



Demystifying the Audit

*A Guide for Nonprofit
Board Members and Executives*

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Introduction

Welcome to the world of nonprofit financial management!

This guide is designed to help nonprofit executives and board members better understand financial audits: what they are and how they play a role in meeting your organization's mission.

Here are a few of the things you'll learn in this whitepaper:

1. Key differences between the way for-profit and nonprofit organizations need to account for revenues and taxes
2. How to prepare for an audit and how to make the audit less stressful
3. What to expect if you are asked to take – and you accept – a position on the board's audit committee
4. What you should expect from the audit, including an overview of internal controls and how they relate to financial risks your organization faces
5. Understanding the management letter and your responsibilities if you get a negative comment

There are many associations that provide guidance to new nonprofit board members about the scope, roles and responsibilities they have for providing oversight to the organization, but we hope that we have helped to demystify the audit and audit process.

"As part of its fiduciary responsibilities to the nonprofit, the board is responsible for oversight of the charitable nonprofit's accounting function and the performance of the independent auditor if one is hired. The board of directors as a whole is responsible, unless it delegates its authority, such as to an audit committee."

National Council of Nonprofits



What Are the Differences Between Nonprofit and For-profit Accounting?

Nonprofit vs. For-profit Accounting: Different Motives, Different Sources of Revenue

Nonprofit organizations are similar to for-profit entities in many ways. Both generally have employees, insurance issues, marketing programs and the need for inflows of resources that exceed outflows in order to stay in operation.

There are, however, a number of differences that not only impact how the organizations operate, but also impact their accounting.

Nonprofits often receive the bulk of their revenue from contributions as opposed to sales, services provided or rental revenue. The source of revenue affects how revenue is recognized and presented. Also, most nonprofits do not need to account for income taxes, while for-profit organizations do.

Tax Exemption

Nonprofits that qualify as charitable organizations under section 501(c)3 of the Internal Revenue Code (one of many tax exempt sections) are generally not taxed on net income except for unrelated business income. This includes income not related to the tax exempt purpose of the organization's exemption. For example, if an organization's tax exempt purpose is to provide funds for cancer research, and it owned a building from which they received rental income, the rental income could be considered unrelated business income.

It should be noted that while these nonprofits may be exempt from income tax, they are still liable for payroll taxes and possibly sales and property taxes. These organizations are also able to receive donations that are tax deductible to the donor.



Revenue Sources

Tax deductions for donors are unique to nonprofit accounting and require their own set of rules regarding how they are treated.

1. A **pledge** is an unconditional promise to give money to a nonprofit. It is generally recorded in its entirety the year it is pledged. For example, if a donor decides to contribute \$1,000 a year for the next five years, that would be considered a pledge assuming it is unconditional – and the full \$5,000 of the pledge would be recorded as revenue during the year it was pledged.
2. Nonprofits often receive **donated goods and services**. These goods and services come in many forms, such as the use of office space or equipment, professional services such as legal or accounting help, or help from volunteers. These contributions need to be recorded as revenue (and the appropriate expense or asset) if one of the following conditions are met:
 - They create or enhance a non-financial asset such as a building or piece of equipment
 - They require specialized skills and are provided by an individual possessing those skills (e.g., accountant performing bookkeeping tasks)
 - They would typically need to be purchased if they were not donated
3. Nonprofits must also account for and track any **restrictions that have been imposed by donors**. These can include a temporary or permanent restriction and a time and/or purpose restriction. A temporary time restriction occurs in the pledge noted above. During the first year, the \$1,000 received in the first year would be “released from restriction” while the remaining \$4,000 would remain restricted to be released each year as the pledge monies are received. Donations that are restricted by the donor for a certain use, such as new equipment, are considered purpose restricted. Those monies must remain restricted until they are used for a suitable purpose, in this case new equipment, before they can be released from restriction.



Financial Statement Presentation

Along with the classifications of net assets, nonprofit financial statements are also presented differently.

Rather than the traditional balance sheet, nonprofits have a “statement of financial position.” Similar to the for-profit balance sheet, it lists assets and liabilities, but the equity section is replaced by net assets. The net assets are typically shown as with or without restrictions.

Nonprofits also have a statement of activities as opposed to an income statement. This statement of activities lists the revenues and expenses as well as the net assets. The most significant change is evident when there are restricted net assets and a release is recorded. The revenue section of the statement lists all revenue classified by its restriction and also shows all amounts that were released by restriction during the period. One other difference is for-profit entities show the difference in revenue less expenses as net income. In the nonprofit world the difference is shown as changes in net assets because the goal of the nonprofit is not to generate net income, but to reflect how it uses its net assets to accomplish its mission.

Functional Expense Allocation

Another difference is that expenses are most commonly classified as two types of functional expenses: program services and support services. The functional expense allocation determines the amounts included in the statements of activities. Expense allocation varies by organization. Supporting services generally include fundraising activities and management and general activities such as accounting services.



Roles and Responsibilities of Nonprofit Audit Committees

Know What You're Signing On for If You're Considering a Role on a Nonprofit's Audit Committee

Do you know what you're signing up for if someone asks you to be on the audit committee of a nonprofit organization?

The answer to this varies from organization to organization. Some organizations lay out a very detailed list of responsibilities for their audit committees while others have a very broad range of responsibilities that sometimes blends with that of the finance committee.

In most cases the audit committee (and even the full board) should be operating at a macro level. That is not to say they shouldn't dig into details. Rather, they should generally not get involved in the details to such a degree that they are micro managing. The key is to think "big picture."

1. Oversee the Selection and Performance of the Outside Audit Firm

One responsibility of the audit committee is to oversee the selection and performance of the outside audit firm.

Even though auditor rotation is not required for nonprofits, audit committees should evaluate the performance of the outside auditor, the efficiency of your audit, and the fees charged to make sure the organization is getting the best return on the money it's spending.

The bid process is usually not done more often than every five years. When you do go through a bid process, the audit committee should weigh credentials, comments from client references, and other qualitative factors, as well as the fees, of the CPA firms that submit proposals.

2. Monitor the Process of the Annual Audit

Another responsibility of the audit committee is to monitor the process of the annual independent audit. There is no way to completely eliminate all financial risk, but proper oversight is a key compensation control that external auditors look for in a good system of internal controls.

The audit committee should be informed of the audit timetable, and receive periodic updates on the progress of the audit and any issues that are developing.

When the final audit is complete the audit committee generally reviews the deliverables, which are the financial statements, the board governance letter and the management letter. They work with day-to-day management to correct any weaknesses or recommend that certain risks were mitigated to an acceptable level. In the case of larger organizations the audit committee might also monitor the activities and results of audits performed by internal auditors.

When an organization receives federal funding, either directly or through pass-through entities, monitoring of reports regarding federal financial assistance by the audit committee can extend to the programs even if there is not a formal internal audit process.

3. Be a Link Between Employees, Stakeholders, Nonprofit Management and the Full Board

A good audit committee functions as an independent link in the chain of management to the full board.

For instance, if there was a questionable situation in an organization, some people might not be comfortable going to day-to-day management or even the C-level executives in the nonprofit. In this case the audit committee can fill the vital role of listening to the concerns of employees or other stakeholders.

Being independent, audit committee members can provide a certain distance to make the situation more anonymous while they investigate the concern to see if it's valid or if there was just a misunderstanding. Many organizations set up direct reporting processes to the audit committee. Sometimes this is done internally and other times they use an outside reporting service, such as an employee hotline.



Five Things Nonprofit Board Members Should Expect Out of An Audit

What Does an Audit Tell You About Your Nonprofit Organization?

The accounting profession has been dealing with what we call the “expectation gap” probably for as long as audits have been performed. There have been many attempts to bridge that gap but it has been a very slow and tedious process.

The profession has many audit standards that address the expectation gap but unless you are an auditor in public accounting, you probably have not read any of them. The latest attempt to bridge the gap is in how the auditor’s opinion now appears where there are specific sections on the auditor’s responsibilities versus management’s responsibilities.

Basically the underlying premise is that management is responsible for the books and records, maintaining a control structure that safeguards assets, and proper financial reporting. The books and records and the financial statements belong to management even if you hire a public accounting firm to help with some functions.

Auditors are responsible for designing audit procedures and tests to obtain “reasonable” assurance that the financial statements materially represent the organization’s true financial picture. Auditors accomplish that by “testing” various items in the books and records. Unfortunately, because we can’t possibly review every transaction, there is always the possibility that something may be missed.

When dealing with financial audits we run into a problem when there is one set of audit standards that applies to two different financial worlds. The standards are written to make sure the financial statements are fairly presented. In simple terms that mean assets, equity and income are not overstated and liabilities and equity are not understated. These are extremely important to public companies because there can be pressures to hit certain expectations to keep the markets happy and stock values up. They are also important because the financials are made available to anyone who wants them for investing purposes, and if something isn't disclosed properly you can't have 10,000 people calling the CFO to ask questions. Because of this, financial statements are more like books and have so much information it's hard to distinguish the information that really impacts someone's decision.

So here is the summarized bottom line in what you can expect out of the audit.

1. An audit should provide reasonable but not absolute assurance the financial statements are fairly stated.
2. While the audit cannot detect any and all frauds that may occur, audit procedures are designed to look for material misstatements or errors.
3. If an auditor encounters situations where they believe there are material weaknesses or significant deficiencies, they must report them to you.
4. If an auditor encounters areas that are not true material weaknesses or significant deficiencies, but are comments that can help improve efficiencies in operations, they should communicate those to you as a "value added service."
5. An auditor can help address any areas of specific concern by designing special procedure engagements outside of the audit to help management achieve its goal of having a finely-tuned financial organization.

It's essential for board members to understand they can never fully delegate away their responsibilities of being on the board, but they need to know the most effective way to manage that responsibility through the use of various services of CPA firms.



Internal Controls: Nonprofits, Make Your List and Check It Twice

Concentrate Internal Controls on Your Biggest Risks

Nonprofit organizations that don't exercise constant vigilance in adhering to internal controls open the door to fraud.

While many nonprofit leaders believe employees work at an organization as much for the mission as they do for the paycheck, sometimes that just isn't the case. It's also very common for management to respond to a detected fraud in disbelief because "they trusted the person." If you think about it, would you put them in a position where they could steal from you if you didn't trust them?

Unfortunately, weak economic conditions have only increased the likelihood of theft, making internal controls more important than ever. You can keep such measures in the forefront by regularly reviewing and updating your organization's internal controls and concentrating your energies on the biggest risks.

Narrow Your Focus On the Most Risky Activities

A detailed internal controls list potentially contains hundreds of items related to everything from governance to financial statements to payroll to information technology. If your nonprofit has never drafted such a list, talk to your auditors or other financial advisors about doing so.

Most nonprofits, however, engage in far fewer risky activities and should, therefore, focus on a smaller group of controls. For example, a startup that's putting donations to work as quickly as they come through the door

Cash and bank accounts have the greatest exposure to theft. Therefore, they require the greatest scrutiny and controls. Making sure receipts get recorded is very important, so you need to have good controls to make sure all of the efforts to raise funds pay off with the money actually getting into the bank. Once in the bank you need to make sure disbursements are for legitimate organizational purposes. With the advent of electronic banking it has become harder to enforce controls, so reviewing the transactions after they have posted are just as important as approving the disbursement.

Whether the controls are done by segregation of duties or by compensating monitoring controls with additional review after the fact, one or the other is essential to avoid a terribly negative surprise that can prove to be a very public embarrassment for any nonprofit.

Don't Let Foxes Watch the Henhouse

Even the best internal controls can't protect your nonprofit from fraud if managers override them. Although auditors review internal controls, audits aren't designed to detect every fraudulent act that could occur, especially management overrides. It's a good idea to ask your auditor or someone experienced in fraud prevention to observe how well your organization is adhering to controls and to identify any potential risks.

One of your best lines of defense might be your board of directors. Your board can help prevent management-perpetrated fraud by:

1. Overseeing annual audits
2. Ensuring that material weaknesses identified by auditors are addressed
3. Reviewing monthly bank reconciliations, investments reconciliations and analysis of other material accounts
4. Regularly reviewing financial statements
5. Signing off on completed IRS forms.

Your board might also stipulate additional policies, such as requiring the approval of at least one board member on the rare occasion a manager needs to override controls.

Your board also should look for signs that managers aren't following internal control policies to the letter—for example, failing to report risks and actual management overrides in a timely manner. Sloppy accounting and reporting errors and disputes with auditors and outside advisors are possible signs that a manager might be committing fraud.

Regularly Review Internal Controls

You and your staffers probably have a lot on your plates—so it's understandable if internal controls occasionally get lax. Remedy such lapses as quickly as possible by reviewing with employees and managers alike the policies designed to control fraud.



Three Common Nonprofit Management Letter Comments and How to Avoid Them

An Auditor's Perspective on Management Letter Comments

A primary responsibility of nonprofit directors and officers is to ensure that their organization is accountable for its programs and finances to contributors, its members, the general public and government regulators.

During the annual audit process, the auditor is required to issue a letter to officers and directors regarding its internal controls. The letter is known as the "management letter." This letter includes items of concern, found by the auditors, which probably need attention by the organization's management team.

Normally when these items are brought to management's attention, it means there are "deficiencies" or "weaknesses" in the controls of the organization. Internal controls are systems of policies and procedures that protect the assets of an organization, create reliable financial reporting, promote compliance with laws and regulations, and achieve effective and efficient operations. These items might have an impact on the future of the organization, such as receiving or losing grants or donations, avoiding penalties, or even as severe as misappropriation of the organization's assets.

It is very important for nonprofit executives to understand and design controls that avoid having these kinds of issues show up in a management letter. Strong controls will help preserve your organization and its purpose.

Common Management Letter Comments

Organizations have different policies and procedures that are designed to meet their unique needs. However, the fundamental approach to maintaining and establishing policies and procedures is the same for all organizations. Common weaknesses in internal controls of nonprofits appear in many organizations, regardless of size.

2. Grant Reporting and Reimbursement Request

In many organizations, federal funds or other granting sources are a valuable source of revenue. The grants may impose very specific and stringent operational or reporting requirements, which can cause complications and misunderstanding between the organization and the grantor.

How to avoid it — Many nonprofits properly file and request reimbursements in a timely manner, but not necessarily accurately, according to the requirements of the grant.

To ensure that these reports are being filed properly, nonprofits should practice extreme care in preparing these reports, ensure all support is adequate and attached to the report, and have management review the reports before filing them. You should document in your organization's policies and procedures a report review process that should occur before filing. This should help prevent any filing errors and ensure all filing requirements have been met.

3. Board Monitoring of Accounting Functions

Many nonprofit organizations maintain a small staff. This might make it challenging to segregate critical duties. Establishing proper segregation of duties is the most important factor in developing strong internal controls within an organization.

How to avoid it — One recommendation is to involve the board in monitoring and approving cash disbursements, reviewing bank reconciliations, approving revenue classifications, and any other important process that is relevant to your organization. By involving the board it will give your organization strong governance over the internal controls of your organization.

From an Auditor's Perspective: What's the Most Important Thing You Can Do?

From an auditor's perspective, the number one way to establish that your controls are being properly implemented is to maintain adequate documentation of all transactions, including proper signoffs on any review or control processes.

It is also important to review your policies and procedures on an annual basis with all parties involved in the process, including the board of directors. Employees who put these policies and procedures into practice should also be involved in this annual review to reinforce their understanding of the rules. This should help prevent miscommunication and misunderstanding, and ensure that important policies and procedures are followed.

Be Strong by Exercising and Implementing Key Controls

Following these fundamental recommendations and recognizing the importance of strong internal controls will help you safeguard your organization. It will also potentially eliminate any further management letter comments by your auditor.



Five Tips for a Less Stressful Audit

Communication is Key for Successful Nonprofit Audits

Do you bite your nails before your nonprofit's external audit each year? Does your staff start showing signs of anxiety in anticipation of the auditors walking in the door?

If this sounds like your situation, take a deep breath. Here are five tips for making the audit experience run more smoothly for you and your auditors.

1. Be Ready

Ask your auditor for a list of items they'll need during the audit, with deadlines for each item, if such a list isn't provided automatically. Talk to your auditor before the fieldwork if you have questions about any of the items, and let your auditor know right away if you won't be ready by the agreed-upon dates.

Because a certain amount of surprise procedures are a required element in the audit, you'll also need to produce some information on the spot, such as specific expense reports, journal entry support, or grantor or program reports. But you can still prepare by establishing files during the year to collect the information you may need.

2. Have Realistic Expectations

Your expectations of the audit should mirror your contract with the auditing firm. It will spell out what the audit will accomplish and your responsibilities.

Auditors once did accounting "clean-up" work for their clients during the audit, such as preparing year end journal entries, fixed asset schedules, and various prepaid expense and accrued liability analyses. Today's professional standards draw a clear line between accounting and auditing services, and your auditor must stay independent of your accounting processes. Some of these procedures are still allowed but the

3. Minimize Your Risks Year-round

Draft and review your accounting and procedures manual. Self-assess inherent internal control weaknesses and determine the necessary internal controls to mitigate such weaknesses. Periodically ascertain whether your organization's policies and procedures are being followed. Creating a policy or procedural manual does not have to be an overwhelming task. It can be done in pieces and can be as simple as writing memos to outline procedures as you are actually performing those procedures.

If your operations have changed or evolved, discuss these developments with your auditor during the year and update your policies and procedures accordingly. Waiting until fieldwork begins can delay the audit process.

4. Be Prepared to Deal with Any Control Deficiencies

Your auditor will apply risk standards during the audit. AICPA Statement on Auditing Standards No. 115, Communicating Internal Control Related Matters Identified in an Audit (SAS 115), defines deficiencies in internal control and other "material weaknesses" and "significant deficiencies."

The auditor, for example, will look to see if there's:

- More than one person handling cash receipts and reviewing and approving cash disbursements and payroll,
- A second person authorizing contracts and their payment, and
- Adequate oversight of your checks and balances system.

After reviewing the risk and internal control information you've assembled, your auditor can determine whether there is a "significant deficiency" or the more serious "material weakness."

For any matter identified in the auditor's SAS 115 letter, prepare a written response including whether you have taken or intend to take any action in response to the finding. This is important to the audit committee and board as they oversee the audit and the overall system of checks and balances.

5. Stay in Touch

Don't let the annual audit be the only time you talk to your auditor. If you save up all your questions, it's likely to extend the length of the audit.

Also ask if there are new accounting pronouncements or changes for the year so you and the board aren't surprised after year end. Be proactive in understanding the new guidance and its impact on your next audit and future financial reporting.



It's All Good

Although the audit — and the preparation that precedes it — requires some work, the benefits are plentiful. The audit not only assesses your overall financial condition, but can also pinpoint problems with financial management and financial reporting, identify ways to reduce risk and strengthen internal controls. An auditor must maintain independence but an audit does not have to be an adversarial process. Communication is the key, so make sure you understand why your auditor is doing certain procedures and you may even be able to identify something that could accomplish the same goal more efficiently.



Five Things Your CPA Wants You to Do Before Your Nonprofit's Next Audit

Being Prepared Can Take the Dread Out of Your Next Audit

Many nonprofits think there's not much worse than going through a financial audit. Some of our nonprofit clients see it as a "necessary evil," while a mere few actually look forward to the auditors coming in to check their financial information, processes and controls.

Regardless of how you view your annual audit, there are steps you can take to make it less painful. Here are five things to do ahead of time to make your next audit go more smoothly.

1. Document Your System of Procedures and Controls

One of the first things an auditor has to do is understand your system of procedures and controls.

It is always best if the auditee has their procedures and controls documented, whether it's narratives or flowcharts. If this isn't possible, the auditor can usually provide some checklists or questionnaires for the auditee to complete. Your completed questionnaire will help the auditor get the information he or she needs.

While you might have excellent documentation of your service areas, the auditor will concentrate on key financial processes and controls that impact the production of financial statements.

3. Plan a Realistic Audit Timetable and Stick to It

Lots of unexpected things can upset a timetable, but it's important to develop and stick to the timetable for pre-audit planning, fieldwork, post-fieldwork wrap-up and completing the deliverables.

This timetable should be laid out in the planning phase so both the auditor and auditee know the target dates. If a milestone in the timetable is not going to be met, it needs to be discussed as early as possible.

If it is the auditor's issue, they need to figure out how to get back on track. If it is the auditee's issue, they too have to adjust. Otherwise it is likely the auditors might ask for an increase in fees due to the delays and schedule disruptions.

4. Take the Approach of Full Disclosure

Not all nonprofits are well versed in generally accepted accounting principles (GAAP). Because of this, surprises can occur but it is always best to tackle unusual items up front with your auditor.

If you have an unusual or new type of transaction, discuss it early and don't wait for the auditors to find it. If you have new programs, grant agreements, contributions, leases or contracts, discuss them with the auditor during the year or at least in the planning stage of the audit. Doing this can save considerable time and effort and avoid delays in completing the audit.

5. Allocate Proper Time for the Audit

While the auditors spend a lot of time digging through paper and electronic records and other audit evidence, much of the audit involves communication with your staff.

Allow time in your schedule – and your staff's schedule – to be available to the auditors a couple times during the day. They will need to discuss various items they encounter during the audit as well as confirm their understanding of your processes and controls. Nobody understands your organization better than you, so you are an integral part of the audit process. Is it difficult to be available for the audit while still handling your normal work load? Yes, but planned properly, it will be a much less draining process for everyone involved.

Being Prepared Can Change the Way You Look at the Annual Audit

Audits can be a terrible experience if the auditors (the CPA firm) and auditees (the nonprofit) are not on the same page. Understanding who is responsible for what, and when, is extremely important. Communication and preparation are essential to an efficient audit.

Being prepared for your next audit will go a long way toward feeling like your auditor came in and helped you, versus feeling like the audit was an adversarial process.

About Gross Mendelsohn

Gross, Mendelsohn & Associates is a full-service CPA and consulting firm serving the complete financial needs of nonprofit organizations, privately-held businesses and high net worth families in the Mid-Atlantic area. The firm has offices in Baltimore, Maryland and Fairfax, Virginia.



Nonprofit Expertise

When it comes to working with nonprofits, we're known for reliable, reasonably priced financial statement audits and much more, including:

- Financial controls and budgeting
- Endowment fund management
- Recording different types of donor support
- Employee benefit plan audits
- Strategic planning
- Hiring in-house accounting personnel
- Investment management
- Communicating financial information to board members
- Cyber security
- IT support / managed services
- Software solutions

What Makes Us Different From Other CPA Firms

Nonprofits often start looking for a new audit firm when they start to realize they only hear from their CPA once a year and/or they never get advice tailored to their specific situation. That never happens at Gross Mendelsohn.

The three anchors of our firm are people, data and innovation. Our people make the difference for our clients and, through data-driven insights we help our clients make sound financial choices for the future. We have been at this for decades and our services go far beyond what you may expect a CPA firm to offer.

Following are just three things that differentiate us from other firms:

1. Low partner-to-staff ratio
2. Data-driven insights passed along to clients
3. Experienced innovators who bring new ideas to clients

Meet the Author



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Lisa Johnson has over 20 years of public accounting experience. She is co-director of the firm's Nonprofit Group and specializes in issues that nonprofit organizations face, including year-end considerations, new FASB technical pronouncements, specialized accounting procedures and unrelated business income issues. She chairs the firm's audit and accounting department and also performs the audits of many of the firm's employee benefit plan clients.

Lisa holds the American Institute of CPAs' Not-for-Profit Certification, which is awarded to CPAs who prove their proficiency in nonprofit financial reporting, auditing, governance and tax compliance.



**Want to Get In
Touch?**

Let's Talk

Or call 800.899.4623

She has served in numerous nonprofit board of director roles. Lisa earned her degree in business administration from James Madison University and is a member of Maryland Nonprofits, Maryland Association of CPAs, Greater Washington Society of CPAs and American Institute of CPAs.