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Untangling the Audit Confusion

Your audit will go more smoothly if you're familiar with these steps.

By Frank J. Grippo and Joel G. Siegel. Reprinted with permission.

Nonprofit managers are often confused about the role of auditors—and about their own role in an audit. Auditors, for their part, don't always understand the special challenges of auditing a nonprofit organization. To help sort out this confusion, here is a rundown of steps that auditors and nonprofits should take:

Step 1:
Understand the audit's purpose.

The role of auditors is to give an opinion on the fairness (accuracy and validity) of the financial statements as a whole (not on individual accounts). That is, they determine whether the financial statements are in conformity with generally accepted accounting principles (GAAP).

Auditors do their work in accordance with generally accepted auditing standards (GAAS). They aren't concerned with the financial quality of the organization, the business acumen of management, or the business decisions that management made. Rather, the auditors' primary concern is with financial presentation.

Nonprofit professionals should be familiar with three publications:

***Accounting for Contributions Received and Contributions Made,* Statement of Financial Accounting Standards (SFAS) No. 116,** issued by the Financial Accounting Standards Board (FASB), requires nonprofits to distinguish between contributions received with permanent restrictions, temporary restrictions, and no restrictions. It also stipulates that promises to give with payments in the future (pledges) must be reported at fair value.

***Financial Statements of Nonprofit Organizations*, SFAS No. 117,** establishes standards for preparing general-purpose financial statements for nonprofits. A statement of financial position, a statement of activities, and a statement of cash flows are required. In addition, voluntary health and welfare organizations must provide a statement of functional expenses.

Audits of Certain Nonprofit Organizations is issued by the American Institute of Certified Public Accountants (AICPA). Its purpose is to enhance understanding of accounting issues. It provides guidance for accountants, auditors, and nonprofit professionals about performing audits.

Step 2:
Understand the nonprofit environment.

As stated in Statement on Auditing Standards (SAS) No 22, *Planning and Supervision*, "auditors should obtain a level of understanding about the nonprofit organization that will allow them to understand the events, transactions, and practices that, in the opinion of the auditors, will have a significant effect on the financial statements including knowledge about matters that relate to the nature of the nonprofit organization, operating characteristics, and accounting practices common to the nonprofit organization."

There are a number of differences between nonprofit organizations and profit-making enterprises that require the modification of audit procedures. These include: organizational goals, source and use of resources, measures of performance, accounting and management controls, personnel issues, business and activity constraints, funding sources, legal requirements, political and economic issues, and operating characteristics such as sources of revenues (for example, contributions versus service fees).

In addition, the following complexities of nonprofit organizations affect the way auditors will check their financial statements:

- audit restrictions imposed by funding sources, such as eligibility requirements
- risks associated with the use of volunteers, in-kind services, and nonprofit boards
- problems associated with comparing budgets to actual results
- the difficulty of accounting for multiple programs, grants, or contracts with year-ends different from the nonprofit's year-end
- risks caused by complex chart of accounts and coding systems
- tax considerations resulting from unrelated business income
- specific audit requirements imposed by the funding source that go beyond generally accepted accounting principles (GAAP) for nonprofit organizations

Step 3:
Make a judgment about materiality.

Auditors' next step is to review the financials and determine which items are material. Material transactions are those that, in the auditors' opinion, have an impact on the organization's overall financial condition.

Materiality is a judgment call of the auditors. The decision of what is material will vary from auditor to auditor.

Auditors must obtain a preliminary understanding of materiality before planning the audit. Their goal is to conduct the audit so that there is little risk of failing to detect important misstatements.

Auditors use a number of approaches when they make preliminary judgments about materiality. One common method is to measure materiality in percentages using a base (such as total assets or total revenues) that is relevant to the organization's financial position.

Step 4:
Understand the five components of internal control.

Unless auditors have an understanding of the internal control structure, they can't assess the risk in financial statements. A nonprofit's internal control structure consists of five major components, which auditors must make sure are in proper place in the organization:

Component #1: The control environment sets the organization's tone. It determines whether managers believe that financial control is important. The control environment consists of the following factors:

- integrity and ethical values (management's moral and behavioral standards)
- commitment to competence (extent to which employees have appropriate skills)
- board and audit committee (amount of involvement and direction provided to management)
- management's philosophy and operating style (approach to managing its business)
- organizational structure (relationships and guidelines on who reports to whom)
- authority and responsibility (how both are assigned)
- human resource policies and procedures (hiring an adequate number of employees with the skills, knowledge, and values to meet the demands of the business)

Component #2: Control activities are the policies and procedures used to pinpoint risks and situations that would prevent the organization from achieving its mission. Control activities include accounting controls (such as segregation of duties) and administrative controls (such as performance reviews).

Component #3: Risk assessment is an evaluation of the following three types of risks:

- ***Control risk*** is the risk that a material misstatement will bypass the internal control structure and get through to the financial statements. To assess this risk, auditors note the effectiveness of checks and balances, such as segregation of duties and physical controls.
- ***Inherent risk*** is the risk that a material error will find its way into the financial statements because there is no way to control it. Inherent risk is present even in organizations with good internal controls. As stated in SAS 47, *Audit Risk and Materiality in Conducting an Audit*, inherent risk is “the susceptibility of an assertion to a material misstatement assuming no controls existed.” Examples of inherent risks are technological advances, management turnover, skill levels of managers, and past problems and practices. Any of these factors may cause a misstatement in the financial records. In addition, nonprofit entities experience a number of financial pressures such as inflation, retrenchment, adverse demographics, and reduced funding. The typical nonprofit responds to these pressures by such measures as cost cutting, expanding alternative programs, aggressive investment strategies, interfund borrowings, external debt, and aggressive fundraising strategies. Such responses expose auditors to additional risks. Auditors need to know what the potential risks are so that they can properly design their audit program.

- ***Audit risk*** is the risk that auditors may give an unqualified opinion on financial statements that are misstated. To lessen such problems, auditors must determine which components of the financial statements have a greater risk for material misstatement and plan and prepare their audit work accordingly. SAS 47 requires that auditors assess audit risk, including the risk of errors in the financial statements due to fraud. SAS 82, *Consideration of Fraud in a Financial Statement Audit*, states that "auditors cannot obtain absolute assurance that the financial statements are free of material misstatements caused by fraud. The role of the auditors is to obtain reasonable assurance that the financial statements are free from material misstatement." When it comes to audit risk, there is no important distinction between error and fraud.

Component #4: Information and communication refers to the accounting system used to prepare financial statements and to provide stakeholders with financial information. The auditors need to decide whether this reporting system is working properly. An effective reporting system will be able to do the following:

- ***Identify and record*** all transactions that occurred.
- ***Present transactions*** in enough detail to permit proper classification in the financial statements.
- ***Assess transactions*** so that their proper monetary values are reflected in the financial statements.
- ***Reflect transactions*** in the proper accounting period.
- ***Prepare financial statements*** so that stakeholders understand the nonprofit's rights and obligations.

Component #5: Monitoring explains how well the organization's managers assess the internal control structure's effectiveness over time. Managers must evaluate and update the internal control structure on a regular basis.

Step 5:
Plan and perform the audit.

It is vital that auditors perform the above steps before they establish their audit objectives. Only then can they plan the audit, decide what auditing procedures to use, and determine the timing and extent of their work.

Audit procedures should be designed to detect noncompliance with donors' requirements. For example, a donor may make a large gift and require that only the interest can be used for operating activities. The principal should remain as a permanently restricted gift. Auditors must design their audit program to discover whether this is the case. Any use of contributions that isn't congruent with donors' restrictions exposes the nonprofit organization to legal penalties.

The auditors should summarize all areas of noncompliance—no matter how small—and tell managers how to address these problems. Auditors usually do so by preparing an audit report and an opinion letter. The report gives the auditors' opinion on the validity and accuracy of the financial statements. The letter summarizes weaknesses in the organization's internal control system along with suggestions for improvement. The organization's managers should share this letter with the board and devise a plan to correct the problems.

Step 6:
Reevaluate the audit approach every year.

Resource inflow and outflow will be different each year because of evolving business conditions. Thus, auditors and nonprofit managers must reevaluate their objectives and methods every time they perform an audit.

Resources

Muehrcke, Jill, ed., *Accounting & Financial Management, Leadership Series, Volumes I and II.*
O'Neil, Michael, "Preparing for Today's Nonprofit Audit," *Nonprofit World*, Vol. 13, No. 4.
O'Reilly-Allen, Margaret, "How to Have an Audit without Breaking the Bank," *Nonprofit World*, Vol. 20, No. 4.
Ross, Frank, "The Audit Committee: Why You Need One, How to Form One," *Nonprofit World*, Vol. 6, No. 6.
Sopher, Marti, "Setting Up a Control System," *Nonprofit World*, Vol. 16. No. 3.

These resources are available from the Society's Resource Center, www.snpo.org.

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A Short Audit Glossary

AICPA (American Institute of Certified Public Accountants) is the organization that develops accounting practices. The AICPA publishes the Statements of Position (SOPs) and Audit Guides that auditors use to perform audits.

Audit committee is a board committee set up to review the audit plan and financial statements with the auditors and oversee the organization's internal accounting controls.

Audit report is the auditors' written opinion on how accurate and sound the organization's financial statements are.

Audit risk is the risk of auditors giving an unqualified opinion on errors, including fraud, in financial statements.

Control risk is the risk of errors on financial statements due to an organization's internal controls.

FASB (Financial Accounting Standards Board) was formed by the AICPA to issue accounting standards.

GAAP (Generally Accepted Accounting Principles) are the accepted rules of accounting. They are dynamic and subject to change as new information becomes available and are often issued in AICPA and FASB publications.
Auditors must state in their opinion letter whether the financial statements are presented in conformity with GAAP.

GAAS (Generally Accepted Auditing Standards) are the rules that auditors must observe when performing an audit. Their opinion letter must state whether the audit was performed in accordance with GAAS.

Inherent risk is the risk of errors in financial statements because the organization's internal controls can't guard against them.

Internal controls are the checks and balances used by an organization to protect its assets.

Materiality is a concept used by auditors to determine the impact of various transactions on the organization's overall financial condition.
Judgments about what is material will vary between auditors.

Opinion letter (also called the management letter or letter of reportable conditions) accompanies the audit report. It tells the organization's management what deficiencies exist in the internal control system and how those problems can be corrected.

SAS (Statements on Auditing Standards) are interpretations of GAAS issued by the Auditing Standards Board. Rule 202 of the Code of Professional Conduct requires compliance with SAS. Thus, auditors must justify any departures from SAS.

SFAS (Statements of Financial Accounting Standards) are new or modified GAAPs issued by the FASB.

How You Can Save Time & Money on Your Audit

Your audit will go faster and cost less if you understand the steps auditors take. Be available to answer auditors' questions, and be prepared to give them the documents they need. Below is a checklist of information you should have available to share with auditors:

• articles of incorporation and bylaws
• state and federal tax-exempt letters
• documentation of any relationships with other tax-exempt organizations and taxable subsidiaries
• a list of board members' names, addresses, and titles
• minutes of board and committee meetings
• job descriptions for accounting personnel
• a list of transactions between the organization and members of the board
• a representation letter, signed by the executive director, stating that management is responsible for the presentation of financial statements, that all records have been made available to the auditor, that contracts are in compliance, and that illegal acts have not been committed
• a list of any events occurring after fiscal year-end that may negatively impact the organization's financial condition
• prior year's audited statements and tax returns
• books of original entry, including the general ledger, cash-receipts journal, cash-disbursements journal, payroll journal, pledges receivable, grants receivable, and accounts payable
• balance sheet and income statement
• budget comparison of revenues and expenses
• written explanations of variance between budget and actual results
• functional expense reports for such functions as fundraising, administration, and programs
• a list of all active and closed checking, savings, and money market accounts used during the fiscal year, including account numbers, type of account, purpose, custodians, names of all check signers, and any restrictions on disbursement
• a reconciliation of each bank account
• an explanation of the location of petty cash and procedures for its access
• a list of all investments
• an explanation of inventory policies, including the location of inventory, method and frequency of counting inventory, procedures to prevent theft, and policies to safeguard items
• a schedule showing all purchases of property, plant, equipment, and improvements
• copies of all purchasing documents
• a schedule of any prepaid or deferred charges at fiscal year-end, such as prepaid rent, prepaid employee benefits, insurance, and postage remaining on postage meters
• list of other assets, such as travel advances, security deposits, telephone deposits, and loans receivable
• an aged listing of all accounts receivable and payable
• a schedule of all outstanding debt, including mortgage, lines of credit, and short-term notes payable
• a schedule of deferred revenues—funds received during one accounting period but applicable to services to be performed or expenditures to be incurred in a later accounting period
• a schedule of insurance policies
• a description of all income-producing activities and an explanation of how each activity accomplishes the organization's exempt purpose
• a list of all contributions received and services donated
• purchase orders, canceled checks, and vendor invoices
• copies of payroll forms, including Employer's Quarterly Federal Tax Returns, State Unemployment Tax Forms,
State Income Tax Withholding Forms, Employer's Annual Federal Unemployment Tax Return, Social Security Forms, and Worker's Compensation Insurance Policy Forms
• a copy of the organization's personnel handbook
• copies of all lease agreements and a schedule of required lease payments for rented property and rented equipment
• a schedule of all transfers among funds

How Good Are Your Internal Controls?

The better your internal control system, the more pain-free your audit will be. Ask yourself these questions. If your response to any of them is "no," focus on remedies to turn it into a "yes."

___ **Do you have written policies and procedures**, including a personnel handbook, spelling out what is permissible and what isn't?

___ **Do you keep detailed, accurate records**, including financial, payroll, and personnel records?

___ **Have you prepared an organizational chart** showing your management structure, including key volunteer positions?

___ **Does your financial reporting system** classify transactions properly and completely?

___ **Before you hire employees**, do you check their references carefully?

___ **Do you present financial information** to your stakeholders in an understandable form?

___ **Do you review your internal controls** at least once a year and make any necessary changes?

___ **Are you careful to track donations** and comply with donors' requirements?

___ **Do you understand** all federal and state guidelines that apply to your organization's financial statements?

___ **Is your budget realistic**, and do you compare it to actual results on a regular basis?

___ **Do you evaluate all risks** that may affect your financial reports?

___ **Do you keep flowcharts** of your accounting systems?

___ **Are you aware of the potential** for error and fraud so that you're ready to act before they occur?

___ **Do you separate financial duties** among employees, making sure that the person who collects cash doesn't maintain bank records?

___ **Does your board** review your financial statements, and do board minutes reflect that fact?

___ **Do you document controls** on your information systems, such as who has access and passwords to accounting programs?

___ **Is financial integrity** the foundation of your organization's operations?

___ **Do you know how you will respond** to an internal-control weakness?

___ **Do you have procedures for reporting deficiencies** to top management and the board of directors?