NONPROFIT AUDIT 101

A Guide to the Fundamentals and More

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Overview

If you're a nonprofit leader, you know all too well the audit process can seem cumbersome. In fact, according to **2016 Nonprofit Finance Study** respondents, more than half of their organizations require two weeks, plus, to prepare for an audit.

This burden is compounded for the 36 percent of nonprofit finance professionals who report undergoing more than one audit a year.

In addition to feeling burdensome, audits can be costly – ranging from $5,000, up. Way up.

However, you also know that the benefits your organization can glean from financial clarity and transparency can mean the difference between mission success and merely getting by, year-over-year.

From the nuts and bolts of the nonprofit audit, to selecting the right auditor for your organization, to recognizing how technology can empower and protect you through the process, our **Nonprofit Audit 101 Guide** covers exactly what your nonprofit finance team must understand to drive growth and success.

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Chapter One:

The Fundamental Nuts and Bolts

An "audit" or "audited financial statements" refer to the "work product" resulting from the independent examination of a nonprofit's financial records by a licensed certified public accountant (also referred to as an auditor or auditing firm), according to the Council of Nonprofits.

Some types and formats of an "audit" may include:

Independent Financial Audits

Independent audits are called such, because the certified public accountant (CPA) conducting your examination is not employed by your nonprofit, but instead contracted to provide an unbiased "independent" opinion regarding whether your financial statements are free from material misstatement.

An independent audit typically includes the examination of financial statements, comprised of your organization's statement of financial position, related statement of activities, cash flows for the year ended, and related notes to the financial statements.

The auditor conducts his or her audit in accordance with generally accepted accounting principles (GAAP).

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected are at your auditor's discretion, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Many CPAs or auditing firms refer to their work as Assurance Services, because an audit is the highest level of assurance an auditor can provide and an organization can receive on a set of financial statements.

The end product, submitted to your Board of Directors and/or Audit Committee, is typically called an Independent Auditor's Report, or opinion letter, because it expresses an opinion regarding your financial statements, based on the completed audit.

Three Stages of an Audit

1 **Stage One: Planning**

In this stage, your auditor will likely send you an engagement letter, which is essentially a vendor agreement, along with a "Prepared by Client" list that outlines what supporting schedules your auditor needs you to prepare and share.

2 **Stage Two: Field Work**

Here, the actual audit is performed, complete with testing and conversations with key staff members.

3 **Stage Three: Post Work**

The auditor's final report is submitted to your Board of Directors and/or Audit Committee.

Chapter One:
The Fundamental Nuts and Bolts (continued)

Common Misconceptions of an Independent Financial Audit

1 **Misconception: The auditor's report includes an opinion on the nonprofit's internal controls.**

Fact: Though your auditor is certainly checking to see if your internal controls are designed and implemented appropriately, he or she will not render an opinion regarding the operating effectiveness of your internal controls.

2 **Misconception: The audit is intended to detect fraudulent activity.**

Fact: An audit is not initiated to detect fraudulent activities; however, in reviewing and questioning financial statements and personnel, fraud may be detected. If something looks off, either due to fraud or error, it will be brought to your board's attention.

Your Role in the Independent Audit

As the client, you're expected to prepare and fairly present your financial statements in accordance with accounting principles generally accepted in the U.S.

This includes the design, implementation, and maintenance of internal controls relevant to the preparation, and fair presentation of financial statements that are free from material misstatement.

Single Audits

If your nonprofit expends $750,000 or more in federal or state funds in a single fiscal year, you're required by law to undergo a single audit under the 2 CFR Part 200, Subpart F (Uniform Guidance).

The Single Audit Act of 1984 was passed (and later amended to extend the single audit concept to nonprofit organizations) to provide assurance to the federal government that a nonprofit's (or state's, city's, or university's) management and use of these substantial federal funds comply with the federal government's funding requirements.

A single audit differs depending on the recipient and the federal program, but generally speaking, it covers the entire scope of an organization-wide financial audit, plus a compliance-based audit.

The federal government requires auditors to perform a compliance audit in both the planning stage and field work stage. In the planning stage, the auditor is required to determine whether there's a high risk that the nonprofit doesn't comply with laws and regulations, identify the relevant federal program, and evaluate the program.

In the actual field work stage, the auditor audits the federal or state assistance and programs. Per the Office of Management and Budget (OMB), the auditor must "perform a compliance audit that scrutinizes operations of the specific government-funded program, examining files, documents, contracts, checks, etc. These functions are compared with the laws and regulations applicable to the program to see if they comply or not. The auditor is required to perform enough procedures to form an opinion on whether the program (as a whole) complies with laws and regulations."

Chapter One:
The Fundamental Nuts and Bolts (continued)

Other Types of Financial Reviews (Non-Audits)

Compilation Report

An Independent Accountant's Compilation Report is just as it sounds, a compiled report of an organization's financial position, including related statements of activities, functional expenses, and cash flows. It's not an audit or even a review of financial statements. And thus, no opinion or assurances are provided regarding whether the financial statements accurately reflect the organization's financial position or are in accordance with GAAP.

A compilation report merely provides an organization with formatted financial statements and records that can be easily reviewed and consumed by third parties, such as your board or bank.

Independent auditors are contracted to take the numbers provided by management and prepare compilation reports on the rare occasion a nonprofit simply doesn't have the internal capacity or expertise to put together financial statements in proper format, or when it's looking for a substantially lower cost than conducting an independent financial review or audit.

Financial Review

An Independent Accountant's Financial Review falls somewhere between a compilation report and an audit.

Substantially less in scope than an audit, it's a review of a nonprofit's statement of financial position, statement of activities, and cash flows. It includes applying analytical procedures to management's financial data and making inquiries of an organization's management.

A financial review is conducted in accordance with Statements on Standards for Accounting and Review Services, issued by the American Institute of Certified Public Accountants. These standards require the auditor to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements.

Nonprofit leaders will typically have a financial review conducted to provide some kind of assurance to either a regulatory body, insurance company, or lender that their organization's financial statements have been reviewed by a CPA. And, because you're provided less assurance, the price tag for a financial review is lower than that of an audit.

Chapter One:
The Fundamental Nuts and Bolts (continued)

Why Conduct a Financial Audit or Review?

You may not be required, by law, to conduct an audit or review. So, why go through the entire process and related expense?

Having your financials audited or reviewed by an unbiased, third-party professional is all about fiduciary capacity. When a nonprofit acts in a fiduciary capacity to safeguard the funds entrusted to it by donors and other funding sources it feels obligated (or perhaps should) to assure funders that it is, in fact, protecting their funds.

In a nutshell, an audit or review:

- Assures supporters – and particularly your high-wealth donors – that you're being a good steward of their donations, which can positively impact future fundraising efforts.
- Assures government funders that you're conducting your accounting correctly.
- Gives board members and executive leadership the confidence to make important data-driven decisions that impact the future sustainability and growth of your organization and mission.

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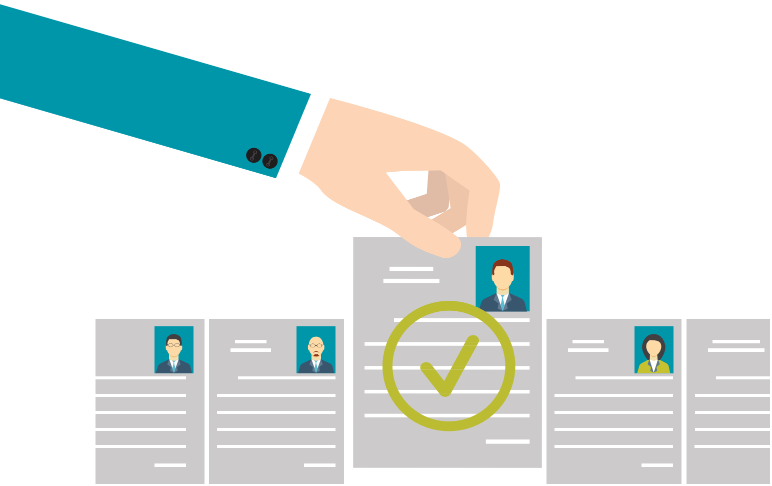
Chapter Two:

How to Select the Right Auditor for Your Organization



Nonprofit audit services require a unique expertise, so you'll want to look for an auditor who specializes in nonprofit audits; someone with a firm grasp on accounting principles that specifically relate to the nonprofit sector.

You might consider using a request for proposal (RFP) to solicit proposals and narrow the field. You'll find plenty of examples and templates online by searching key words such as, "nonprofit audit RFP." In-person interviews should also be conducted, whether you go the RFP route or not. These interviews are a prime opportunity for you to understand the level of detail an auditor will provide.

Some merely offer the basics, while others will conduct detailed analytic procedures that compare your organization's current year financials to prior year's. During this procedure, the auditor will compare year-over-year performance, and note and investigate any anomalies to identify potential high-risk areas.

In addition, a comprehensive audit will analyze the way contributions are used, by computing the relative percentages of each type of income distribution and comparing the results with other "like" nonprofits in your revenue range, vertical, and geographic area. Again, the purpose is to identify and investigate anomalies.

Planning for Your Audit

Before beginning your auditor search, you should conduct thorough internal planning. Fiscal Management Associates (FMA), in its Nonprofit Auditor Selection Guide, suggests these five planning steps:

1. Ensure that the board's audit committee is involved in the selection process from the beginning. If your organization doesn't have a separate audit committee, the finance committee should take on this role. Identify one individual from the committee to manage the process and coordinate with members of management.
2. Clarify the logistics of the selection process and determine a timeline to complete the process and finalize the decision.
3. Conduct initial research (for example, gathering recommendations from peer organizations).
4. Identify key attributes of the auditor and determine a method for auditor evaluation.
5. Consider your organization's strategic objectives and plans in selecting an auditor.

Chapter Two:
How to Select the Right Auditor for Your Organization (continued)

Word to the wise: Don't be terribly concerned if anomalies are uncovered during your audit – this is not an uncommon occurrence. And, unless they're significant, they likely don't point to a high risk of material misstatements in your financials.

A thorough audit will also carefully analyze your accounting system to ensure you're taking extra care to avoid unethical accounting practices and costly mistakes. This includes closely examining your system of internal controls – the policies and safeguards you have in place to protect your cash and financial records from fraud and/or mismanagement.

Lastly, when conducting an exhaustive audit, your CPA will review your reporting procedures to ensure that reports are accurate and submitted in a timely fashion.

Of course, the more comprehensive the audit, the costlier. For example, a small, two-person audit shop that provides you with minimum assurance that there are no material misstatements in your financials may charge as little as $5,000 to conduct your independent audit. While, a detailed audit for a large nonprofit with multiple operations and significant revenue could cost into the millions.

What Role Do Internal Controls Play in Your Audit?

Proper internal controls are essential for all organizations, says the Greater Washington Society of CPAs Education Foundation. They can also help ensure a clean audit. Controls around cash are generally the most important to a nonprofit, as cash is the asset that's most likely to be misappropriated. Here are sample controls you should consider:

Cash - General

- Do not allow a single employee to handle a cash transaction from beginning to end.
- The cash handling function should be separated from the function of recording cash transactions in the books of account.
- Cash receipts should be deposited to the bank intact on a daily basis.
- Employees not involved with cash processing should prepare bank reconciliations.
- Bank reconciliations should be performed on a timely basis at the end of each month.

Cash – Disbursements

- A separate purchasing function that includes all necessary approvals, well-organized information, and documentation for all purchases.
- A separate receiving function to verify that all goods ordered have been received in proper condition, etc., using documentation from the purchasing function.
- A process whereby the accounting department prepares the disbursement check from the vendor invoice, including all approved and matched documentation from purchasing and receiving.
- Checks signed only by authorized individuals, only with the availability of the complete voucher package, and only after complete agreement of all documentation is reviewed (also, the voucher package should be effectively canceled after payment to ensure that duplicate payments do not occur).

Chapter Two:
How to Select the Right Auditor for Your Organization (continued)

What Happens if Fraud is Discovered?

As you're interviewing independent auditors, be sure to ask them what happens if they find fraud.

- Will they simply alert you of the anomalies they've discovered?
- Or will they help to gather evidence and assist in the investigation?
- Do they have the capacity to guide you through the "what's next?"
- Can they connect you with a fraud examiner to further the investigation?

Can they advise you on how to bolster your internal controls to avoid fraud from going undetected again in the future?

Chapter Three:
From the Auditor's Perspective

In most standard audit opinions, you'll see language that outlines "Management's Responsibility for the Financial Statements."

Basically, you're "… responsible for the preparation and fair presentation of financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error."

So, what all does that entail? Here, from an auditor's perspective, is how you can create a "perfect world" scenario for the field work stage of your audit. You should provide:

- All the supporting schedules (requested by your auditor in the planning stage) for all your financials gathered, well organized, and ready to hand over. This list may include schedules and reconciliations around cash, investments, accounts receivables, accounts payable, expenses, fixed assets, revenue, net assets, debt, and more. All your numbers on your supporting schedules should add up and agree to your accounting records. If they don't, there's not a whole lot your auditor can do.
- Thorough documentation around your accounting procedures and internal controls – either provided to your auditor in a Word document or spreadsheet. Your documentation should answer questions like, "How do you process money coming in?" "How do you process money going out?" And, "How do you handle cash?" If you don't have this documented, your auditor will have to gather this information through interviews with your nonprofit's management.
- Explanations for any large variances your auditor will uncover during the analytical process. (For example, if your fixed assets went up by 30 percent this year, you should let your auditor know, up front, that your nonprofit added a new program during the fiscal year and had to purchase two new vehicles to support it.)
- Dedicated accommodations in which your auditor can conduct his or her field work.
- A point-person in your organization to act as a liaison between your finance team and independent auditor.

Red Flags

These red flags may, at the very least, mean your audit will be a bumpy ride, and at most, indicate you're at risk for material misstatements:

- ! You don't have supporting schedules
- ! Your numbers don't add up and/or don't agree
- ! You don't have internal controls, or if you do, they're not documented and accessible
- ! You have large "Miscellaneous" or "Other" expense categories (indicating a possible classification issue)
- ! You're unorganized, handing over to your auditor the dreaded, disordered box of documents

Chapter Four:
How Technology Can Help Ensure a Smooth Audit

For some, particularly small nonprofits, out-of-the-box accounting software may be all you need to organize, track, and report your financials. However, if you find yourself using one-off spreadsheets to manage various programs, this could leave you open to error and inadvertent financial mismanagement, and consequently, a rocky audit.

Using a true fund accounting™ system can help you better track budget progress, meet compliance and reporting standards requirements, make informed financial decisions, and prepare for your audit.

A true fund accounting™ system provides you with:

A fully-auditable general ledger
If any modifications are made throughout the fiscal year to invoices, for example, you and your auditor will have full visibility into the entire trail of changes. On the contrary, if you're using generic accounting software or Excel spreadsheets, there's no way to know if entries are deleted or modified, creating a potential security risk. Your accountant would just see the last item entered, and would have no way of knowing if he or she needed to dig deeper.

Compliance help
You can easily generate a product and loss statement (P&L) for your auditor so he or she can examine and test expenses back to each individual grant. Your fund accounting software-generated P&L will show exactly what was expensed, without having to track down and pull numbers from multiple spreadsheets.

The ability to classify net assets
You may classify your net assets (typically as permanently restricted, temporarily restricted, or unrestricted) and provide this information to your auditor, who can then quickly and clearly see what restrictions are satisfied. Because these classifications are already made in the system, you save your auditor time reconciling. And then, because you're starting the new year reconciled, you save yourself time not having to conduct an entirely new exercise of reclassifying assets.

The capability to easily pull grant information
Your true fund accounting™ system will help you track grants by funding source, group them by state or federal grantors, and even assign attributes to these grants. When your auditor asks for grant-specific details, you can swiftly pull the necessary information into a report. This capability is particularly helpful when determining if you require a single audit, because it can clearly show auditors whether your organization falls above or below the monetary threshold.

The ability to create multiple budgets
A true fund accounting™ system allows you to create as many budgets as your organization needs for its various funding sources and programs, and then report back out on these budgets, individually. This will help you keep track of money within categories, as well as keep an eye on expenses.

Chapter Four:

How Technology Can Help Ensure a Smooth Audit (continued)

Easy access to fixed assets
Because you can easily scan and attach invoices when you enter them into your fund accounting software, your auditor can pull them directly out of the system.

Robust security controls
Within your fund accounting software, you have complete control over who has access to what. For example, your program managers can be given access only to their specific program budget. Your executives can be given executive-only access. You can even give your auditor access, so he or she can self-serve within the system during the field work stage. Additionally, when it comes to the IT portion of your audit, you can send a report right to your auditor that clearly specifies who in your organization has access to what.

Help with internal control processes
Purpose-built software enables you to define what expenses can be allocated where. And, because you can configure the system to control transaction entries and what segments can and can't be combined, for example, there can be no intentional or unintentional misappropriation of funds. Additionally, you can automate certain business rules to prohibit errors.

The tools to avoid double dipping
Double dipping – using the same monies for multiple things – is easy to do in a QuickBooks-type environment, but not so with true fund accounting™ software.

Please note: We suggest you always consult a certified public accountant (CPA), independent auditor, or auditing firm to discuss specific questions surrounding audit procedures and practices.

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Dan Murphy is currently the Senior Product Manager for Abila MIP Fund Accounting™. He has a background in nonprofit financial management, with degrees in finance and accounting and more than 10 years of nonprofit accounting experience.

About Abila

Abila is the leading provider of software and services to associations and nonprofit organizations that help them improve decision making, execute with greater precision, increase engagement, and generate more revenue. Abila combines decades of industry insight with technology know-how to serve nearly 8,000 clients across North America. For more information, please visit abila.com. To subscribe to our blog, visit Forward Together at blog.abila.com.

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