Alert

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The Changing State *of* Nonprofit Audits

How to Prepare for an Audit in a World of New Auditing Standards

By Donella Wilson

Being a nonprofit is never easy. Finding adequate funding and facing continual demands for accountability from the government and general public is tough enough. But now, nonprofits are also about to see their auditing process become more complex and increasingly expensive.

The changes are due to a March 2006 revision in the American Institute of Certified Public Accountants (AICPA) auditing standards. These revisions, known as the eight "risk assessment" standards, must be followed in audits of financial statements for periods beginning on or after December 15, 2006. In other words, if your nonprofit finishes its fiscal year on December 31, you'll be one of the first organizations to experience the change.

Why did this change happen?

Two words: Enron and Worldcom. The corporate accounting scandals of Enron and Worldcom seriously undermined the public's confidence in the effectiveness of audits. Accounting and audit reforms were inevitable. In 2002, the government approved the Public Company Accounting Reform and Investor Protection Act, also known as the Sarbanes-Oxley Act (SOX) after sponsors Senator Paul Sarbanes (D-MD) and Representative Michael G. Oxley (R-OH). SOX provided for an overhaul of corporate fraud, securities and accounting laws, created a regulatory board to oversee the accounting industry and punish corrupt auditors, and established criminal penalties for executives who deliberately defraud investors. This has led to major changes to the regulation of financial practice and corporate governance and, in turn, in the rules and standards followed by auditors.

Although Sarbanes-Oxley is only applicable to publicly traded companies, SOX has also triggered changes in nonprofit policies such as new standards in document retention and whistleblower and conflict of interest policies. SOX has also affected nonprofit financial procedures. Soon after SOX was passed, the Independent Sector recommended that nonprofits voluntarily incorporate certain "good governance" provisions of the Act (see *Sidebar: BoardSource and Independent Sector Checklist* on page 7). The California Nonprofit Integrity Act of 2004 re-enforced those recommendations by requiring California nonprofits with over $2 million in revenue (not counting government grants that already require an audit of how the funds were used) to have an annual audit; for the Board to approve CFO and CEO compensation; and for a Board audit committee to hire,

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review and fire an outside auditor as necessary.

The new auditing standards apply to for-profits and nonprofits and are expected to provide more informed risk assessments and improved audit procedures. In turn, these improvements are expected to generate more informed audits and lead to better recommendations for how all organizations can tighten their internal controls.

How have audits changed?

The new auditing standards are still based on the previous rules and policies, however, the changes are significant. One of the biggest changes is the focus on understanding the organization and putting its financial statements and needs in perspective. Auditors are expected to focus on understanding the following three issues:

1. The organization and its operating environment,
2. The needs of the users of the financial statements, such as Board, senior management, potential donors or investors, banks and lenders, and governmental funding agencies, and
3. Internal controls or procedures that prevent financial mistakes or fraud.

The goal is to identify the risk of "material misstatement," errors in the financial statements that would misinform the reader (whether caused by error or fraud), and to determine what the organization is doing to reduce those risks. Unfortunately, this level of comprehension takes time. Understanding and evaluating the internal controls — and determining if they have been implemented — requires more of the auditor's time and increases the overall cost of an audit.

One way to think about the change is that the new standards provide a framework for the auditor to work within when analyzing an organization's financial records. In the past, an auditor would simply provide a checklist for an organization to complete regarding the policies and controls in-place to prevent fraud or financial misconduct. Now, an auditor must go through the checklist and sit with staff members to see how they handle such transactions as receiving a donation or payment, writing a check to a vendor and entering financial records.

Auditors must also assess the organization's commitment to having controls and policies in place to prevent financial misstatements. For instance, they may seek to learn the following:

- Does the organization have bylaws that they review and update periodically?
- Is the Board well-structured with appropriate committees?
- Does the organization have an employee handbook and written accounting policies and procedures?

Having these policies and procedures in place, and actively using them, demonstrates to the auditor that the organization puts a great emphasis on the importance of internal controls. The lack of these controls doesn't mean that the company or nonprofit is doing anything illegal, but it does tell the auditor that they need to learn more about the organization in order to understand why those controls aren't in place.

These changes have affected some of the most fundamental auditing practices. For most audit firms — especially those that were not already using a "risk-based" approach — implementing the new risk assessment auditing standards means making significant changes to their current activities. In some cases, they have had to provide lengthy re-training sessions for all employees from the staff accountant up to the partner level.

How will this affect my nonprofit's audit?

The answer depends. If in the past your auditor has utilized a risk-based approach, you may find that your audit has not changed very much. However, for most nonprofits the new standards will lead to a longer and more involved auditing process.

Nonprofits should expect that the auditor will now be using five additional audit procedures:

1. Observing the organization's activities and operations,
2. Inspecting documents (e.g. strategic plans), records and internal control manuals (such as accounting policies and procedures manuals),

3. Reading reports prepared by management (such as quarterly management reports and interim financial statements) and by those charged with governance (such as minutes of Board of Directors' meetings),
4. Reviewing previous audit reports, and
5. Visiting the organization's premises and any other related facilities.

These procedures are geared towards understanding the nonprofit and its field, determining management's objectives and strategies, determining how financial performance is measured, and, of course, understanding the internal control environment.

The auditor is specifically required to understand controls for each "significant class of transaction." Determining what is considered a significant class of transaction requires considering the volume of transactions and their relative importance to the organization. For example, payroll and personnel costs are generally significant for a social services nonprofit organization, while grant awards and payments are significant for a private foundation. This requires a two-fold understanding: the auditor needs to evaluate the design of the control (e.g. is it capable of effectively preventing or detecting and correcting material misstatements?) and verify that the control has been implemented (i.e. that the control exists and the organization is using it). For instance, if a nonprofit organization notes in its policies and procedures manual that the Executive Director (or another person who is independent of payroll preparation and timekeeping) will review and approve payroll before payment, this is probably a good control. However, if the Executive Director does not actually conduct the final approval, the control is worthless.

In the past, the auditor might have given the nonprofit an internal control checklist, which required a yes/no/not applicable response. This helped the auditor evaluate the design of established controls, but did not enable the auditor to determine whether the controls were actually being used. Now, an auditor must verify that the control has been implemented. Verification typically takes the form of a "walk-through" test, where the auditor might trace one or two payrolls in the general ledger and look for evidence of final payroll approval, such as the Executive Director's signature. If the auditor finds that the control is not being used, this should be reported to management. The auditor must then develop an alternative audit procedure in order to obtain reasonable assurance about the completeness and accuracy of personnel costs in the general ledger.

In addition, the auditor will now put more focus on information technology (IT) controls. The auditor needs assurance that the information flowing through the accounting system is being generated properly. Without this assurance, there's no basis to rely on the financial information stored in the system. Some auditors may use a technology specialist, especially when the IT environment is complex or where systems do not create paper trails. However, for most audits, the auditor will simply interview the IT manager or designated IT personnel to determine that an IT security plan exists. The auditor will also confirm that the financial software does not allow users to change the code or reporting parameters and restricts access to employees based on their job responsibilities. (For more on accounting software options, see *Resources,* page 9.)

In short, clients can expect lengthier visits from auditors in the planning stage, and increased interaction across the organization, not just in the accounting department.

These new auditing standards will probably result in increased recommendations for strengthening internal controls and operating efficiency. However, it should be remembered that the purpose of an audit is still to express an opinion on the financial statements, and not to express an opinion on the effectiveness of the organization's internal control. The walk-through tests are merely to verify that controls have been implemented and are not intended to test their effectiveness. Senior management and the Board are still responsible for designing and implementing effective internal controls. Having an annual audit cannot be considered part of a client's internal control process (although an accounting firm other than the auditor can be part of a client's internal control.)

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Family Resource and Referral Center
Irvine Health Foundation
Target Corporation
Zellerbach Family Foundation
Pacific Gas and Electric
Richard and Rhoda Goldman Fund
Edison International
ABC-Learn, Inc.
Wells Fargo Foundation
Majestic Realty Foundation
Alpha Grant Solutions
Turning Point Community Programs

Renewing Members

123EZCORP
Abigail Grafton, MA
ABILITY Awareness
ABS CBN Foundation
Adopt-A-Watershed
Adventures in Caring Foundation
Advisors Network
AEG Foundation
AGAPE Foundation
Alameda Health Consortium
Ali Akbar College of Music
Alliance for African Assistance
Alliance for the Arts
Almaden Valley Counseling Service
Alpha Plus Corporation
Alternative Family Services
Amador-Tuolumne Community Resources
American Society on Aging
American Sports Institute
American Youth Hostels—Los Angeles Council
Ames Education Associates (CA Space Grant Foundation)
Amigos Sin Barreras (Friends Without Barriers)
Angel Flight
Angel Island Immigration Station Foundation
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Arc Ecology
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Ark of Refuge Inc
Armstrong and Associates, Insurance Services
Arts Council of Kern
Asian & Pacific Islander American Health Forum
Asian American Economic Dev. Enterprises, Inc.

How should nonprofits prepare for the new auditing process?

When hiring your auditor, or starting your annual auditing process, nonprofit staff should discuss the following with their auditor:

- The impact on audit fees,
- The timing of the various stages of the audit,
- Client responsibilities, and
- Access to client personnel for the various inquiries and walk-through tests.

Nonprofits may find it helpful to start their audit with a kick-off meeting. In the past, auditors often hosted their own internal team brainstorming session before beginning the audit, but now, with the additional audit procedures, it's also essential that nonprofit staff affected by the audit know what to expect.

Feel free to ask your auditor for more in-depth information about what needs to be achieved in the preliminary stages of an audit and to request an audit strategy or audit plan. An audit strategy is the broad approach of how the audit will be conducted and takes into account such factors such as the scope of the engagement, audit and report deadlines and recent financial reporting developments. The audit plan or audit program is more detailed and describes the nature, timing, extent of risk assessment, and further audit procedures to be performed.

In preparation for the audit, nonprofit staff should revisit their accounting policies and procedures manuals, with an eye toward controls, and be willing to revise their policies if necessary. Most accounting manuals focus on process, such as how the bank reconciliation should be prepared. But it is also important to consider and document the controls surrounding that process. For example, if the bookkeeper prepares the bank reconciliation, then it is important to document who later reviews and approves the bank reconciliation. See *Figure 1, Control Framework — Contribution Revenue* for an example of these controls in process.

If adequate controls are in place and are working, ensure that the records illustrate this. For example, if one of the controls over cash is that the Executive Director receives the unopened bank statements and reviews the statements for unusual transactions and the cancelled checks for unusual signatures, then the Executive Director should initial the bank statement as proof of his or her review. This demonstrates to the auditor that controls are in place and are being implemented.

Revising the accounting policies and procedures manual may seem like a daunting task, so many auditors recommend that clients start by first documenting and assessing controls over their financial reporting. At the minimum, clients should document the following:

- The procedures (automated and manual) by which transactions are initiated, authorized, recorded, processed and reported in the financial statements,
- The types of accounting records and supporting information the nonprofit uses, and how this information is stored (e.g. the fixed asset ledger is often maintained in an Excel spreadsheet outside of the general ledger),

Figure 1: Control Framework -- Contribution Revenue

Questions to Ask	Real-life Donation Example
What is the control objective?	To ensure that all contributions received are recorded.
What are the risks?	Contributions may be misappropriated, accidentally or otherwise.
What is an effective, practical control, considering the size of the organization?	Two people should open the mail and prepare a list of receipts. Checks should be immediately restrictively endorsed and deposited on a daily basis (or physically secured until depositing). The list of checks received should be later compared to cash receipt records and bank deposit slips.

- How the information system captures events and conditions (other than routine transactions) that are significant to the financial statements (e.g. the notification that the nonprofit organization has been designated as an irrevocable beneficiary in a charitable remainder trust),
- The financial reporting process used to prepare the financial statements, including significant accounting estimates and disclosures, and
- How the nonprofit resolves cases of incorrect transaction processing and how automated processes are overridden when necessary.

Another suggestion is to look at the audit journal entries that were booked during last year's audit, and ensure similar entries are booked before the audit, if at all possible. If a nonprofit has numerous late journal entries, it can raise questions about the financial reporting process.

And finally, nonprofit staff and the Board audit committee should look at any internal control recommendations that were made during last year's audit and ensure they have been addressed. As mentioned earlier, more recommendations and findings are expected as a result of the new risk assessment auditing standards. To avoid recurring findings, the recommended improvements to internal control should be taken seriously by management and addressed in some form.

What About Smaller Clients?

Smaller, less complex nonprofits may use less formal means and simpler processes and procedures to achieve their internal control objectives. For example, smaller nonprofits may not have extensive descriptions of accounting procedures or detailed written policies. Smaller organizations typically have fewer employees, which may limit the extent to which "segregation of duties," a key internal control, is possible. The focus for the auditor in smaller organizations will be on the control environment, which sets the tone of an organization. The potential for management override of controls depends to a great extent on this control environment, and in particular, management's attitudes about the importance of internal control.

Smaller nonprofits may actually have fewer possible issues than a larger organization where things may fall through the cracks. Since smaller nonprofits tend to have leaders who are more hands-on, they are able to access actual results and budgets much faster and tend to have a closer feel for the organization and the people working for them. What small organizations lack in segregation of duties, they often gain in an involved management team that is deeply integrated into daily activities.

Smaller organizations that don't have strict segregation of duties can show their commitment to controls in other ways. For instance, a nonprofit can demonstrate ethical behavior and a commitment to ensuring adequate controls through the comments made by Board members in meetings and recorded in minutes, how the staff members interact, by how often the officers of the organization are present, and by their relationship with the staff. A small nonprofit can have staff who wear many hats, but their behavior and interactions can still highlight their commitment to controls.

That's not to say that small organizations should use their size as an excuse for not implementing any controls. Even in tiny organizations, controls can be implemented to protect against possible problems. For instance, suppose one staff member receives the bills, writes the checks, enters the payments into the ledger and brings the checks to the Executive Director to sign. A different staff member, or even a Board member, should receive the bank statements with the cancelled checks and take responsibility for checking for unusual amounts or signatures.

Final Thoughts

Although implementing the new risk assessment standards will be time consuming for nonprofits and their auditors, the end result should be well worth it. More informed audits should lead to better recommendations for how all organizations can tighten their internal controls and prevent costly accounting mistakes in the future.

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Asian Law Caucus, Inc.
Asian Pacific Community Fund
Aspire Foundation
Association of Community Human Services Agencies
Association of Moving Image Archivists
Atwater Park Center
Auburn Community Foundation & Placer Community Fdn.
Auburn Ski Club Associates, Inc.
Audubon Canyon Ranch, Inc.
Austism Speaks, Inc
Autism Research Institute
Autism Society of America-LA
Bay Area Community Services, Inc. (BACS)
Bay Area Outreach & Recreation Program
Baykeeper
Beanstalk
Becoming Independent
Beginnings, Inc.
Beneficient, Inc.
Berkeley Place, Inc.
Bethel Church
Big Brothers/Big Sisters of Santa Cruz
Blackbaud, Inc.
Blue Garnet Associates LLC
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Breast Cancer Action
Breathe California Golden Gate Public Health Partnership
Burbank Housing Development Corporation
Butte Environmental Council
C.G. Jung Institute Of Los Angeles
CA Staff Assault Task Force
Cabrillo College Foundation
Cabrillo Music Festival
Cabrillo Music Theatre
California Arts Advocates
California Certified Organic Farmers
California Coalition for Youth
California Communications Access Foundation
California Council of Churches
California Court Appointed Special Advocate Assn.
California Creativity Association
California Historical Society
California Housing Consortium Institute
California Institute for Rural Studies
California Kindergarten Association
California Newsreel
California Pan-Ethnic Health Network
California Partnership to End Domestic Violence
California Poets in the Schools
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California Shock Trauma Air Rescue (CALSTAR)
California Urban Forests Council
California Wilderness Coalition
Capital Research and Management Company Endowments
CARE Foundation
Casa De Esperanza
Center for Community Benefit Organizations
Center for Community Dispute Settlement
Center for Governmental Studies
Center for Investigative Reporting
Center for Living and Learning
Center for the Future of Teaching and Learning
Centro Legal De La Raza
Century Club of San Diego
Charlotte Maxwell Complementary Clinic
Charter Schools Development
Child Development Resources of Ventura County, Inc.
Children of Lesbians & Gays Everywhere
Children's Book Press
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CHRIMS
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Common Counsel
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Community Clinic Consortium
Community Foundation of Napa Valley
Community Health Charities
Community ITP, Inc.
Community Overcoming Relationship Abuse