Proposal for the Auditing of Charitable Nonprofit Organizations

by

Matthew Breuner

A THESIS

Presented to the Department of Accounting
and the Robert D. Clark Honors College
in partial fulfillment of the requirements for the degree of
Bachelor of Science

June 2014

An Abstract of the Thesis of

Matthew Breuner for the degree of Bachelor of Science
in the Department of Accounting to be taken June 2014

Title: Proposal for the Auditing of Charitable Nonprofit Organizations

Approved: Michele Henney

Michele Henney

American public charities received over $1.59 trillion in revenue in 2011. Despite receiving funding equivalent to 10% of US GDP, the nonprofit sector still has finite resources, leading to fierce competition among the organizations for donations and volunteers. This competition necessitates the need for verifiable comparability between nonprofits for potential donors and fraud prevention.

My solution for these unresolved needs is the implementation of a program to require the external audits of larger nonprofits with the audited financials being made public and with the internal controls of nonprofit organizations (NPOs) being developed and improved.

The organization best suited to implement this plan is the IRS. The IRS will need authorization to expand its responsibilities/power to mandate audits for NPOS. These responsibilities include the mandating of audits, the facilitation of public access to audit findings, and the potential revocation of tax-exempt status for NPOs not in compliance.

Acknowledgements

I would like to thank Professor Henney and other names thereafter, for helping me to fully examine the specific topic and consider the various perspectives and contexts related to this subject matter. Her expertise and experience in the worlds of nonprofits and accounting proved invaluable. Last but not least, her willingness to take the time to work with me when I refocused my thesis made the entire process a pleasure.

Additionally, I would like to thank Professor Peterson for providing excellent critiques at my thesis defense and an additional accounting perspective that helped refine my paper. Finally, I would like to thank Professor Sandler for providing a literary perspective on my thesis that helped the dialogue with the reader.

I would also like to thank my parents, Erich and Sue Breuner, for being patient with my slow initial progress on my thesis and for being supportive throughout the entire process.

I would like to thank Kathy McCoy for connecting me with Medical Teams International. I would also like to thank Medical Teams International for taking the time to meet with me. Our meeting radically altered the course of my thesis.

Finally, I would like to thank my roommates, Kyle Raze and Michael Nunziato, for listening to far too many half-baked ideas and helping me find the diamonds in the rough.

Table of Contents

List of Tables

Executive Summary

Currently the nonprofit sector in the USA employs over 10 million people with public charities alone receiving over $1.59 trillion in revenue in 2011. Despite receiving funding equivalent to 10% of US GDP, the nonprofit sector still has finite resources, leading to fierce competition among the organizations for donations and volunteers. This competition necessitates the need for verifiable comparability between nonprofits for potential donors. Additionally, the amount of wealth moving through nonprofits indicates the need for preventative measures to be taken against fraud.

My solution for these unresolved needs is the implementation of a program to require the external audits of larger nonprofits with the audited financials being made public and with the internal controls of nonprofit organizations (NPOs) being developed and improved. The independent review of the operations and financials of NPOS could lead donors to funnel capital into the more efficient organizations, leading to a greater net benefit for the public. Additionally, the soothing of the public's concerns regarding the fraudulent use of its money could lead to a greater public expenditure on the nonprofit sector.

The organization best suited to implement this plan is the IRS. The IRS will need authorization to expand its responsibilities/power to mandate audits for NPOS. The IRS will additionally require a small increase in budget to carry out its new duties. These duties include the mandating of audits, the facilitation of public access to audit findings, and the potential revocation of tax-exempt status for NPOs not in compliance.

Introduction

When I originally devised my thesis, the plan was to examine accounting principles and guidelines that specifically apply to nonprofits in search of detrimental codifications. The idea is that most accounting legislation is reactive as opposed to proactive, leading to oversights in guidelines that might unnecessarily impair nonprofits. I would then interview CPAs and CFOs at nonprofits, find the parts of GAAP that caused them the most issues, research these specific principles online in the Journal of Accountancy and the FASB's Staff Accounting Bulletins, produce a cost-benefit analysis of the codifications for a sampling of nonprofits, and forward any relevant findings to the Financial Accounting Standards Board. While I still believe that this is a worthy endeavor, a more pressing issue came to mind while carrying out interviews.

While visiting and interviewing management at Medical Teams International (MTI) on January 3, I managed to interview Pamela Blikstad, the vice president of finance at MTI. While chatting with her about her experience managing the bookkeeping and general accounting of MTI, she mentioned in passing that while nonprofits had GAAP guidelines the same as for-profit companies, there is a lack of an oversight body for nonprofits that operates in a similar function to the SEC, the regulatory body that enforces requirements for certain internal controls and financial reporting of publicly traded companies. This immediately struck me as strange due to trillions of dollars' worth of capital and goods donations that flow into nonprofits from both private and public donors. Add in the seemingly annual scandals involving someone in top level management siphoning-off hundreds of thousands, if not millions, of dollars from causes devoted to bettering the public good, such as the siphoning of millions of dollars from the Metropolitan New York Council on Jewish Poverty in 2013 by the chief executive[1], and suddenly I had the impetus to switch gears to examining the oversight of nonprofits.

[1] http://www.nytimes.com/2013/09/16/nyregion/an-anonymous-whistle-blower-exposed-a-scandal-at-a-jewish-charity.html?_r=0

Situational Analysis

Scope of Non-profits

The case can be made that American nonprofit organizations are legion. Currently over 1.4 million nonprofits actively work in the US that range from public charities to private foundations and from chambers of commerce to fraternal organizations[2]. Some of the largest include the American Red Cross, the endowment funds for Harvard and Yale, and the Kaiser Foundation hospitals. The most common type of nonprofit has the designation of "501(c)(3)", an Internal Revenue Code section which grants tax-exempt status, and is either a public charity or a private foundation. A private foundation receives the majority of its funding from a small number of donors, such as a family or corporation, and generally directs money to other nonprofits[3]. An example of a private foundation is the Bill and Melinda Gates Foundation. A public charity has a broader base of donors and is more hands-on in how it uses its funding. Examples of public charities include schools, hospitals, and medical research organizations.

In regards to the people who work in it, the nonprofit sector employs over 10 million people, making it one of the largest "industries" in the US[4]. Additionally over 25% of Americans over the age of 16 volunteered through or for an organization between September 2009 and September 2012[5]. This percentage represents over 75 million Americans volunteering in their communities, a number that is larger than the

---

[2] http://nccs.urban.org/statistics/quickfacts.cfm
[3] http://www.nolo.com/legal-encyclopedia/irs-charity-classification-private-foundation-public-charity.html
[4] http://cnmconnect.org/nonprofitstatistics.aspx
[5] http://nccs.urban.org/statistics/quickfacts.cfm

combined populations of Spain, with roughly 46 million people, and Australia, with roughly 23 million people.

In regards to the monetary value of these nonprofits, public charities reported over $1.59 trillion in revenue in 2011, with the median revenue being below $100,000, and total assets of $2.87 trillion dollars[6]. They also reported $1.49 trillion in expenses in 2011. For perspective, the expenses of public charities in the US exceed the GDP of Spain in 2012, the country with the 14th largest GDP in the world.

In the following section, the regulations of publicly-held companies are examined. The relevance to the nonprofit world stems from this important parallel: for-profits are to nonprofits as the investing public is to the donating public and the financial return on investment (ROI) is to the community-improving return on investment. Both cases have a large, fluid membership that invests capital with the expectation of a ROI, either in the form of a direct financial benefit or the sense of goodwill from helping the community.

Publicly-held companies and Regulations

The US has the largest GDP in the world at $16.44 trillion as of 2012[7]. While fairly manufacturing-oriented for much of the 20th century, 86% of US workers work in the services industry as of 2010[8]. The US for-profit sector is composed of public and private companies. Public companies are companies that have equity and/or debt securities available for trade on US stock exchanges and must file unaudited quarterly reports (Form 10-Q) and audited annual reports (Form 10-K) with the Securities and

[6] http://nccs.urban.org/statistics/quickfacts.cfm
[7] https://www.cia.gov/library/publications/the-world-factbook/geos/us.html
[8] http://www.nytimes.com/interactive/2012/01/20/business/the-iphone-economy.html

Exchange Commission (SEC). These earnings reports are available to investors and the public. Private companies are companies whose securities are not available to investors on public stock exchanges. Private companies do not file earnings reports with the SEC, therefore not giving away any information about their performance to competitors. However, private companies may still be audited due to requirements imposed by banks or other external parties.

History of the SEC and accounting regulations for publicly held companies.

Prior to the stock market crash of 1929, the sale of stocks and bonds was loosely regulated under "blue sky" laws, state laws that regulated the exchange of securities. These laws were easily bypassed by practices such as trading across state lines and insider trading across state lines, building a precarious financial markets environment[9]. This culminated in the crash of 1929 that plunged the US into the Great Depression.

In 1934, the Securities and Exchange Commission (SEC) was formed to regulate financial markets in an effort to make them more stable and transparent. Interestingly, Joseph Kennedy, President John F Kennedy's father, was chosen to chair the committee at a time when he was regarded as a bit of a crook in the finance industry. President Franklin Delano Roosevelt justified his choice by saying, "Takes [a crook] to catch one"[10]. With this mindset, the SEC set out to protect the integrity of markets and crack down on fraud.

In 1973, the SEC delegated the creation of common financial accounting standards to the Financial Accounting Standards Board (FASB), which in turn

[9] http://www.law.cornell.edu/wex/blue_sky_law
[10] http://content.time.com/time/magazine/article/0,9171,991275,00.html

formalized the “Generally Accepted Accounting Principles (GAAP). GAAP forms the basis for accounting in the US and is composed of all the codifications that aim to ensure a relatively stable financial market by providing the public with reliable, comparable, and relevant information.

Over the years, new rules, regulations, and clarifications have been developed in response to various situations. A major regulation that was enacted in 2002 is the Sarbanes-Oxley Act which was designed to create greater accountability for corporate executives and public accounting firms following the massive Enron, Worldcom, and Tyco scandals[11]. Another major regulation was the Dodd-Frank Act of 2010, following the 2008 financial crisis, which created new rules largely aimed at increasing the accountability and reducing risky behavior of Wall Street[12].

From a practical standpoint, a public company must file quarterly earnings reports with the SEC (Form 10-Q) that include unaudited financial statements that are meant to keep the public, particularly the investing public, abreast of developments in the company as the year progresses[13]. A company must also file annual reports (Form 10-K) that include audited financial statements and a comprehensive overview of the company’s condition[14]. Both the 10-Q and the 10-K are meant to give comparable measures of a company’s performance relative to its peers and to warn investors of potential financial dangers that a company is facing.

---

[11] http://www.sechistorical.org/museum/galleries/wwr/wwr06a-scandals-enron.php
[12] http://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform
[13] http://www.sec.gov/answers/form10q.htm
[14] http://www.sec.gov/answers/form10k.htm

Current Regulatory Environment for Nonprofits

Unlike public for-profit companies, nonprofits are not subject to the SEC's jurisdiction. Instead they are subject to oversight from a mix of federal, state, and private parties. In regards to federal agencies, nonprofits answer to the Office of Management and Budget (OMB) and the Internal Revenue Service (IRS). The OMB's primary functions are to develop the budget for the Executive Office of the President and to provide oversight to federal funding[15]. As such, nonprofits that receive at least $750,000 of funding from the federal government are required to undergo financial audits in accordance with OMB Circular A-133[16]. The recent increase of the OMB threshold from $500,000 to $750,000 in 2013 greatly increases the chances of NPOs slipping through the cracks and not being required to undergo an audit.

Additionally, nonprofits are subject to oversight from the IRS. IRS oversight can manifest the form of an audit or a compliance check. An IRS audit can cover a variety of things including the accuracy of Form 990, a financial report that can provide the public with some information about the organization's operations and is prepared by either the organization or a 3rd party. IRS audit selection for nonprofits primarily arises from the Returns Information and Classification System (RICS), a computer system that analyzes returns and selects organizations that have met various criteria[17]. Additionally, the IRS employs compliance checks that verify an organization is following "recordkeeping and information reporting requirements"[18]. Essentially, a compliance

---

[15] http://www.whitehouse.gov/omb/organization_mission/
[16] http://www.fdcpa.com/Healthcare/0114-healthcare-7-omb-revisions-to-a133-audit-requirements.htm
[17] http://www.gao.gov/products/GAO-02-526
[18] http://www.irs.gov/Charities-&-Non-Profits/Scope-of-Audits-and-Compliance-Checks-of-Exempt-Organizations

check fills the same role as an IRS audit but in a much simpler, more limited fashion. It should also be noted that the IRS's budget has decreased by almost $1 billion since 2010 leading to a budget-induced reduction of IRS audits[19]. For example, audits of for-profit entities dropped from .71 percent of businesses in 2012 to .61 percent of businesses in 2013[20].

Of the four primary divisions of the IRS, the Tax Exempt and Government Entities (TE/GE) Division is the one responsible for administering tax law for NPOs. This division was created in 1999 as part of a modernization of the IRS. Its main priorities are to provide education regarding relevant tax law to tax exempt and government entities, to provide rulings when disagreements arise, to examine and address non-compliance with relevant tax laws, and to provide efficient customer service regarding filings and requests for information.

On the state level, state Attorneys General (AGs) have authority over the regulation of nonprofits registered within the state. The degree to which the financial statements of NPOs are examined varies with "some Attorneys General require[ing] annual submission of the federal Form 990, some Attorneys General require[ing] audited financial statements at specific thresholds, and some states require[ing] no registration or financial information from organizations at all"[21]. A basic parallel would be Blue Sky laws prior to the SEC that led to markedly different levels of regulation from state to state and the increased possibility for fraud.

[19] http://money.cnn.com/2014/03/21/pf/taxes/tax-audits/
[20] http://www.dwdcpa.com/blog/irs-2013-audit-rates-vary-significantly-among-taxpayers/
[21] Public Mandates, Market Monitoring, and Nonprofit Financial Disclosures

According to a study performed by Professor Thad Calabrese at Baruch College in 2011, the following table is a breakdown of public audit requirements for a sampling of 191,232 charitable NPOs from 1998 to 2003. He gathered this data from digitized data files from the National Center for Charitable Statistics (NCCS), merging this with data regarding Attorney General requirements by state, and finally merging all of this with the A-133 database from the Census to see which nonprofits would be subject to the OMB requirements. What can be immediately gleaned is that 29% of total revenues derived by public charities were not subject to independent verification of the accuracy of financial records, leading to $1.6 trillion in nonprofit funding not being externally monitored and verified in its use on a regular basis. What is particularly concerning is that the $1.6 trillion of $5.5 trillion figure is the aggregate from 1998-2003; giving to public charities totaled $1.5 trillion in 2011, meaning that if the 2011 figure is multiplied by the 6 year period, NPOs will have projected total revenue of $9 trillion with $2.61 trillion not subject to federal or state audit requirements ($1.5 trillion/year * 6 years * 29%).

Table 1: Charitable NPOs and Revenues Subject to Public Audit Requirements

	Subject to OMB A-133 audit requirements	State AG audit requirement threshold met	Not subject to federal contract or state audit requirements	Total
Observations	89,466	279,006	588,314	915,881
Organizations	22,860	65,106	143,066	191,232
Total Reported Revenues, 1998-2003	$2.1 trillion	$3.2 trillion	$1.6 trillion	$5.5 trillion
Percentage of total revenues	37%	56%	29%	100%

Note: Some columns do not add across columns since 40,905 observations are subject to both OMB A-133 and state AG audit requirements. These observations account for approximately $1.4 trillion of total revenues from 1998-2003. Further, some organizations are represented in more than one column since they became subject to audit requirements during the study's time frame, or became no longer subject to these requirements. Total reported revenues is the total amount of the sample for 1998-2003.[22]

While nonprofits may or may not be subject to audit requirements from government agencies, NPOs are occasionally subject to audit requirements from private donors, for-profit business relationships, and accreditation organizations. If a private foundation or a wealthy individual has an interest in donating a large sum of money to a nonprofit, the donor may require that an external audit is performed to ensure that donations are being properly used. This means that the NPO has to evaluate whether it receives a net benefit from accepting a donation. An example would be if a donor announced that it would like to donate a sum of $10,000 dollars with the stipulation that the nonprofit undergo an external audit. If the cost to the NPO to undergo the audit was $5,000, then it would be advantageous to go ahead with the audit; if the cost was closer to $15,000, then the NPO would probably turn down the offer. Additionally, a nonprofit may reject an offer that requires an audit if it has something to hide.

[22] Public Mandates, Market Monitoring, and Nonprofit Financial Disclosures

In the case of business relationships, a bank extending a loan or a builder constructing new facilities may require a NPO to undergo an audit to have some assurances of financial solvency. This is also common practice for private for-profit businesses when entering into contracts with other businesses. Essentially, these for-profit entities cannot afford to compromise their own financial security by simply trusting the word of a board member from a nonprofit; doing so could lead to a sizable financial loss for the company and/or the termination of the employee(s) who failed to verify the ability of the client organization to pay. While private donors and business contractors may require an audit to be performed, this audit information is not required to be accessible to the general donating public. In the case of accreditation agencies, such as the Better Business Bureau (BBB), NPOs are subject to various requirements, including audit requirements, if they want to receive a rating from a nationally respected organization. In the case of the BBB, which is itself an NPO, NPOs bringing in more than $250,000 in gross revenue must be audited annually in order to receive a high rating[23]. The one issue that an NPO based accreditation/evaluation system faces is that of raising the revenue to support its operations. In 2013, a branch of the BBB in LA area was found to be using extortion practices, such as giving high ratings to NPOs that paid a fee and giving poor grades to those that opted out of paying dues[24]. While this appears to be an isolated incident, economic realities could sway the judgment of accreditation-oriented NPOs which the American public relies upon when donating, and due to its voluntary nature, not all NPOs subject themselves to BBB requirements.

[23] Audit Value and Charitable Organizations
[24] http://business.time.com/2013/03/19/why-the-better-business-bureau-should-give-itself-a-bad-grade/

Objectives

Given the deficiencies in the ways that NPOs are monitored and regulated, the best course of action is to implement an audit requirement so as to increase comparability between nonprofits that do similar work for donors and to allow for greater controls to be in place against fraud. More specifically, nonprofits of the charitable variety and a certain minimum size should be subject to an audit requirement, regardless of where their revenues come from, so as to make such an endeavor feasible.

Comparability between charitable NPOs is vital for informed donors to make rational decisions. When deciding where to donate money, some donors look to quantitative measures of performance, similar to how the investing public looks at different financial ratios when deciding where to invest in the stock market. In terms of charitable nonprofit comparison, the most common figure looked at is the "percent spent on charitable purpose"[25]. This figure is the percent of expenses incurred by the charity that was not spent on either administration or fundraising. An example of this would be the American Red Cross. 5.1% of its expenses relate to fundraising and 4% relates to administration, meaning that 90.7% of its expenses relate to giving aid to those who need it[26]. The above case makes comparison of nonprofits look incredibly easy which is simply not the case.

A case example of the difficulty in comparing charitable NPOs come from mebendazole, a dewormer drug used by NPOs that deliver medical aid throughout the world. When an NPO receives a "gift in-kind", a donation of goods or services as opposed to cash, it can record the donation on its books. This valuation gets tricky

[25] http://www.charitywatch.org/criteria.html
[26] http://www.charitynavigator.org/index.cfm?bay=search.summary&orgid=3277#.U14EI_ldV8E

when the goods that are donated come from foreign sources where the drugs are manufactured for two pennies a piece whereas the value in the "Red Book", a drug-pricing guide, is $16.25 per pill, a figure that happens to be an 81,000% increase[27]. This means that a NPO wanting to improve its "percent spent on charitable purpose" could increase the value of the pill from $.02 to $16.25, suddenly inflating the relative percentage spent on its charitable aspects, making the organization far more attractive to donors. While organizations such as PQMD, Partnership for Quality Medical Donations, attempt to implement voluntary standardization of valuations of gifts in-kind (GIKs) among its member NPOs, member organizations still have autonomy in assigning the values to medical supplies, and the number of member NPOs is still fairly small. In the case of PQMD, there are a total of 14 member NPOs as of April 1, 2014[28]. If instead there was a mandatory audit that standardized the valuation process of donations, potential donors would more efficiently allocate resources, resulting in beneficiaries receiving a higher standard of service.

Fraud is a serious issue for NPOs. Not only does fraud directly lessen the flow of goods and services to the beneficiaries of NPOs, but fraud also leads to distrust indirectly lowering the flow of goods as services. Back in 2002, a scandal broke in Washington, D.C. when the CEO of the local chapter of United Way was found to have taken $1.5 million in "questionable payments", such as payment of future wages and undocumented reimbursements[29]. The public was greatly disturbed by this, leading to donations falling from $45 million in 2001 to $18 million in 2002. When looked at as a

[27] http://www.forbes.com/sites/williampbarrett/2012/02/02/bbb-asks-charities-to-explain-deworming-med-valuations/
[28] http://www.pqmd.org/faq
[29] Confidence in the Nonprofit Sector through Sarbanes-Oxley-Style Reforms

whole, the beneficiaries of this United Way chapter lost $28.5 million in aid, $1.5 million from the CEO and $27 million from the drop in donations. The need for aid didn't drop by over 50% in the course of a year, but the resources to provide that aid did.

While a required audit is not a guarantee against fraud but rather an assurance of reasonable accuracy, an independent audit does have some features that fight fraud. First, an auditor might come across discrepancies when reviewing the books of an organization. The odds of catching a deliberate falsification of records directly through an audit are relatively low, around 9.1% according to the ACFE, but the bigger the fraud, the more likely that the auditor will catch it[30]. The second component of an audit is the review of internal controls of an organization and an advisement of how to better protect the integrity of the organization. This often comes down to basic things such as the segregation of duties within an organization and an anonymous hotline that employees/volunteers can use to report suspected fraud without fear of retaliation.

In summary, required audits would serve two purposes. The first is to increase comparability of charitable NPOs by introducing mandatory standardization of how the valuation of non-cash donations is executed. The second is to reduce fraud, not from the standpoint of guaranteeing against fraud, but from the standpoint of subjecting NPO financial records to scrutiny on a regular basis and shoring up internal controls within nonprofits.

[30] Fraud Auditing and Forensic Accounting

Solutions

To meet the need for greater comparability between charitable NPOs and the need for greater controls against fraud, the IRS's Tax Exempt and Government Entities (TE/GE) Division should undergo an expansion of duties to include the active monitoring and enforcing of nonprofits through the use of mandatory audits for charitable NPOs receiving a minimum of $250,000 in annual funding regardless of the source of funding for the charity or the type of funding, cash versus non-cash donations.

The determination of the annual revenue comes down to maximizing regulatory efficiency and working within the fiscal realities that face nonprofits. When analyzing the distribution of revenue among nonprofits, the $250,000 cutoff allowed for the monitoring of 99% of annual revenue attributed to reporting charitable nonprofits while only requiring audits of 22.7% of the population. Requiring the auditing of charitable nonprofits receiving less than $250,000 would place disproportionately large reporting requirements on NPOs that compose an insignificant piece of the NPO pie.

Table 2: Charitable NPO Distributions by Revenue Class

Number of Charitable NPOs by Revenue Class (2004-2013)

Annual Revenue	With Non-Reporting Charities: Total	Percentage		Without Non-Reporting Charities: Total	Percentage	
<$100,000	3,668,117	39.3%		3,668,117	65.5%	
$100,000-249,999	637,788	6.8%		637,788	11.4%	
$250,000-499,999	377,713	4.0%		377,713	6.7%	
$500,000-999,999	289,623	3.1%		289,623	5.2%	
$1-5 million	399,106	4.3%	13.9%	399,106	7.1%	23.2%
$5-10 million	92,552	1.0%		92,552	1.7%	
$10-100 million	118,512	1.3%		118,512	2.1%	
>$100 million	21,033	0.2%		21,033	0.4%	
not reported	3,738,053	40.0%				
	9,342,497			5,604,444		

Total Revenue for Charitable NPOs by Revenue Class (2004-2013)

Annual Revenue	With Non-Reporting Charities: Total	Percentage		Without Non-Reporting Charities: Total	Percentage	
<$100,000	$ 49,218,010,257	0.4%		$ 49,218,010,257	0.4%	
$100,000-249,999	$ 97,718,058,381	0.7%		$ 97,718,058,381	0.7%	
$250,000-499,999	$ 129,484,930,746	1.0%		$ 129,484,930,746	1.0%	
$500,000-999,999	$ 199,981,518,461	1.5%		$ 199,981,518,461	1.5%	
$1-5 million	$ 873,420,783,039	6.4%	98.9%	$ 873,420,783,039	6.4%	98.9%
$5-10 million	$ 643,463,662,678	4.7%		$ 643,463,662,678	4.7%	
$10-100 million	$ 3,192,957,615,209	23.6%		$ 3,192,957,615,209	23.6%	
>$100 million	$ 8,360,840,318,657	61.7%		$ 8,360,840,318,657	61.7%	
not reported	$ -	0.0%				
	$ 13,547,084,897,428			$ 13,547,084,897,428		

The boxed figures in both tables correspond with the revenue classes required to undergo audits under my proposal. The single percentage to the right of the boxed numbers is the total percentage applicable to the target group of NPOs. The category of "Not **Reported" represents charitable NPOs that receive less than $5,000 in annual donations and religious congregations. Both of these groups are not required to register and file with the IRS following the receipt of** a determination letter that gives these groups tax-exempt status. Since the "Not Reported" group does not record **revenue, a parallel set of figures with "not reported" left out has been provided. Additionally, the table regarding the** number of charitable NPOs uses the sum of nonprofits from 2004-2013, meaning that there are not 5,604,444 or 9,642,497 nonprofits. The use of a 10 year span allows for smoothing of the data.

This data was drawn from the NCCS gathered from the IRS. http://nccsweb.urban.org/tablewiz/bmf.php

In order to qualify for the audit requirement, the charities must average over $250,000 over the past three fiscal years so as to smooth out spikes and drops in their revenue flows. The audits are carried out by licensed CPAs in accordance with GAAS, generally accepted auditing standards, every two years. The reasoning behind the two year figure is to keep financial records available to the donating public informative and relevant due to the potential for a boom or bust cycle to happen within a charity. While having audits every year for charities would be optimal for inter-charity comparability and fraud prevention, the costs of implementing an audit, particularly for smaller organizations, outweigh the benefits received for annual audits. In regards to concerns that large amounts of money are not monitored closely enough, the larger the nonprofit is, the more likely it is to accept federal funds, thus placing it under the annual audit requirements of the OMB. The audits also include financial ratios specific to NPOs including the "percent spent on charitable purpose" that currently is subject to broad interpretation and inflation.

The penalties for failing to comply with biennial audits are twofold. The first offense results in a fine of 5% of total revenues as assessed by an IRS auditor. A second offense in a 10 year period leads to the loss of an organization's tax-exempt status. The reasoning behind the first penalty is to prevent organizations from abusing the system; the percentage fine is designed to be onerous enough to effectively deter the skipping of audits for charities of all sizes. The second penalty is designed to prevent an organization from continually absorbing the 5% fine in the pursuit of maintaining a tax-free entity without external scrutiny. The fines collected from uncooperative charities will go toward the general funds of the TE/GE Division of the IRS. Charities may petition the division if they believe themselves to be subjected to extenuating circumstances.

Form 990, the financial statements submitted to the IRS by NPOS, prepared by licensed CPAs are made available to the public via an internet database hosted by the IRS. Additionally the internet database would also host copies of audited financials performed in accordance with OMB regulations regarding federal funding. The audited financials on the database are free to query for the public. However the raw download of data comes with a one-time fee so as to partially offset the cost of hosting large amounts of data.

The charities undergoing audits are responsible for covering the costs of their own audits. The reason behind this is to preclude any signs of favoritism that would stem from federal subsidization. Additionally nonprofits may find that CPAs occasionally perform audits of NPOs pro bono, particularly of smaller organizations, making cost less of an issue for the more cost-conscious charities.

Stakeholders

As a result of the audit requirement, the donating public benefits from improved comparable data between charitable NPOs and improved confidence in the charities being donated to. The comparable data allows donors to make more efficient contributions to charitable causes. This conscious increase in the efficiency of contributions will increase the sense of happiness that people receive from helping others.

The beneficiaries of the work of charities benefit from enhanced service due to the more efficient allocation of donations. The increase in efficient giving to and subsequent use by charities is vital as the US continues to pick up the pieces from the 2008 Financial Crisis that left many people without work but with devastated finances. This need for an efficient use of resources is equally important for charities that operate internationally.

Charitable NPOs experience both pros and cons from this audit requirement. The first benefit that charities derive is improved donor confidence, which can lead to increased investment in NPOs, assuming that the NPOs are operating in a legal and ethical manner. The second benefit is smoothed interactions with for-profit entities that require verified financial records, such as when charities wish to secure debt agreements with banks or to start a capital expenditure project such as expanding a facility. The first downside that charities face is the cost of paying for an external audit. The second downside is the penalty aspect of failing to undergo external audits in a timely fashion, leading to potential fines or loss of tax-exempt status.

For-profit entities that work with charities will benefit from more readily available externally-verified financial statements. Having to put a business relationship on hold for several months while waiting for an audit to be conducted can be costly to the business, potentially leading to the business seeking other customers at the expense of the charity if the verification of financial health takes too long.

Technical Plan

Expansion of powers and responsibilities of the Tax Exempt and Government Entities (TE/GE) Division of the IRS

1. Receive authority from the Department of the Treasury to expand powers of the TE/GE Division.

2. Include budget for proposed expansion of TE/GE within the annual federal budget.

3. Receive requested funding from Congress

4. Formally expand division and write new audit requirements into the Internal Revenue Code.

Execution of independent audits

5. Use Form 990 as basis for determining which NPOs should start under the new audit requirements.

6. Use the previous two fiscal years as predictors of which charitable NPOs will be undergoing audits and submitting the results

7. Carefully review Form 990 for NPOs that historically had qualified for the audit requirement, but in the current year have dropped off in revenue.

8. Use tax deduction records from Form 8283, a tax deduction form for the donation of noncash assets, and from individual tax returns for cash donations to monitor for any upsurge in revenue into a previously nonqualified NPO that would make it a candidate for an external audit. This could be done with a computer program that compares donations against registered charities.

9. After receiving the audited financials from qualifying charities, upload these to the IRS public-facing network in an easily searchable format. Add audited financials from OMB audit requirements to the database. Make querying the database free and downloading the database require a small fee.

10. If a qualifying charitable NPO is found to have not submitted an audit, penalize it for 5% of its annual revenue. If this is its second omission in 10 years, strip the organization of its tax-exempt status. Include an appeals process that allows for 3 attempts to justify the omission.

Management Plan

The IRS, specifically the Tax Exempt and Government Agencies Division, is primarily responsible for implementing this plan. This ranges from the building/acquiring the physical infrastructure, the human resources needed to run this operation, the web infrastructure for public use, the digital pathways to receive audits from the OMB, and the predictive computer program for determining which NPOs will likely qualify for an audit. Additionally, the IRS will be responsible for fining the offending charities and revoking the tax exempt status of repeat offenders.

Congress will be responsible for allocating more funds to the IRS dedicated to this plan. Additionally, if granting new powers to a division of the IRS is outside the authority of the Department of the Treasury, then Congress is additionally responsible for granting the new powers through legislation.

The OMB is in charge of managing its audits of charitable NPOs receiving more than $750,000 in federal funding and funneling the applicable audits to the IRS for database purposes.

External auditors are responsible for conducting the audits in a professional manner that accurately states the financial positions of charitable NPOs.

Charitable NPOs are responsible for dutifully reporting accurate figures to the IRS and providing honest assistance to external auditors.

Costs

The costs for the IRS revolve around the cost of additional human capital, physically housing the division expansion, and the data management and webhosting. Due to the constantly shifting price of web-accessible data storage and the variable demand for personnel that rests on the degree to which the new policies are automated makes accurate pricing at this time impossible. Since the new responsibilities are similar to but smaller than the SEC, which has a budget of $1.3 billion, I would assume that the required IRS budget increase would be a miniscule drop in the bucket of a federal budget of over $3.5 trillion dollars.

The cost to qualifying charities is the cost of an audit, something that varies with the complexity and size of an organization. According to the Council of nonprofits, audits can cost around $10,000 for a relatively small NPO and potentially upwards of $20,000 for large NPOs[31]. It should be noted that many of the NPOs already undergo external audits, meaning that cost is a null factor to them.

[31] http://www.councilofnonprofits.org/nonprofit-audit-guide/what-is-independent-audit

Conclusion

The immense nonprofit sector in the US does huge amounts of good through bringing together communities and helping those in need. While I recognize the power for benefits that nonprofits bring to the public, I believe that those benefits could be maximized through the use of an external audit that would allow for greater, unbiased comparability between organizations and for reducing the opportunities for fraud. The federal agency best suited for pursuing this goal is the IRS with its Tax Exempt/ Government Entity division. With this in mind, I request the thoughtful consideration of this plan for strengthening the sector with the public's interests most at heart.

Bibliography

Brostek, Michael. "Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities." *U.S. GAO - Tax-Exempt Organizations: Improvements Possible in Public, IRS, and State Oversight of Charities*. US Government Accountability Office, 28 May 2002. Web. 05 Apr. 2014.

Buettner, Russ, and William K. Rashbaum. "Whistle-Blower's Letter Led to Charity's Firing of Chief Executive." *The New York Times*. The New York Times, 15 Sept. 2013. Web. 28 Apr. 2014.

Calabrese, Thad, and INC ELSEVIER SCIENCE. "Public Mandates, Market Monitoring, and Nonprofit Financial Disclosures." Journal of Accounting and Public Policy, 30.1 (2011): 71-88.

"Charity and Nonprofit Audits: Scope of Audits and Compliance Checks." *Charity and Nonprofit Audits: Scope of Audits and Compliance Checks*. Internal Revenue Service, 18 Oct. 2013. Web. 05 Apr. 2014.

"Charity Navigator Rating - American Red Cross." *Charity Navigator*. Charity Navigator, June 2012. Web. 28 Apr. 2014.

Colby, Robert. "Wrestling with Reform: Financial Scandals and the Legislation They Inspired." *(Fall of Enron)*. Securities and Exchange Commission Historical Society, 1 May 2013. Web. 05 Apr. 2014.

Ellis, Blake. "Taxpayers Hit with Fewer Audits." *CNNMoney*. Cable News Network, 21 Mar. 2014. Web. 05 Apr. 2014.

Fishman, Stephen. "IRS Charity Classification: Private Foundation or Public Charity?" *Nolo.com*. Nolo, Aug. 2013. Web. 05 Apr. 2014.

"IRS 2013 Audit Rates Vary Significantly Among Taxpayers." - *Blog*. Dulin, Ward and DeWald, Inc., 2013. Web. 28 Apr. 2014.

Kitching, Karen, and INC ELSEVIER SCIENCE. "Audit Value and Charitable Organizations." Journal of Accounting and Public Policy, 28.6 (2009): 510-524.

Mead, Joseph, and MICH LAW REV ASSOC. "Confidence in the Nonprofit Sector Through Sarbanes-Oxley-style Reforms." Michigan Law Review, 106.5 (2008): 881-900.

"Nonprofit Statistics." *Nonprofit Statistics*. Center for Nonprofit Management, 2012. Web. 05 Apr. 2014.

"Quick Facts About Nonprofits." *Quick Facts About Nonprofits*. National Center for Charitable Statistics, n.d. Web. 05 Apr. 2014.

Sarkar, Deepa. "Blue Sky Law." *LII / Legal Information Institute*. Legal Information Institute, n.d. Web. 05 Apr. 2014.

Sidey, Hugh. "The Dynasty The Kennedys." *Time*. Time Inc., 14 June 1999. Web. 05 Apr. 2014.

Singleton, Tommie W., and Aaron J. Singleton. *Fraud Auditing and Forensic Accounting*. 4th ed. Hoboken: John Wiley & Sons, 2010. Print.

"The IPhone Economy." The New York Times. The New York Times, 19 Jan. 2012. Web. 25 Apr. 2014.

"The Mission and Structure of the Office of Management and Budget." *The White House*. The White House, n.d. Web. 05 Apr. 2014.

"World Factbook - United States." *Central Intelligence Agency*. Central Intelligence Agency, 27 Mar. 2014. Web. 03 Apr. 2014.

"7 OMB Revisions to the A-133 Audit Requirements." 7 OMB Revisions to the A-133 Audit Requirements. Feeley and Driscoll, PC, n.d. Web. 25 Apr. 2014.