Are Your Best Opportunities Hiding in Plain Sight? Find out with an Operational Audit

Take a deep dive into the effectiveness of your organization's activities by performing a different kind of audit.

By John Citti

Some of your biggest opportunities are often right in front of your eyes, but it may take a shift in perspective to see them and make the most of them. That's true of your organization's operations, which, if you're like most nonprofits, you rarely take time to assess.

An audit of your operations can reveal vital ways to improve revenues, cash flow, expenses, investments, and much more. An operational audit performed by a skilled professional with a broad financial background can help you discover new resources and make better, wiser decisions.

What Is an Operational Audit?

Large organizations employ financial professionals to review operations, but most nonprofits are too small to hire such experts full time. Small and mid-sized nonprofits can benefit from hiring a financial professional on a consulting basis to perform an operational audit. You might be thinking, "Wait! We're audited every year by our CPA. Isn't that the same thing?" No, CPAs do essential work verifying balances on financial statements and preparing 990 forms, but operational auditing is outside their expertise.

In an operational audit, a finance professional reviews the processes for paying bills, recording accounting transactions, making investments, delivering employee benefits, and other operational activities. They review management reports, governance structure, and regulatory compliance to identify opportunities for improvement.

What Improvements Can You Expect?

An operational audit will provide you with valuable recommendations, such as the following, to improve operations:

INCREASE EFFICIENCY.

Many of your transactions can be automated, thus speeding up management-report production and making staff available for more value-added work. An experienced financial professional can recommend changes that increase efficiency by streamlining processes, making better use of existing technology, and helping you implement new tech tools.

For example, one nonprofit audit identified an opportunity to create efficiency in recording employee expenses by integrating the expense reporting software with the general ledger system, eliminating the need to enter data twice. The new interface reduced the burden on accounting staff and made it possible to reimburse employees more quickly.

CUT COSTS.

Software tools that raise efficiency decrease the need for additional staff, lowering overall compensation expenses. Outsourcing certain functions such as human resources or accounting is another way to decrease costs.

CONTINUED ON PAGE 14

An external financial professional is uniquely qualified to "run the numbers" to find opportunities to bring down expenses while maintaining the same service level through outsourcing firms. One such review found that outsourcing the human resources function could trim expenses while providing the same services as an in-house department.

LESSEN THE RISK OF FRAUD.

The risk of fraud at nonprofits is high. One reason is that they tend to operate with a lean staff. In addition, nonprofits often give too much authority to one person – the bookkeeper or accountant – without adequate oversight. In a recent news story, a nonprofit lost $2.6 million because a trusted in-house accountant fell on hard times and took money from the organization to cover her personal cash flow shortages. She intended to return the funds, but her financial situation prevented it.

Some nonprofit executives expect their CPA firm to catch or prevent fraud. While an annual audit will sometimes detect fraud, preventing it is management's responsibility and done through well designed internal control procedures. An experienced financial professional can review and test the internal controls and recommend necessary changes.

> **"Nonprofits often give too much authority to one person."**

REDUCE ERRORS IN FINANCIAL REPORTS.

Even if there is no fraud, inadequate procedures can result in reports that contain serious errors. The fallout can be worse than embarrassing. Incorrect numbers can cause leaders to make disastrous decisions.

In one case, the finance staff at a small nonprofit distributed reports that indicated a loss of $150,000 for the year. But the annual audit revealed that the actual loss was five times higher. The staff would have made much different funding and spending decisions if they'd known the real loss sooner. An operational audit will recommend changes to procedures that can prevent such reporting errors.

MAKE GOOD INVESTMENT DECISIONS.

Few bookkeepers or accountants have experience selecting investments or determining credit and investment risk. Even experienced professionals can inadvertently make poor investment choices, as seen from the Madoff investment scandal and the FTX fraud case. An operational audit conducted by a professional with investment experience can determine if the organization's portfolio is too risky. In that case, the recommendation might be to change the mix of assets or hire an outside investment advisor.

It's also possible for an organization to take too little risk. When an organization has strong revenue streams and cash reserves, it's prudent to begin building an endowment or other investment pool to provide long-range sustainability and income. Since such investment portfolios have a longer

> Nonprofits that rely on volunteers or a skeleton staff are especially vulnerable.

timeframe, it's appropriate to include some stocks and bonds for diversification and growth. An operational audit can determine if an organization is taking too much or too little risk with its investments.

COMPLY WITH REGULATIONS.

The penalties for failure to meet regulatory requirements on the federal and state level can include large fines and even loss of tax-exempt status. While CPA firms monitor changes in regulatory requirements, they can miss important updates. Small nonprofits that rely on volunteers or a skeleton staff are especially vulnerable to failing to comply with all the rules.

For instance, a church that was renting out space in its building didn't report the earnings from that business as unrelated business income (UBI). An operational audit showed that the church could be subject to tax on the revenue. In this case, the church was lucky. After a great deal of research by members of the congregation and the auditors, it was determined that there was no tax due. An operational audit can identify potential risks in the organization's regulatory compliance practices or give everyone comfort that the rules are being followed.

STRENGTHEN GOVERNANCE PROCEDURES.

Clearly defining the roles and responsibilities of different offices and committees creates an organization that runs effectively. But many organizations haven't assigned their staff or committees specific duties or haven't put those duties in writing.

For example, do the finance, investment, retirement, and other board committees understand their responsibilities and the extent of their authority? Does management clearly understand the approval process in all situations?

Certain activities should have specific policies. Investments are subject to economic, credit, regulatory, environmental, market, and even reputational risk. Gifts made in securities, commodities, and cryptocurrencies bring financial and reputational risks as well. How to manage these assets, the decision to sell or hold non-cash gifts, and whether to accept gifts from donors with certain characteristics should be spelled out in policies approved by the board of directors.

By defining the responsibilities of board committees and developing written policies, you'll decrease financial risk and confusion over authority. An operational audit can bring these risks to light and help you strengthen your governance structure. Such an audit is an easy, low-cost way to move your mission forward by seizing opportunities that are hiding in plain sight.

Opportunities Made Real

Good opportunities abound if you know where to look. Find more ways to improve governance, comply with regulations, increase income, avert fraud, and raise efficiency with articles such as these at NonprofitWorld.org:

What's the Best Way to Avoid Financial Misuse? (Vol. 36, No. 3)

Streamline Your Processes with These Key Steps (Vol. 40, No. 3)

Action Steps for Effective Governance: Test Yourself (Vol. 35, No. 3)

Are You Breeding the Conditions for Fraud to Occur? (Vol. 39. No. 3)

Investing with Care: How to Avoid Investment Scams and Surprises (Vol. 27, No. 4)

Top Tips for Writing Your Policies (Vol. 29, No. 5)

Do Your Board Members Know Their Fiduciary Responsibilities? (Vol. 33, No. 1)

IRS Proposes UBIT "Silo" Rules for Nonprofits (Vol. 38, No. 3)

Setting Up a Control System for Your Organization (Vol. 16, No. 3)

How to Move from an Operational to a Governance Board in Five "Easy" Steps (Vol. 39, No. 3)

John Citti, CPA, CTP, MIM (john@impactingnonprofits.com, impactingnonprofits.com), builds nonprofit resources and capacity through outsourced financial management and financial consulting.