Avoid an Unwanted Auditor's Letter

Even the smallest nonprofit can put these five essentials to good use.

By David Hess & Mark H. Haney

If you're not careful, you may be receiving an unwanted letter — a mandatory communication from your auditor.

> "The memo must demonstrate the organization's commitment to managing risks."

Professional standards require this letter if your auditor finds weaknesses or deficiencies in your internal controls.[1] And it's common for auditors to find such problems, especially in small nonprofits.

Receiving such a letter would be extremely embarrassing for your organization. But you can avoid it — no matter how small your organization is — if you implement an effective internal control system.

With proper planning, even the tiniest nonprofit can prove to its auditor that it has good internal controls. To illustrate, let's use our local Habitat for Humanity as an example, since it's a very small nonprofit, with a business structure limited to only three people.[2] As its internal control system shows, there are five components to a good control system.

Here are those five essentials. Here, too, are ways to prove that you're actively embracing them:

1. CONTROL ENVIRONMENT

A healthy control environment is the cornerstone for a quality system of internal control. Without it, all other efforts are undermined. Characteristics documenting a strong control environment include:

Both the board and management are actively involved in activities related to the organization's financial health. Well-prepared board minutes document this practice.

There is a documented history to show that managers and board members have followed through on any comments by auditors in previous years.

Managers provide formal training for staff and board members before they begin performing their duties.

Managers, staff, and board members possess the knowledge and experience to do their jobs well.

Before they're hired, employees document their knowledge and experience for the position they are considering.

Managers review well-prepared financial information every month. The board reviews this information at least quarterly (and in some circumstances, monthly).

The board prepares and maintains an employee handbook, which every employee receives.

At least one member of the board has financial reporting, accounting, and internal control expertise.

2. RISK ASSESSMENT

Someone on the board or in management serves as the risk assessment manager. It may be necessary to actively recruit someone with the proper experience and knowledge for this role.

The risk assessment manager analyzes and manages any risks that might affect the financial reporting process.

> “Even with only three people, it’s possible to perform a segregation of checks and balances.”

At least once a year, the risk assessment manager prepares a memo documenting changes in personnel, operating environment, technology, and accounting pronouncements and how they may impact financial reporting. The memo can be as short as one page, but it must clearly demonstrate the organization’s commitment to identifying, analyzing, and managing risks.

3. CONTROL ACTIVITIES

Assume that the organization has only three people: an administrative assistant, an executive director, and an active, interested board member. Using these three people, it’s possible to perform a reasonable segregation of checks and balances, as follows:

Cash Receipts

- **The executive director opens the mail** and endorses all checks.
- **The executive director prepares a record** (list of all the checks received) and initials this list.
- **The executive director gives the checks and check listing** to the administrative assistant, who initials the check listing, makes a photocopy of each check, records each check into the accounting system, prints out a summary of the entry, and prepares the bank deposit slip.
- **Every month, a designated board member reviews and initials** the deposit record, which includes the accounting summary printout, copy of the deposited checks, and bank deposit slip.

In this cash receipts system, the executive director has access to assets, while the administrative assistant has access to records. The administrative assistant’s access to assets is restricted and controlled by both the restrictive endorsement and the board member’s timely review and approval of the deposit package. It’s important to note that the executive director does *not* have access to the accounting records.

Cash Disbursements

- **The administrative assistant codes and records invoices for payment,** prepares all checks, and keeps the checks in a locked file.
- **The executive director approves all invoices** (initials the voucher package), signs all checks, and mails the checks.
- **A second signature by a board member** is required on all checks.

As with cash receipts, the executive director is given access only to assets, the administrative assistant is given access only to accounting records, and the designated board member’s involvement adds a final level of control.

Bank Reconcilement

- **The administrative assistant prepares the bank reconcilement** monthly.
- **The executive director and the designated board member review and initial this reconcilement** on a timely basis. This review allows for checks and balances on both the cash receipts and cash disbursement systems.

The Five Requirements in a Nutshell

Essential to a quality system of internal control is a commitment at both the board and management level. A simple summary documenting this commitment includes:

1. **Control Environment:** an active, competent board, fostering a culture of compliance to high financial and accounting standards
2. **Risk Assessment:** a board member or executive who annually documents the management of risks
3. **Control Activities:** one employee responsible for assets, another employee responsible for records, and a board member (specifically recruited for this function) who reviews accounting records and financial statements monthly
4. **Information and Communication:** quality accounting software, made effective by an investment in training, maintenance, and upgrades
5. **Monitoring:** a process to review and update the internal control system whenever employee turnover occurs

Payroll

- **The administrative assistant prepares all payroll records** and reports.
- **Checks are issued** via the normal cash disbursement process (described above).
- **The designated board member reviews payroll reports** for proper withholding amounts.

Property, Plant, & Equipment

- **The administrative assistant prepares accounting records** associated with all property and equipment owned or rented by the organization.
- **The designated board member reviews these accounting records** quarterly.

Inventory

- **The executive director has access and responsibility** for the inventory.
- **The administrative assistant maintains** the supporting records.
- **Together, the executive director and administrative assistant perform an annual physical count** of the inventory.
- **The designated board member reviews and approves** the results of the inventory.

Financial Reporting

- **Either the executive director or a board member (preferably both)** must have the technical competence to review, understand, and approve financial records.

Continued on page 18

4. INFORMATION AND COMMUNICATION

The organization must have well-designed and comprehensive financial records. Many of these can be generated through the proper use of professional accounting software.

The organization must be committed to using this software effectively. This means investment in training, maintenance, and regular upgrades. Having a board member with expertise in the software will help employees use it productively.

Essential to realizing the full benefit of accounting software is a good basic design up-front. This means drafting an effective chart of accounts, ensuring basic competence in daily use, and gaining a full understanding of all the reports the software can generate. Many internal controls and cross checks are natural byproducts of the information generated by the accounting software.

All expenses are supported by a voucher package including purchase order, receiving report, and invoice.

All cash receipt deposits are supported by necessary correspondence attached to an authenticated deposit ticket.

Payroll records for each pay period are supported by approved time sheets.

Detailed inventory lists and property, plant, and equipment records support balance sheet amounts.

Every month, the administrative assistant documents the process of reconciling subsidiary records with control accounts (for example, accounts receivable and accounts payable).

Accounting worksheets support each balance sheet account not having a subsidiary ledger (for example, bank reconcilements supporting cash and an insurance expense/prepaid insurance analysis supporting prepaid expense).

A simple document details regular software back-up activity.

There is active information flow to the executive director and board.

> "The organization must be committed to using accounting software effectively."

A qualified board member reviews the bank statement, bank reconcilement, and general ledger every month.

Once every quarter, board members compare financial statements with an approved budget. They expect to see detailed explanations of any variances between the two.

In a small organization, many expenses can be analyzed and interpreted on a quarterly basis. Examples include payroll, payroll taxes, employee health insurance, pension costs, rent, depreciation, interest on savings, and professional fees (these tend to be board approved). Any variances in these accounts are easy to identify. An additional component that would strengthen information and communication would be the development of a simple accounting manual. This could be produced by a generous board member.

5. MONITORING

The organization performs an audit every year.

The organization implements and embraces all comments from its auditor.

Every time there is employee turnover, the executive director and the designated board member evaluate the organization's system of controls.

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[1] With the issuance of *Statement on Auditing Standards Number 115 (SAS 115), "Communicating Internal Control Related Matters Identified in an Audit,"* auditors are required to send a letter to those charged with governing the organization, pointing out any material weaknesses or significant deficiencies in internal controls. A material weakness is a deficiency or combination of deficiencies in internal control resulting in a reasonable possibility that a material misstatement will not be prevented or detected and corrected on a timely basis. A significant deficiency is a deficiency or combination of deficiencies in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. While SAS 115 does not require an auditor to perform specific procedures to identify deficiencies in internal control, it is nonetheless common for an auditor to discover deficiencies in internal control during the course of conducting an audit. If these deficiencies aren't corrected, the letter will continue to be issued each year.

[2] The local Habitat for Humanity affiliate is a highly respected institution in the community. It is a nondenominational Christian organization committed to providing decent, affordable housing to those in need living in the region. The board is composed of banking officials, active church leaders, members of the Rotary and Chamber of Commerce, local clergy and government officials, and other community leaders. The organization, made up of many generous volunteers, takes great pride in building a better community. The organization's business structure is limited to three employees. The executive director oversees all activity and reports directly to the board. An administrative assistant/accounting clerk provides technical support. A building manager directs all construction activity and controls one of the entity's principal assets, building materials inventory.

Reduce Your Risks

For more, see these articles at www.NonprofitWorld.org/members:

How to Have an Audit without Breaking the Bank (Vol. 20, No. 4)

Setting Up a Control System for Your Organization (Vol. 16, No. 3)

To Write Or Not to Write: Do You Need a Personnel Handbook? (Vol. 11, No. 3)

Get Ready for a Better Audit (Vol. 30, No. 2)

Need a CPA at Little Or No Cost? Five Ways to Find Help (Vol. 28, No. 2)

How to Find the Perfect Auditor (Vol. 22, No. 3)

Training Programs Need More than Good Information (Vol. 21, No. 2)

What Is the Board's Role in Managing Risks? (Vol. 15, No. 5)

If It's Not in the Minutes, Did It Happen? (Vol. 14, No. 6)