How to Have an Audit without Breaking the Bank

No matter how small your organization, you can afford an audit if you follow these steps.

BY MARGARET O'REILLY-ALLEN

If you're one of the many nonprofits required to have a financial audit, don't despair.[1] While the thought of an audit may be overwhelming, you can take steps to ensure that it proceeds smoothly and quickly. And the faster and more trouble-free the audit, the less it will cost.

Find Good Auditors.

If you or someone on your board doesn't know a reliable CPA firm, ask other nonprofits in your area for suggestions. An auditor will do the following:

- Examine and analyze your organization's internal-control structure, accounting records, and related source documents.
- Produce a report containing an opinion on the fairness of the financial statements.
- Plan and perform an examination to detect material fraud in the financial statements.

Meet with Auditors Ahead of Time.

Schedule a planning conference with the auditors at least a month before the audit begins. Discuss the overall audit plan and find answers to such questions as these:

- When will the audit begin and end?
- Where will the audit work be conducted?
- What will the auditors need from you?

Remember, if auditors have to spend time doing bookkeeping duties and locating data that your staff could easily provide, the length and cost of the audit will increase. By preparing as much information as possible in advance, you can reduce the number of billable auditor hours.

Also schedule an exit meeting at the end of the audit process. That will give you a chance to discuss any unresolved issues.

Nonprofit World • Volume 20, Number 4 July/August 2002 • Published by the
Society for Nonprofit Organizations • 5820 Canton Center Road, Suite 165, Canton, Michigan 48187
800-424-7367 • www.snpo.org

Gather Data.

Ask your auditors to list the information they will need so that your staff can start collecting it. Figure 1 provides a list of information that is likely to be required.

Document Your Internal Controls.

The first thing the auditors will do is assess your organization's internal controls.[2] This is the most important part of the audit, because the stronger your internal controls, the less time and effort the rest of the audit will require.

The auditors will begin by interviewing key personnel, observing your accounting procedures, and reviewing records and documents. They will examine your organization's internal controls and assess the risk that those controls may pose. For example, certain controls may fail to detect or correct material misstatements that could affect the financial statements.

To prepare for this portion of the audit, review your internal controls, including the handling of cash and deposits. Check the processes in place for spending and disbursements. Address any weaknesses that you know exist. The auditors will be interested in how aware you are of such weaknesses and risks, how you manage them, and how you assess the likelihood of occurrence. Focus on the following five areas, which are the components auditors are required to evaluate:

1. Control Environment

The control environment is the tone set by top management. It is considered the foundation for all other components and includes factors such as your operating style, integrity, and ethics.[3] To document your control environment, be sure to do the following:

Prepare an organizational chart. The auditors will need to know who is responsible for various functions within your organization. If you don't already have

Figure 1

Checklist for Your Financial Audit

By anticipating the auditors' needs, you can speed the process and ease the burdens associated with this fiscal responsibility. Here's a checklist of what to do ahead of time:

- ✔ Prepare information on your accounts receivable. List (by category) the parties who owe you money. Include updated addresses, amounts, and due dates. The auditors will ask you to prepare confirmation letters that will be returned directly to the auditors.
- ✔ Create an inventory statement. If your organization purchases and sells fundraising merchandise, provide a record of purchases and sales for the year. Document that you took a periodic inventory count during the year. Be prepared for the auditors to count the inventory.
- ✔ Provide a statement of property and equipment (fixed assets). List the date acquired, the amount paid, the expected life, annual depreciation, and depreciation to date.
- ✔ Note your account payables. To whom do you owe money? What is the amount and date due? Make a list, and provide copies of invoices and loan agreements.
- ✔ List your deferred revenue. If your organization has deferred any contributions due to donor conditions or restrictions, list this information.
- ✔ Detail your grants, contributions, and gifts. List donor names and addresses, grant period, grant amounts, date received, restrictions, and copies of the grant letters and grant applications.
- ✔ Describe donations. List all donated services and materials. Estimate a dollar value on contributions of services and materials.[4]
- ✔ Provide other information if the auditors ask for it. This information may include the following:
  - annual budget for the fiscal year being examined, including funding sources and costs for all programs, for management, and for fundraisers
  - leases and other contracts
  - monthly bank statements and reconciliation
  - payroll records, including federal and state tax returns related to payroll
  - vacation records
  - records showing types and levels of insurance coverage for the organization, key employees, and board members.

one, prepare an organizational chart that shows the complete management structure, including key volunteer positions. Such information can save valuable time during the audit.

Describe your board. The auditors will need a written document describing the function of the board and listing the members and their qualifications. You should also provide dates and minutes of board meetings. (An effective board should meet at least quarterly. If your board meets less frequently, be prepared to tell the auditors why.) The board's function should include regular review of your financial statements, placing special emphasis on controls that are in place to track donations and revenue sources. This is a critical internal-control issue for nonprofits. Be sure the board's discussion of these topics is documented in the minutes. If your board hasn't previously reviewed this information, be prepared to explain why.

Assess your control over compliance issues. List all federal and state guidelines that apply to your organization. Also, provide copies of policies and procedures in place to show compliance with these requirements. Provide evidence of an up-to-date IRS tax-exempt form 990.

2. Risk Assessment

Be prepared to do the following:

Brief the auditors on how you address risks that arise from changes in your operating environment, new personnel, new technology, and new accounting regulations directed at nonprofits. Address risks related to economic, industry, regulatory, and operating conditions, as well as any other risks relevant to achieving financial reporting objectives.

3. Control Activities

Control activities are procedures ensuring that management policies are carried out throughout an organization. To document your control activities:

Provide flowcharts of accounting systems as well as copies of applicable policies and procedure manuals. If you don't have this information available, begin to prepare it now.

Show that there is separation of duties among employees. Separation of duties is considered a critical internal control. For example, the person who collects cash shouldn't be responsible for maintaining bank records. If your organization is small and one person handles all cash functions, this should be documented and described as a weakness. The auditors will then conduct more extensive testing in this area.

The auditors will be interested in how aware you are of weaknesses and risks.

Document controls on information systems, such as who has access and passwords to specific accounting programs. Provide copies of user manuals for accounting software packages.

Verify your payroll controls. Describe how new employees are entered into the system and how they are paid. Explain controls to prevent someone from entering a fictitious employee name and issuing a payroll check.

List your policies for identifying authorized check signers and the number of signatures required on checks that exceed specified dollar amounts.

4. Information and Communication

Provide information on the process used by managers to communicate internal-control responsibilities. Describe the information system that produces reports about operational, financial, and reporting-related data.

5. Monitoring

Detail how management monitors the quality of internal-control processes. Explain how the organization responds to an internal-control weakness once it has been identified. Include procedures for reporting deficiencies to top management and the board of directors.

Prepare Other Audit Evidence.

In addition to evidence about internal controls and other information requested by the auditors, you will be required to provide a written statement confirming oral statements made during the audit in response to various inquiries. Matters the auditors may inquire about include:

- accounting errors or irregularities involving management or employees
- communications from regulatory agencies concerning deficiencies in compliance
- any current litigation
- circumstances that affect the carrying value of assets
- any material issue that could affect your financial statements.

You can save time and money by having this information readily available in advance of the audit.

Be Ready to Address Deficiencies.

The final phase requires the auditors to prepare a written report accompanied by a letter of reportable conditions. The audit report expresses an opinion on the fairness of financial statements. The letter of reportable conditions addresses significant deficiencies in the design or operation of the organization's internal-control system. (It is possible to have reportable conditions and still receive an unqualified or "clean" opinion.) The auditors will advise you to discuss any reportable conditions with your board and to develop a corrective plan to address such deficiencies in the future. ■

Footnotes

[1]Nonprofits expending $300,000 or more in federal awards for any given year must have a single or program-specific audit completed every year within nine months of year-end.

[2]See "Setting Up a Control System," "How a Small Organization Can Audit Its Books," "Preparing for Today's Nonprofit Audit," and "Protecting Your Organization's Assets: A Primer on Internal Control" in *Accounting and Financial Management, Leadership Series* (see "References.")

[3]Consider conducting your own ethics audit before the financial audit takes place. See the sample ethics audit in "Why Ethics Tools Don't Work," *Nonprofit World,* Volume 17, No. 2 (www.snpo.org).

[4]See "Financial Records and the Value of Volunteers" in *Accounting and Financial Management, Leadership Series* (see "References.")

References

Dennis, A., "Best Practices for Audit Efficiency," *Journal of Accountancy,* September 2000.

Fleming, R., *New Accounting and Reporting Standards for Nonprofits—What You Need to Know,* www.eskimo.com/pbarber/fasb 116.html.

McNamara, C., *Checklist to Assess Financial Activities in Nonprofit Organizations,* United Way of Minneapolis Area, www.mapnp.org/library/org.

Muehrcke, J., ed., *Accounting & Financial Management, Leadership Series, Volumes I and II,* www.snpo.org.

Margaret O'Reilly-Allen, Ph.D., C.P.A., is an assistant professor of accountancy, College of Business Administration, Rider University, 2083 Lawrenceville Road, Lawrenceville, New Jersey 08648-3099, 609-895-5505, oreillyallen@rider.edu.