Maximizing the Audit Process

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More than just a snapshot of financial health, an audit can help maintain best practices, assess performance, and avoid future problems.

Nonprofits find themselves maneuvering in a stormy sea of public skepticism, litigation, and increased governmental oversight. Is there a life preserver nonprofits can cling to in this turbulence? An audit can often help organizations survive and stay on solid ground, or get back safely if they find themselves drifting out to sea.

Since receiving and spending money is fundamental to every nonprofit organization, an audit (1) helps ensure financial accountability to an organization's constituencies, (2) provides reasonable assurance that the financial statements are free of material misstatement, and (3) results in an independent evaluation of many significant financial management areas, including internal controls, information systems, accounting and reporting, and compliance with tax and other significant laws and regulations.

The Senate Finance Committee is considering whether to introduce legislation requiring audits or reviews over certain annual revenue thresholds, but currently audits of nonprofits are generally voluntary. Federal laws governing tax-exempt organizations do not require audits unless federal awards of $500,000 or more per year are provided. A number of states require audits of certain charitable organizations.

Even though most nonprofits are not required to have an audit, the donor public increasingly expects charities to have an annual independent audit. Only very small charities avoid this expectation.

Charities often go through the routine of obtaining an annual audit in an obligatory manner to satisfy donors, foundations, and regulators. Proactive charities openly embrace the audit with a view to maintaining high financial standards and improving the organization. Here are five key ways to maximize the audit process:

Be sure the board is in the audit driver's seat. The nonprofit board has the responsibility to oversee the audit process. This includes assessing the financial controls, policies, procedures, and condition of the organization and overseeing the external auditor.

The auditor should be selected by the board and should make a report to the board. Management may provide input in the auditor selection process, but the selection of the auditor must rest with the board. The board could delegate the responsibility of choosing the auditor to the audit committee, but this would represent a very significant delegation of board authority for most nonprofits.

Review the auditor's independence. The board should be certain that the auditor is independent and objective in performing duties. It should identify any threats to objectivity and analyze the significance of such threats. Objectivity does not require that the auditor be completely free of all factors that might affect the ability to make unbiased audit decisions, but the auditor should be free from those that rise to the level of compromising that ability.

Factors that may pose threats to independence and objectivity include: self-interest (the auditor acts in his or her own emotional, financial, or other personal selfinterest), self-review (the auditor audits his or her own work or the work of a colleague), and familiarity (the auditor is influenced by a close relationship with an audit client).

Choose your auditor carefully. Even with rigorous efforts by professional bodies governing the practice of Certified Public Accountants to improve the quality of audits, not all audits are created equal. The quality of an audit is directly impacted by

- the experience and competence of personnel assigned to the engagement
- the emphasis and priority of the audit firm on nonprofit audits and advisory services

Initial screening of potential audit firms should focus on industry experience, professional qualifications, expertise of the engagement team, and ability to provide the highest quality and best value of audit services.

Invest your audit dollars wisely. While it is important to be certain the audit fees are reasonable in light of the quality and value of an audit, focusing too much attention on cost can be detrimental to the health of the audit and ultimately to the organization.

If an organization truly values the independent audit and desires the benefits that can come from an independent firm helping it maintain best practices, anticipate and avoid problems, and assess its performance, then cost should be secondary to quality. Value is a correlation of both quality and cost.

Properly use your audit committee. The audit committee should be the fulcrum of the financial reporting function. Start with an independent audit committee. The committee members should not be members of the nonprofit's staff. Invite staff members to committee meetings to answer questions and to provide information.

Financial literacy should be a hallmark of the committee. If there aren't enough board members with financial literacy to place on the committee, use nonvoting, nonstaff advisors rather than board members, if state law permits.

The audit committee must have an open, candid dialogue with the auditor each year. At least a portion of each meeting should be conducted in the absence of staff to maximize candor in board-auditor discussions. Multiple meetings each year are appropriate for large nonprofits.

The principal responsibility for the quality of a nonprofit's financial report rests with management, not the board. Yet, it is the board's responsibility to oversee the financial process. Board members do not make journal entries or prepare financial statements, but they should understand the organization's operations — top to bottom. They must see the snapshot picture and the panoramic view and be willing to ask the tough questions about the nonprofit's finances.

Where to Find an Auditor

- The Web site of the Evangelical Council for Financial Accountability provides names and contact information for auditors who are performing audits for one of the Council's members.
- Get references from your local CPA association or contact the national organization, AICPA.
- Check with other nonprofit organizations to see whom they use and get their assessment.

References

- "Making the Best Use of the Auditing Process" *Regulatory Landscape 2005* (Nonprofit Quarterly).
- BoardSource and Independent Sector, *The Sarbanes-Oxley Act and Implications for Nonprofit Organizations* (2003).

The Audit Committee's Must-Do List for 2010

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Since the Sarbanes-Oxley Act (SOX) was enacted in 2002, the number of audit committees and their role in governance has greatly expanded. While the act focuses on publicly traded companies, the nonprofit sector has responded by reevaluating its governance structure and processes as well.

Traditionally, the role of the audit committee has been to monitor, oversee, and advise the organization's managers and external auditor as they prepare financial statements and conduct audits, subject to the ultimate authority of the board. However, with the public focus on transparency and accountability, as evidenced by the expanded disclosures on the new Form 990 and the bad press that accompanies a scandal, the challenge for audit committees is to be more proactive in fulfilling their traditional role, complying with current and new legislation, and upholding their organization's good standing under public pressure. This expanded role can be defined by some "must-do's."

1. **Oversee the external audit process**

   The audit committee is directly responsible for the appointment, compensation, oversight, and retention of the independent auditor. Under SOX, the relationship between management and the outside auditor was meant to be replaced largely by one between the audit committee and the outside auditor. Yet many nonprofit organizations have yet to form a separate audit committee, and, whether distinct or not, many of the committees or groups charged with the responsibilities for the audit still depend heavily on management in the disposition of these responsibilities.

   Audit committees should be intimately involved with the selection of the auditor. The committee should participate in a planning meeting with the auditor to better understand the audit process and to provide insight to the auditor as to inherent risks that may exist in the operations of the organization.

   Upon the culmination of the audit, the auditor should report to the committee concerning

   - all critical accounting policies and practices
   - the strength (or weaknesses) found within the internal control structure
   - alternative treatments of financial information within generally accepted accounting principles employed by management and the ramifications of their use over methods preferred by the profession and by the auditor

    - other matters of formal communications including
        - the representation letter signed by management
        - the letter to management and the full board covering suggestions for improvements to the systems of internal controls and in the financial accounting and reporting processes
        - a schedule of adjustments proposed by the auditor and details of any unadjusted differences

    An executive session with the auditor should be a matter of common practice for the audit committee. Staff should be asked to leave the meeting so that the auditor can speak directly and freely to the committee on matters concerning management and the organization, such as

    - any disagreements that may have occurred with management
    - any major issues that may have been discussed
    - whether the auditor is aware of management seeking consultation from other external accountants
    - the capabilities of management and the finance department as it pertains to their contribution to the success of the audit
2. **Oversee the financial reporting process**
   While the auditor certainly helps the audit committee fulfill one of its primary functions, this relationship, no matter how strong and reliable, cannot eliminate the need for the audit committee (in partnership with the finance committee) to oversee the financial reporting process throughout the year. Monthly and quarterly financial statements are the primary way in which to monitor the operations of the organization. The committee should be cognizant of the methods of reporting, enforce the systems to ensure accuracy, and demand timeliness of the data being received. With the economic downturn, financial reports might include not only historical data and budget-to-actual results but projected cash flows as well. These statements should be discussed with management and management should be prepared to give a thorough analysis of the historical results and trends as well as its expectation for the nearterm future of the organization.
3. **Pay attention to risk assessment and risk management**
   Assessing controls and processes to determine where a fraud can occur or an error can go undetected is to understand risks that can threaten the very life of the organization. It is important to understand that fraud is not just the theft of assets but misreporting as well. Either one can do irreparable harm to the organization. Trusting management and those in your finance department is just not enough. Internal controls that segregate duties or provide supervisory checks keep honest people honest.

   The audit committee should be aware of management's actions and attitudes towards improving internal controls and financial accounting and reporting processes. If the auditor is making the same recommendations in the management letter each year, if interim financial reports or the audited annual statement are untimely, if the finance department is understaffed or its infrastructure is unable to support its financial reporting needs, if there is significant and frequent turnover – these are indicators of inherent risk. They also can tell an audit committee about the true "tone at the top" – the attitude from the highest levels of the organization regarding ethical and compliance behaviors of all the employees. For an audit committee to be truly effective, it must influence this tone. It must ensure that management clearly communicates to employees that financial misreporting is absolutely unacceptable. The committee should ask tough questions with the proper amount of skepticism and insist on receiving bad news as well as good promptly and fully. It then needs to react quickly to such issues not only to resolve them but to install preventative measure.

Whistleblowing has become a new buzz word for the reporting of "bad news." The audit committee should establish specific procedures for handling complaints received by the organization regarding finance, accounting, internal accounting controls, and audit matters. The whistleblower policy should allow for the confidential submission by employees of their concerns of questionable accounting, reporting, or auditing matters. And the audit committee should ensure that each employee receives a copy of the policy and is assured of confidentiality and protection.

Some good questions for the audit committee to ask this year include

- Is there detailed planning for internal control documentation and evaluation?
- Did this work identify any weaknesses in internal controls?
- Do we have sufficient resources to maintain the key controls?
- Is our staff adequately trained in such matters?

Audit committees need to be vigorous in the fulfillment of their responsibilities in order to effectuate proactive oversight. Strong oversight will help to protect the organization and ensure its sustainability and the success of its important mission within the nonprofit sector.

MORE ON THE WEB
about audit committees

References

Frank L. Kurre, "Challenges Affecting Audit Committees of Not-for-Profit Organizations" *Forward Thinking, Issue 13* (Grant Thornton).

Thomas A. McLaughlin, *Financial Committees* (BoardSource 2004).