Are YOU READY FOR RISK–BASED AUDITING?

New Circular A–133 raises rewards for good internal controls.

BY GERARD M. ZACK

Beginning in 1997, the Office of Management and Budget (OMB) is changing the way CPAs audit federally–funded nonprofits. The changes, reflected in OMB Circular A–133, are good news for nonprofits.

OMB Circular A–133, first issued in 1990, describes audit requirements for federal funds received by nonprofits. These audits focus on grant administration, allowability of costs, and compliance with pertinent laws and regulations. Most changes in the new circular become effective for fiscal years ending June 30, 1997, or later.

ONE BIG CHANGE: A HIGHER DOLLAR THRESHOLD

The biggest change in the revised circular is the increased threshold for having to undergo an A–133 audit. Under the new circular, you won't need to be audited if your organization receives less than $300,000 a year in federal funding. This is a great leap from the current audit threshold of $25,000.

ANOTHER BIG CHANGE: RISK–BASED AUDITING

Another important change is the way CPAs choose grants or programs to audit. Targeted programs—called "major programs" in the circular—used to be chosen solely on dollars expended. Under the new rules, CPAs will target programs based not only on how expensive but also how risky each program is.

The introduction of risk into the selection process provides an exciting opportunity. If your organization has sound internal controls and takes corrective action in response to audit findings, you may find the scope of future A–133 audits greatly reduced—even if you receive large amounts of federal funding.

Under this new approach, CPAs will target programs to audit using the following steps:

1. Identify the organization's larger programs, and classify them as "Type A" programs. Type A programs are those whose expenditures exceed $300,000 or 3% of total federal expenditures (whichever is greater) up to $100 million ($3 million or 0.3% if federal expenditures are between $100 million and $10 billion, and $30 million or 0.15% if federal expenditures exceed $10 billion).

2. Label the smaller programs (all those not identified as Type A programs) as "Type B" programs.

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3. Segregate Type A programs which meet the following criteria for consideration as "low risk":

   - The program has been audited as a major program in at least one of the two most recent audit periods.

   - In the program's most recent audit, auditors reported nothing questionable (such as noncompliance with laws and regulations, questioned costs over $10,000, fraud affecting a program, or inadequate follow–up on prior audit findings).

   In identifying low–risk Type A programs, auditors may use their own judgment. After considering the program's inherent risk and the level of federal oversight, for example, they may classify the program as low–risk despite previous audit findings. In addition, federal agencies may target any Type A program, regardless of risk (but only with OMB approval and notification of the nonprofit organization and its auditors within 120 days of year–end).

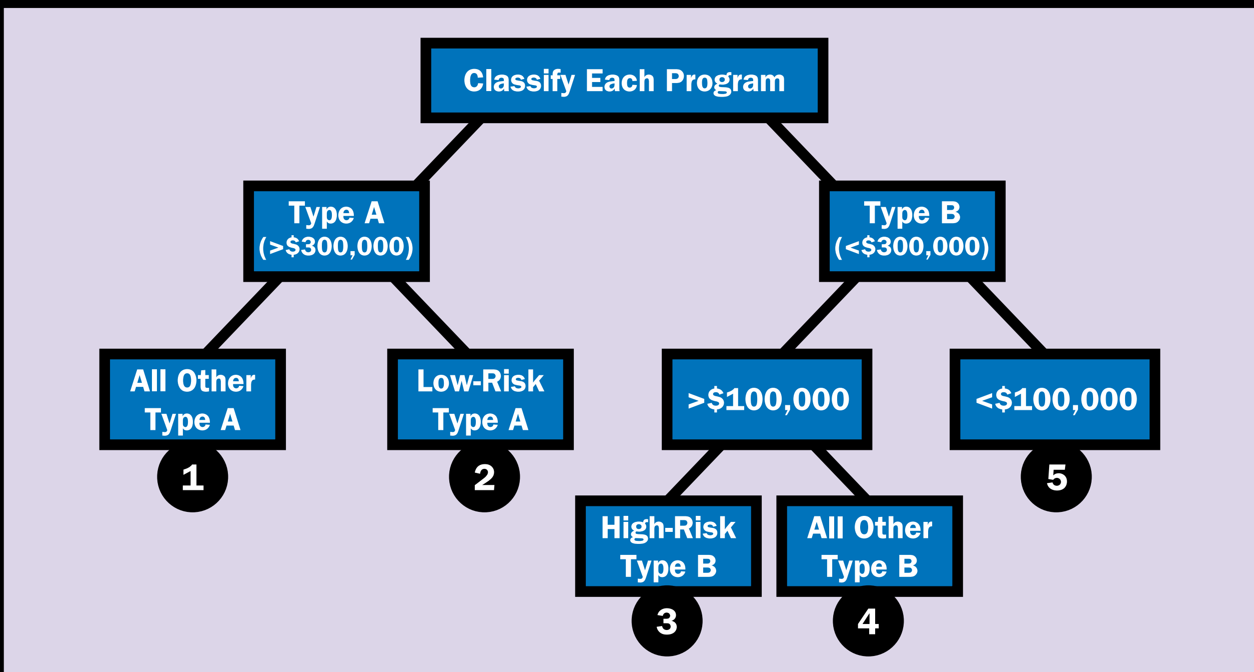
4. Identify "high–risk" Type B programs, using the same three criteria as above: prior audit results, inherent risk, and federal oversight. Auditors need not assess risk for all Type B programs. They must evaluate risk only for Type B programs whose expenditures exceed $100,000 or 0.3% of total federal expenditures (whichever is larger) up to $100 million ($300,000 or 0.03% if the total exceeds $100,000).

After completing this classification process, the CPAs decide which programs to audit. They must audit all the following:

1. All Type A programs not identified as low–risk programs.

2. Any other Type A programs identified by the federal funding agency, with OMB approval.

Steps to Target Programs for Audit under Circular A-133



1. Must audit.
2. Only audit if necessary to meet 50%/25% rule.
3. Must audit half of these (but no more than the total identified in 2).
4 & 5. Only audit if necessary to meet 50%/25% rule.

3. Half the high–risk Type B programs. However, auditors are never required to audit more high–risk Type B programs than low–risk Type A programs. Thus, if an organization has no low–risk Type A programs, auditors will select no high–risk type B programs at this point.

The changes are good news for nonprofits.

Next, the auditors sum up the expenses of the major programs identified above. They compare this figure with the organization's total federal expenditures. If audit coverage exceeds 50%, the selection process is complete. If not, the auditors must perform a risk assessment on the entire organization to decide whether audit coverage is adequate.

A "low–risk" organization is one which meets the following criteria for the past two years:

1. Its audits were performed in accordance with OMB Circular A–133.
2. The auditors' opinions on the financial statements and schedule of expenditures were unqualified. (A federal agency may waive this requirement if the auditors' report doesn't negatively affect a program's administration.)
3. Auditors reported no weaknesses in internal control. (Here, too, the federal agency may waive this requirement if the weakness doesn't adversely affect program administration.)
4. For Type A programs, auditors found no weaknesses in internal controls, noncompliance with laws or grant provisions, or questioned costs exceeding 5% of the program's expenditures.

If the nonprofit organization doesn't meet these criteria, the CPAs must select other programs for audit. They must continue to do so until they have covered programs encompassing 50% or more of the organization's total federal expenditures. (If the organization has been designated a low–risk organization, the minimum coverage is reduced to 25%.) The CPAs can choose additional programs from the low–risk Type A programs, high–risk Type B programs not already selected, or Type B programs not classified as high–risk. There is no prescribed order for picking programs to meet this "50%/25% rule." Auditors simply select the programs they feel are appropriate for auditing.

What does all this mean for your organization? It means that if your financial controls are sound, there's a good chance your CPA firm will designate you a low–risk organization. Once that happens, your future audits will be far less extensive and burdensome.

OTHER CHANGES IN CIRCULAR A–133

The increased dollar threshold and introduction of risk–based auditing are the biggest but not the only changes. Other new provisions in the updated Circular A–133 include the following:

1. The circular gives better guidance on when subrecipients are required to undergo A–133 audits.
2. The new circular clarifies the responsibilities of all parties, including the nonprofit organization and federal agencies.
3. The circular provides guidance on selecting a CPA firm to perform the audit.
4. The circular expands its guidelines for conducting and reporting on program–specific audits.
5. Auditors' reports will include new assertions which you must sign.
6. Audit reports will be due nine months after year–end. (Currently, organizations have up to 13 months.) ■

Selected References

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These publications are available through the Society for Nonprofit Organizations' *Resource Center Catalog*, included in this issue, or contact the Society at 800–424–7367.

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