

Nonprofit Observer

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Get ready: Preparing for a financial audit

Nonprofits have many reasons to conduct financial audits — from deterring fraud to improving fiscal management to meeting regulatory requirements. And proper preparation can go a long way toward streamlining the audit process and getting back to business as usual. Here are some critical steps to take before the auditors arrive.

Engage in the pre-audit meeting

The pre-audit meeting typically includes the assigned auditors and staff members who'll be directly involved during the audit, and possibly members of the board (including, if applicable, members of its audit committee). The main purpose of the meeting is to develop a timeline for the audit and an outline of documents and records the auditors will require.

But your staff shouldn't be passive participants in the pre-audit meeting. This is a valuable opportunity to ask questions and address issues that can save time down the road. For example, your accounting staff might seek clarification about items on the "Provided by Client" list. Staff can also inform the auditors of any significant changes in your organization since the prior audit, such as

new or terminated programs or grants, and developments related to internal controls. Additionally, you can alert auditors to any anticipated problem areas or anomalies.

Check your accounts

To improve the odds that your auditors will find everything in order, bring an auditor's eye when reviewing accounts. For example, have you analyzed your accounts receivable for collectability? Are assets properly capitalized? Does your donor database reconcile to the general ledger? If you find these or other errors, correct them before the audit.

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You also should review any manual journal entries (a ripe area for error) and calculations for accrual purposes, and check that your revenues are recognized in the correct periods. Reconcile your general ledger with bank and investment statements and other records.

Gather your basic documents

Auditors will want access to your organization's financial statements, including your statements of activities, financial position, cash flow and functional expenses. You can also expect that they'll need to see statements and records for any investment or bank accounts. Tax filings are another area of interest. Your Forms 990 top the list, but auditors may request Forms W-2 and 1099 for your workers, among other forms and schedules.



MAKE AUDIT PREP A YEAR-ROUND PROCESS

You can expedite your audit preparation (see main article) by keeping the upcoming engagement front of mind throughout the year. For example, don't limit your communication with your auditors to "audit season." You should apprise them of unusual transactions and other potential issues as they arise, rather than waiting months to discuss them.

Staying on top of your quarterly or, preferably, monthly closings can reduce the stress at audit time as well. Take the time to conduct a comprehensive closing for each period. That includes confirming that all transactions are properly recorded and revenues recognized, posting closing entries and performing reconciliations.

The annual closing is another opportunity before the audit to ensure your figures are accurate and verifiable and to identify possible red flags. Do your book figures match those in your financial statements? Can you explain any significant variances between budgeted and actual figures? These types of disparities are sure to come up in the audit, so investigate, mitigate (if necessary) and prepare to discuss them in advance.

Auditors generally need copies of your "foundational" organizational documents, too. This includes articles of incorporation and bylaws, board meeting minutes, exemption letters, relevant policies and updated organizational charts.

Collect supporting documentation

The auditors will test various financial transactions as part of their process. That means they'll require documentation for these transactions, such as invoices, receipts and deposit slips. This step often accounts for the bulk of your preparation time. Among other information that you should collect and store in a digital file, you'll need documentation for:

- Expenses and capital purchases,
- Restricted contributions,
- In-kind donations (goods, facilities and labor),
- Significant estimates,
- Valuations,
- Related-party transactions,
- Grants (for example, grant agreements, reports and disbursements),

- Leases, insurance policies and other contracts, and
- Pending litigation.

Management letters from the past several years can provide insights into areas that might receive particular scrutiny from auditors. If those audits highlighted material issues, such as weak internal controls or operating inefficiencies, you should be prepared to demonstrate how you've addressed them.

Compare earlier audited financial statements with your current statements, too. If earlier statements required adjustments, see if you can head off similar adjustments for the current year.

Don't delay

Ideally, audit preparation takes more time than the audit itself. Begin preparations early so your organization can gather documents and review past audit reports. Although it may seem cumbersome, planning can reduce real-time headaches, shorten the audit and possibly even help you save money on fees. Contact your auditor to get started. ●

Independent contractor or employee?

Worker classification demands careful attention from nonprofits

Many nonprofits rely on independent contractors for specialized services, project-based work and temporary staffing. But classifying workers correctly remains one of the most challenging compliance issues organizations face. The U.S. Department of Labor (DOL) continues to reevaluate its approach to worker classification, but one thing hasn't changed: Misclassifying employees as independent contractors can expose employers to back taxes, wage-and-hour claims, penalties and other costly consequences. Here's what your nonprofit needs to know.

Principles-based approach

The Fair Labor Standards Act (FLSA) relies on the concept of “economic reality” when determining whether a worker is an employee or an independent contractor. Rather than focusing on a single defining characteristic, the analysis examines the totality of the working relationship to determine whether a worker is economically dependent on the organization or is truly operating an independent business.

Although the DOL adopted a six-factor rule in 2024, the agency has since announced it's reconsidering the rule and has proposed replacing it with a revised framework. In the meantime, DOL investigators generally apply longstanding economic reality principles while the rulemaking process continues. Regardless of the specific federal standard in effect, your nonprofit should avoid assuming that any single factor automatically determines worker status.

Factors that matter

Whether an individual qualifies as an independent contractor depends on the entire working



relationship. Among the considerations that federal regulators and courts commonly evaluate are:

- Whether the worker has a meaningful opportunity to earn profits or incur losses through managerial decisions, rather than simply working more hours,
- Whether the worker makes significant business investments, such as purchasing equipment, maintaining office space or marketing services to multiple clients,
- Whether the relationship is ongoing and exclusive or temporary, project-based or performed for numerous organizations,
- How much control the nonprofit exercises over when, where and how the work is performed, including scheduling, supervision and compensation,
- Whether the services provided are central to the organization's regular operations or instead represent specialized support performed independently, and

- Whether the worker uses specialized skills together with business initiative to operate an independent enterprise, rather than simply applying technical skills under the nonprofit's direction.

No one factor outweighs the others. Instead, regulators evaluate all relevant facts to determine whether the worker is truly in business for themselves or is economically dependent on the organization.

Important nuances

Some circumstances that appear to favor employee status may not be determinative. For example, requiring a contractor to follow procedures necessary to comply with federal, state or local laws generally doesn't, by itself, establish the level of control associated with employment. However, imposing

extensive policies that exceed legal requirements may indicate an employment relationship.

Likewise, a temporary or seasonal engagement doesn't automatically make someone an independent contractor. The key question is *why* the relationship is temporary. If the arrangement reflects the worker's independent business decisions and the individual regularly provides similar services to other clients, contractor status may be more appropriate.

Review your relationships now

Worker classification remains an active area of regulatory and legal change. So if your nonprofit engages contractors, you should periodically review those relationships. Don't base classifications solely on job titles, written agreements or long-standing practices. Instead, evaluate the actual working relationship and seek professional guidance when questions arise. ●

Key ratios every nonprofit should monitor

Your nonprofit's financial statements tell an important story, but they don't always make trends or emerging risks easy to spot. That's why many organizations supplement traditional financial reporting with key financial ratios. These simple calculations can help boards and leadership teams monitor liquidity, sustainability, operating performance and funding risks — making it easier to identify issues before they become major problems.

Metrics worth tracking

While every nonprofit's needs differ, several ratios provide valuable insight into financial health and long-term sustainability. These include:

1. Current ratio = Current assets / Current liabilities. The current ratio measures your ability to satisfy short-term financial obligations or debts due within the coming year. A current ratio above 1.0 generally indicates adequate liquidity.

2. Accounts payable (A/P) ratio = Accounts payable aged more than 90 days / Total accounts payable. A high A/P ratio can reflect cash flow concerns and predict severe financial consequences, such as an eventual inability to pay bills on time.

3. Accounts receivable (A/R) ratio = Accounts receivable aged more than 90 days / Total accounts receivable. As the A/R ratio increases, the risk



of collection or billing problems — and cash flow issues due to a lack of expected revenue — grows.

4. Defensive interval (DI) = Cash plus marketable securities (excluding donor restricted investments) plus current receivables / Average monthly expenses. The DI ratio measures the number of months' expenses an organization can cover if no additional inflows of quick assets (cash, short-term investments and current receivables) occur. It's particularly useful when contribution inflows are highly variable. An elevated or increasing value generally is better than a low value.

5. Liquid funds indicator = Net assets less restricted endowments, land and buildings, property and equipment / Average monthly expenses. This indicator shows the number of months before a nonprofit will completely exhaust its liquid funds, assuming no additional revenue inflows. Because net assets already reflect the organization's liabilities, this measure is more conservative than the DI metric. But, as with the DI ratio, higher values generally indicate stronger financial health.

6. Fundraising efficiency = Contributed income / Fundraising expenses. In recent years, many donors have focused on the share of spending that nonprofits allocate to fundraising relative to the amount they raise. This ratio shows the average dollar amount *raised* per dollar *spent* on

fundraising. Be careful, though — organizations may incur higher expenses when initiating fundraising campaigns, such as those for capital needs or endowments, and related donations may be received in a later fiscal period.

7. Program expense ratio = Program expense / Total expenses. This ratio evaluates a nonprofit's mission efficiency by considering the share of funding allocated to programs versus administrative or other expenses. Alternatively, stakeholders may scrutinize the administrative expense ratio, calculated by replacing program expense with administrative expense.

8. Cost per unit of service = Program expense / Number of units of service. When nonprofits provide identifiable units of service (for example, meals served), this ratio assesses the program's financial efficiency over time.

9. Reliance ratio = Funding amount / total revenue. Finally, reliance ratios can reveal an unhealthy dependence on one funding source (for example, government grants and contracts, individual donations or earned income). If reliance ratios show that your organization receives almost all its support from government funding and individual donations, funding could decrease in a recession, depression or a change in governmental priorities, threatening your nonprofit's survival. If you haven't already done so, you may need to diversify your income.

Good decisions start with good data

Financial ratios are only as useful as the information behind them. Accurate, timely accounting records are essential for meaningful analysis, and ratios should be reviewed consistently using the same methodology from period to period. Consider incorporating key metrics into your regular board reporting so leadership can spot developing trends and make proactive decisions. If your organization has lender- or grant-related financial covenant requirements, be sure to include those measures in your reporting as well. ●

Why nonprofit donor retention beats constant acquisition

Does your nonprofit devote significant time and resources to attracting new donors? Although donor acquisition is essential, long-term financial sustainability often depends just as much on keeping existing supporters engaged. A well-designed recurring giving program can provide a reliable source of revenue, improve donor retention and deepen relationships with the people who believe most strongly in your mission.

Reaping the benefits

Recurring donors commit to making automatic contributions on a regular schedule, typically monthly. Although individual gifts may be modest, they often add up to greater lifetime giving than one-time donations. Just as importantly, recurring gifts provide more predictable cash flow, making it easier to budget, manage operations and plan for future initiatives.

Recurring donors also tend to feel more connected to the organizations they support. Because they're giving consistently, they may be more likely to respond to special campaigns and volunteer opportunities.

Recent fundraising data underscores the importance of donor retention. While total charitable giving has increased in recent years, much of that growth has come from larger gifts. In fact, the overall number of donors continues to decline, making it more important than ever to retain existing supporters. A strong recurring giving program can help your nonprofit build more predictable revenue while reducing its reliance on constantly acquiring new donors.

Building a successful program

Growing recurring giving starts with making participation simple. Offer an easy-to-find online

enrollment option, minimize the number of steps required to sign up, and allow donors to choose contribution amounts and payment schedules that fit their budgets.

Don't limit recurring giving appeals to year-end fundraising campaigns. Include monthly giving opportunities throughout the year via email, social media, your website and donor acknowledgments. Existing supporters who've already demonstrated a commitment to your mission are often the best candidates for recurring gifts.

Recognition also plays an important role. While recurring donors generally don't expect elaborate rewards, they do appreciate regular updates demonstrating how their ongoing support is making a difference. Personalized thank-you messages, impact stories and occasional behind-the-scenes sneak peeks can reinforce the value of their continued generosity.

Finally, monitor your program's performance. Track participation rates, average recurring gift size and overall revenue generated. These metrics can help identify opportunities to simplify the donor experience and encourage additional supporters to join.

Invest in lasting relationships

Make recurring giving convenient for donors and demonstrate the impact of such ongoing support. It will enable your nonprofit to strengthen donor loyalty while creating a more stable financial foundation for the future. ●

