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What is an independent audit?

The terms "audit" or "audited financial statements" in this Nonprofit Audit Guide© refer to the work product resulting from the independent examination of a nonprofit's financial records by a licensed certified public accountant (CPA) (also referred to in this Guide as the "auditor," or the "auditing firm").

An independent audit 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 the fact that the auditor/CPA is not an employee of the nonprofit but instead is retained through a contract for services, and hence is "independent."

During the independent audit, the auditor will review the organization's financial statements to determine whether they adhere to "[generally accepted accounting principles](#)" (commonly referred to as "GAAP"). These accounting principles are created by the "[Financial Accounting Standards Board](#)," known as "FASB." While not law, these standards carry weight - when they are not followed, the auditors are required to note that in their report.

Why would a nonprofit want to have an audit?

Some independent financial audits are required by state or federal regulations. However, even when not required a nonprofit may choose to have an independent

audit for a few important reasons:

- Independent audits are important for inspiring and maintaining donor trust because they demonstrate that the nonprofit is committed to financial transparency and accountability.
- Audited financial statements help the board of directors have more confidence in the organization's finances because they are based on an analysis by an objective third party.
- Some private foundations require that grant applicants and grantees submit audited financial statements, or similarly certified financial statements, in order to be eligible for funding.

"It is a common misconception that audits serve primarily to uncover fraudulent activities, like embezzlement. Audits rarely detect fraud, but auditors can provide nonprofits with information, tools, and strategies to better protect against such occurrences." Source: [How independent audits and audit committees protect nonprofits](#) (Nonprofit Law Blog)

The Auditors' Report

FASB principles require the auditors to issue a **report** to the board of directors of the nonprofit 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. The Disclaimer report essentially signals: "Something prevented us from forming an opinion, therefore we refuse to do so." Either one of the first two reports is preferable to the adverse opinion or a disclaimer report.

- Receiving an Adverse Opinion or Disclaimer of Opinion can have a serious negative impact on efforts to obtain funding for your organization.
- Sample [audited financial statements](#) that express an unqualified opinion.

Cost and alternatives

The cost of an independent audit varies depending on the geographic region where the nonprofit is located and how large the organization is. Audit fees can be significant for large nonprofits located in major urban areas. The cost is often daunting even for small nonprofits. Because independent audits require a **significant investment** of resources, including staff time and board member time, there is a growing trend among smaller nonprofits to have a "remote audit," which means that the auditors conduct the audit without a site visit.

As an alternative to an independent audit, auditors can provide either a financial statement "[review](#)" or a "[compilation](#)." Neither a review nor a compilation is a substitute for an audit.

If an audit is required by law, or if a third party has strict requirements that the nonprofit conduct an audit, a review or compilation will not satisfy that requirement. Nevertheless, nonprofits trying to manage costs should not be shy about asking whether the third party will accept a review in place of a full audit. The third party (usually a funder) may understand the goal of cost savings and accept a review instead.

Some nonprofits do not conduct an audit annually, but instead conduct one regularly every few years (or whenever there is a significant change in the organization's operations). In the years when the nonprofit does not have an independent audit the nonprofit could elect to have its financial statements reviewed instead.

- [Does your nonprofit need to have an independent audit?](#)
- Learn about [reviews and compilations](#) of financial statements.
- Read more about costs on the [selecting an audit firm](#) page of this Guide (part of the [three-step approach to managing an independent audit](#)).

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Disclaimer: *The resources in this Guide are offered for informational purposes only. The National Council of Nonprofits recommends consulting a lawyer or accountant who has expertise in accounting rules for charitable nonprofits so that you can be confident that your charitable nonprofit is in compliance with all legal requirements. And, when your organization is looking for trusted information about financial management practices, good governance, and accountability, don't overlook the resources that membership in your [state association of nonprofits](#) can provide.*