year:** Being audit-ready isn't something you do every year at the end of the year; it's something that you do at the end of every month.

We'll cut to the chase: the IRS does not require nonprofit organizations to obtain audits (except in very rare circumstances). But that does not mean your organization is *totally* exempt from audits?

The short answer is no. [1] When running a nonprofit, there are a few requirements your organization needs to meet in order to stay compliant with federal and state rules and regulations to maintain your 501(c)(3) status.

One of these requirements is periodic auditing of your nonprofit, but how do you know when your nonprofit needs to get audited?'

Does Your Nonprofit Need an Audit? Nonprofit Audit Requirements

The laws which determine when a nonprofit needs to be audited vary from state to state.

For example, with a slight majority, 26 states require nonprofits to be audited when they reach $1 million in revenue. In these states, your organization would be required by law to be audited once it hits $1 million.

Although most states require audits at a million dollars, others set the bar at a lower or higher dollar amount, outline other circumstances that trigger audit requirements, and some states don't even specify. Moral of the story- it's important that you understand the rules and regulations governing charitable organizations in your state.

👉 Be sure you're in compliance! Look up your state's nonprofit audit rules here.

The purpose of a nonprofit audit is to ensure you're spending money in accordance with the guidelines set forth by your organization's 501(c)(3) status (charitable status). When you file for charitable status, you submit your nonprofit's mission statement, and an audit's purpose is to track how much of the funds you receive actually get spent on your mission as opposed to overhead costs.

How Much Can Legally Be Spent on Nonprofit Overhead Expenses?

Although there are no actual legal restrictions regarding the amount of funds a nonprofit can put toward its overhead expenses, nonprofit organizations do agree to financial transparency as a part of their charitable status. [2]

Watchdog organizations like GuideStar, the Better Business Bureau, Charity Watch, and Charity Navigator set their own benchmarks for overhead spending, overall impact, operations, and more that they use to rate nonprofit organizations.

Read More: What Executive Directors Need to Know about Nonprofit Watchdogs

While these nonprofit watchdogs take additional information into account, the amount of funds spent on overhead expenses is a major factor in their ratings.

Additionally, donors also tend to look at the percentage of every dollar that goes to programs before they make decisions about where to send their money set aside for charitable donations. Having lower overhead expenditures makes your nonprofit much more enticing to potential donors.

Your overhead expenditures should be calculated by looking at the ratio or percent of overhead expenses compared to the nonprofit's total revenue or funds received. The benchmarks vary but, in general, nonprofits should aim not to exceed a ratio of 35% with less than 10% being ideal. [3]

That being said, you need to spend money to make money – even in a nonprofit. Whittling down your overhead costs too far could result in operational issues, costly employee turnover, and other problems that reduce your impact and hinder your mission.

The Importance of Choosing the Right Nonprofit Auditor

Every CPA firm has a couple of nonprofit clients they handle, but this does not make them experts. This can be a problem because these auditors likely aren't aware of all the rules for nonprofits and are not able to provide truly useful or beneficial advice that will help you improve your overhead spending and maximize your impact.

When hiring an auditor for your nonprofit, it's essential that you choose someone who specializes in nonprofit accounting and auditing.

A real-life example: While CFO at Amnesty International USA, Stephen King (current CEO + Founder of GrowthForce) used their audit to help lower fundraising and administrative expenses. The organization grew rapidly by running public service announcements on television. He received a letter from ABC TV notifying the organization that, because their administrative costs had gotten too high, they were no longer able to proceed with the ads.

King was able to reduce Amnesty International USA's overhead spending to 16%, not by spending less, but by improving the organization's joint cost allocation.

To make sure you have an auditor who is not just going to keep your organization compliant but actually help you improve, ask if they know about the joint allocation rules and whether or not they can help you lower your fundraising expenses – before you decide whether or not to hire them.

How Do You Lower Your Nonprofit's Fundraising Spend?

If the percent your nonprofit spends on overhead or fundraising is too high, the best way to improve your spending ratio is not by cutting fundraising programs, but rather by looking more closely at those programs and the actual activities and work that is done to fundraise.

When you look closely, you'll see that most of your time and efforts spent on fundraising are likely actually spent on mission education.

For example, when you mail out a donor letter, you might spend the first 5 or 6 pages explaining more about your mission, telling a story about the people your organization served in the past year, and demonstrating the impact of a $100 donation given to your organization. Then, perhaps, you close with a sentence or two of actual fundraising language, requesting donations. This means that you actually shouldn't charge the entire cost of the letter to fundraising, but also categorize a portion of the cost under program education.

Read More: 5 Steps to Help Nonprofits Run Better, Grow Stronger, and Raise More Money

Likewise, if your executive director is giving a talk at a fundraising event. Their labor costs for the entire time spent at that event should not be entirely allocated to fundraising because a large portion of the time is most likely spent on program education rather than actual fundraising.

So, to reduce the rate of your overall fundraising spend, nonprofit leaders need to perform joint cost allocation (also called overhead cost allocation) which more accurately breaks down your nonprofit's spending habits.[4]

Using Time Tracking and Automated Bookkeeping to Implement Joint Cost Allocation

The problem with joint cost allocation is that you can't arbitrarily pick a spending ratio out of the air – even if you're making an educated guess. You absolutely need proof and documentation to back up the choices you make when allocating overhead costs.

The best way to do this, to have a substantial record that tells a story and will hold up during an audit, is to use a time-tracking system that's available to all of your employees on their mobile devices. This way, you're not reporting an arbitrary 20% of labor cost allocation to a certain program, you can actually demonstrate that 20% labor cost allocation by showing the historical evidence of how each of your employees spent their time.

How to Be Audit-Ready at the End of the Year

Many nonprofit leaders ask us what they should be doing at the end of the year to make sure they are ready for an audit, ready to complete their Form 990, and ready to produce an annual report. However, being audit-ready isn't something you do every year at the end of the year; it's something that you do at the end of every month.

Read More: Financial Management End-of-Year Checklist for Nonprofit Leaders

Don't make the mistake of trying to wade through a mess of records from the previous twelve months at the end of the year. Instead, get in the monthly habit of generating the schedules, financial statements, and notes that your auditor will need to see at the end of the year. So, rather than having an enormous year-end closing process, you can tackle a more manageable month-end closing process that keeps your organization audit-ready all of the time.

Ask your auditor at the beginning of the year to provide you with a copy of the PBC (provided by client) schedule, so that you can collect all the materials you'll need for your audit throughout the year. This will save you and your entire staff time during the audit and avoid having to pay another auditing fee for your auditor to return because you weren't prepared. Being audit-ready throughout the year ensures you won't waste money on additional auditing fees and you won't waste time chasing down information to answer your auditor's questions.

Control Overhead Expenditures and Audit Costs by Staying Audit-Ready With Smarter Nonprofit Accounting

Shoring up your back office will ensure that you're better able to track time and allocate overhead expenses to keep your nonprofit's overhead spending ratios in check.

Additionally, a smart back office that automates your accounting processes simplifies your month-end closing process to ensure your nonprofit is audit-ready with accurate data every day of the year.

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[1] https://nonprofitmegaphone.com/nonprofit-audits-everything-you-need-to-know/

[2] https://smallbusiness.chron.com/percentage-funds-nonprofit-can-spend-management-66153.html

[3] https://quickbooks.intuit.com/ca/resources/nonprofit-organizations/find-right-overhead-ratio/

[4] https://www.growthforce.com/blog/nonprofit-end-of-year-planning