Why and How to Keep U.S. Nonprofits Audit and Compliance Ready in 2025

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Today's Presenters

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Setting the Stage

Ruth McCambridge
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From our last webinar…

- The accounting pipeline and audit firm capacity.
- Increased fees.
- Audits vs reviews vs compilations vs advisory services.
- Determining if you need an audit.
- Alternatives to audits.

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Turns out we do need an audit…

- Delivery method: on-site, remote, hybrid.
- Engagement letter and fee considerations.
- The Expectation Gap: the difference between what the public believes are an auditor’s responsibilities and what auditors actually deliver.

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So, what actually happens in an External Audit?

- Planning and Risk Assessment
- Analytical Procedures
- Control Testing
- Substantive Testing
- Reporting

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Opinion

- We have audited the financial statements of entity and the related notes to the financial statements.
- In our opinion, the accompanying financial statements present fairly, in all material respects as of June 30,20XX, the financials for the year(s) then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

- We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report.
- We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits.
- We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion

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Management's Responsibility

- **Management is responsible** for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

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Auditor's Responsibility

- Our objectives are to **obtain reasonable assurance about whether the financial statements are free from material misstatement,** whether due to fraud or error, and to issue an auditor's report that includes our opinion.
- We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit

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AU-C 265, Communicating Internal Control Related Matters Identified in an Audit

- Understanding the auditor's responsibility and requirements in looking for internal control deficiencies in an audit
- Generally Accepted Auditing Standards (GAAS) require the auditor to communicate in writing to management and those charged with governance **significant deficiencies** and **material weaknesses** in internal control, including those that were remediated during the audit.
- Other deficiencies in internal control identified during the audit that, in the auditor's professional judgement, are of sufficient importance to merit management's attention. If other deficiencies are communicated orally, the auditor should document the communication.

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Begin with the End in Mind

- Stay Organized
- Documented Control Processes
- Periodic Close Processes
- Evaluate Estimates
- Continual Communication
- Working WITH your auditors
  - Timelines
  - Capacity
  - Testing and Documentation

Things to tell your auditor about

- New/Discontinued Programs
- Strategic plans
- Economic impacts
- Political impacts
- Turnover of key management
- Debt Covenants
- Federal/State Grants
- Desk reviews/monitoring reports
- Valuation of investments
- Significant or unusual transactions
- Lawsuits
- Insurance Claims

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Documents they will want to see

- Changes to bylaws
- Board Packets, Agendas and Minutes
- Debt Agreements
- Leases
- Construction Contracts
- Grant Agreements and Budgets
- Other Significant Contracts
- Fundraising Solicitations
- P&L from Special Events

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Practical Tip #1:
Start an Audit Folder on Day One

- Copy documents to the folder as they happen during the year
- Send to the auditors before the first planning meeting
- Less pressure to remember things

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Document Internal Controls

- Focus on major transaction cycles
- Document:
  - Origin of transaction
  - Steps in process and who does them
  - What could go wrong?
  - What prevents it from going wrong?
  - Who is monitoring? How?

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Practical Tip #2: The Internal Control Matrix as a Living Document

- Adjust each time there is turnover or position realignment
- Use in onboarding new employees
- Incorporate new software/interfaces during implementation

Leverage your periodic close

- Start with Prior Year Audit Schedules
- Roll forward each month
- Gather 3rd party reports and statements
- Maintain documentation in a central place

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Sample Close Process List

Monthly	Quarterly	Annually
• Balance Sheet Accounts • Depreciation • Contracted Revenues • Significant Contributions • Payroll Expenses	• Expense Allocations • Search for unrecorded pledges • Net Asset Releases • Form 941 reconciliation	• Bad Debt Allowance • Lease Obligations • Endowment Distributions • Functional Expenses

Practical Tip #3:
Document PERFORMANCE of Controls

- Audit trails recorded by software
- Positive evidence of the performance of monitoring controls
- Documentation of review

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Examine Estimates

- Allowance for Bad Debt
- Depreciation
- Amortization
- Prepaid Expenses
- Deferred Rent
- Investment Values
- In-Kind Revenue/Expense

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Practical Tip #4: Communicate Consistently

- Don’t wait until year end
- Ask questions during the year
- Learn new things together

Working WITH your Auditor

- Plan
- Stick to the plan
- Communicate changes to the plan

Plan the process

- Communicate deadlines
  - Board meeting
  - Debt Covenants
  - Other Compliance
- Agree on fieldwork dates
- Set interim deadlines
- Work backwards to create a project plan
- Assign ownership

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Clarify Expectations

- Start with Prior Year Audit Schedules
- **When in Doubt, Ask for the Auditor’s Objective**
- Be ready to grant access to systems
- Schedule time for process walk-throughs
- Communicate your team’s capacity

Don’t forget review!

- Build in time for internal review
  - Audit Schedules
  - Underlying Documentation
  - Audit Selections

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Practical Tip #5:
Build your project plan around the PBC list

- PBC= Prepared By Client
- Ask your auditors for the list, or refer to last year
- Organize your files the same way

Practical Tip #6:
Plan Capacity for Pulling Selections

- Time sensitive asks during fieldwork
- Offer access to systems for efficiency
- All hands on deck during fieldwork

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Single Audit Preparation

- Gather grant agreements and CFDA numbers
- Prepare your SEFA early and tie to
  - Draw documents
  - General Ledger
  - Activity reports from Grantor portal
- Have your draw support ready

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Q&A

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Resources and Wrap Up

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Risk Assessment Key Points

- Generally Accepted Accounting Principles (GAAP)
- Reasonable assurance
- Materially correct
- Risk assessments
- Internal controls

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Assertions (reference only)

Categories of Assertions		
	Classes of Transactions & Events During the Period & Account Balances at the End of the Period	**Presentation & Disclosure**
Existence	Assets, liabilities and equity interests exist, and recorded transactions and events have occurred and pertain to the entity. (ET)	Disclosed events and transactions have occurred and pertain to the entity. (EP)
Ownership & Obligations	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity. (OT)	N/A
Classification & Allocation	Transactions and events have been recorded in and, if applicable, appropriately allocated to the proper accounts. (CAT)	Financial information is appropriately classified within the financial statements. (CAP)
Completeness & Cutoff	All transactions and events and assets, liabilities and equity interests that should have been recorded have been recorded in the correct accounting period. (CT)	N/A
Valuation	Amounts and other data related to transactions and events and assets, liabilities and equity interests and any resulting valuation adjustments have been recorded appropriately. (VT)	N/A
Accuracy & Understandability	N/A	All financial and other information that should be included and/or disclosed in the financial statements has been included and is accurately presented, properly described and clearly expressed in plain English. (AUP)

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Which Standards?

When?

How?

- Uniform Guidance Compliance Supplements
- Audit and Accounting Guides
- Audit risk alerts
- FASB/GASB Pronouncements
- State/Local Society of CPAs

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Management's Responsibility (cont.)

- In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the company's ability to continue as a going concern within one year after the date that these financial statement are available to be issued.

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Deficiency in Internal Control

- A deficiency in internal control exists when the **design** or **operation** of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.

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Design versus Operation

- A deficiency in ***design*** exists when (*a*) a control necessary to meet the control objective is missing, or (*b*) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

- A deficiency in ***operation*** exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

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Material Weakness

- A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

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Reasonably Possible versus Probable

- Reasonably Possible

  The chance of the future event or events occurring is more than remote but less than likely

- Probable

  The future event is likely to occur

Significant Deficiency

- A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance

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How do auditors evaluate identified deficiencies?

- Potential magnitude impact
- Likelihood
- Consideration of mitigating controls
- Prudent Official Test
- Examples of potential deficiencies

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Evaluating Identified Deficiencies

- The severity depends not only on whether a misstatement has **actually occurred** but also on:
  - The magnitude of the potential misstatement resulting from the deficiency
  - Whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, a misstatement of an account balance or disclosure.
  - A reasonable possibility exists when the chance of the future event or events occurring is more than remote.
  - Significant deficiencies and material weaknesses may exist even though the auditor has not identified misstatements during the audit.

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Evaluating Identified Deficiencies (cont.)

- Factors that affect the magnitude of a misstatement include, but are not limited to the following:
  - The financial statement amounts or total of transactions exposed to the deficiency.
  - The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency.

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Potential Magnitude Impact

Less than inconsequential

Inconsequential

Material

Likelihood

Remote

More than Remote

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Risk Factors We Consider in the Evaluation

- Nature of the financial statement accounts, classes, disclosures and assertions
- Cause and frequency
- Susceptibility of the related asset or liability to loss or fraud
- Subjectivity, complexity, or extent of judgment required
- Interaction or relationship of the control(s) with other controls

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Risk Factors We Consider in the Evaluation (cont.)

- The interaction with other deficiencies in internal control
- The possible future consequences of the deficiency, or deficiencies, in internal control
- The importance of the controls to the financial reporting process
  - General monitoring controls (such as oversight of management)
  - Controls over prevention and detection of fraud
  - Controls over the selection and application of significant accounting policies
  - Controls over significant transactions with related parties
  - Controls over significant transaction outside the entity's normal course of business
  - Controls over the period-end financial reporting process (such as journal entries)

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Consideration of Mitigating Controls

- Do compensating controls exist that effectively mitigate the severity of the control deficiency?

- In determining whether a control deficiency or combination of control deficiencies is a significant deficiency or material weakness, the auditor also should evaluate the possible mitigating effects of effective compensating controls that have been tested and evaluated as part of the financial statement audit.

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Consideration of Mitigating Controls (cont.)

- A compensating control is a control that limits the severity of a control deficiency and prevents it from rising to the level of a significant deficiency or, in some cases, a material weakness.
- Compensating controls operate at a level of precision, considering the possibility of further undetected misstatements, that would result in the prevention or detection of a misstatement that is more than inconsequential or material to the financial statements.
- Although compensating controls mitigate the effects of a control deficiency, **they do not eliminate the control deficiency**.

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Prudent Official Test

The auditor should conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.

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Potential Deficiencies

- Failure in the operation of effectively designed controls over a significant account or process; for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process
- Failure of the information system and communication component of internal control to provide complete and accurate output due to lack of timeliness, completeness, or accuracy.

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Potential Deficiencies (cont.)

- Failure of controls designed to safeguard assets from loss, damage, or misappropriation
- Failure to perform reconciliations of significant accounts
- Undue bias or lack of objectivity by persons responsible for accounting decisions; for example, management's consistent understatement of expenses or overstatement of allowances

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Potential Deficiencies (cont.)

- Selection and application of accounting principles that are not in conformity with GAAP. Having insufficient expertise
- Not implementing antifraud programs and controls
- Insufficient controls over nonroutine and nonsystematic transactions
- Insufficient controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the GL: initiate, authorize, record, and process journal entries and record recurring and nonrecurring adjustments to the FS

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Potential Deficiencies (cont.)

- Ineffective oversight of the entity's financial reporting and internal control by those charged with governance
- Misrepresentation by client personnel to the auditor (an indicator of fraud)
  - Management override of controls
  - Failure of an IT application control caused by a deficiency in the design or operation of an IT general control
  - A deviation rate that exceeds the auditor's expectation in a test of controls

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Formats

- Internal Control Matrix
- Process Flowchart
- Narrative

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Common Audit Schedule Formats

- Reconciliation
- Rollforward/Walkforward
- Recalculation

Reconciliation

Expected Balance +/- Reconciling Items = General Ledger Balance

- Commonly used for cash, receivables and payables
- Start with an expected balance
  - Bank Statement
  - Subledger report
  - Merchant Statement
- Identify reconciling items

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Roll/Walkforward

Beginning Balance + Additions – Subtractions = Ending Balance

- Commonly used for investments, fixed assets, prepaids and net assets
- Additions and subtractions
  - Can tie to underlying documentation of expenditures
  - Can tie to revenue and expense accounts
  - May assist in preparation of cash flow statement

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Recalculation

Units of Activity Driver x Rate per Unit= Total Activity

- Commonly used for sales or tuition revenue, or variable costs
- Units of Activity Driver
  - Clearly defined
  - Available from 3rd party source or non-accounting module
  - Often reported to board or management
- Tie rates to published rate sheets

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Practical Tip #7: Pay Attention to New Software

- Understand audit trails and reporting
- Find information necessary for recalculations
- Document interface configurations

Testing Type 1- Control Testing

Are your controls being performed consistently?

- Walkthroughs
- Review of audit trail reports
- Examination of documentation of controls

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Testing Type 2- Analytic Evaluation

- Budget to Actual
- Year over Year variance
- Recalculations based on a metric
  - Average salary per employee
  - Payroll taxes
  - Average age of plant
- Key ratios

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Testing Type 3- Substantive Testing

- Generally high volume of testing
- ALL the source documentation
- Testing for appropriate accounting treatment
- Includes cutoff testing
- Used for higher risk areas

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Practical Tip #8: Audit Yourself

- In-depth review of periodic draw documentation
- Consult the Compliance Supplement
- Shore up documentation and correct calculations before audit

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