

Do I Want or Need a Financial Statement Audit?

Many not-for-profit entities (NFPs) ask if they need an audit. There are no federal requirements for an independent audit unless the NFP receives \$750,000 or more in federal funds in a single year (threshold raised effective 2015). Twenty-six states have laws requiring charitable NFPs to conduct an independent audit under certain circumstances. National Council of Nonprofits has a resource listing the laws regulating independent audits state-by-state at <http://www.councilofnonprofits.org/nonprofit-audit-guide/state-law-audit-requirements>. Keep in mind, some states have compilation and review thresholds as well. Besides federal and state requirements, some lenders and other funding sources, such as private foundations, require the NFP to undergo a financial statement audit.

Even if there is no specific requirement, an NFP may still wish to have its financial statements audited. Often times a board or committee member coming from a larger organization suggests your organization may need an audit. It is important to have a conversation about why an audit might be needed. If there is concern about something specific, like internal controls or fraud, your not-for-profit can contract for a specific engagement. If there is concern about a specific revenue source or specific area, an independent licensed CPA firm can also perform agreed-upon procedures. This is an engagement to issue a report of findings based on specific procedures performed on specified subject matter.

Understanding Audits, Reviews, and Compilations

CPAs perform various services for NFPs and other entities. For example, an NFP may engage a CPA to audit, review, or compile its financial statements. The following discussion addresses the benefits of an audit and provides a general overview of audit, review, and compilation engagements.

Benefits of an Audit

A financial statement audit provides management, including those charged with governance, and other financial statement users with an independent CPA's opinion about whether the financial statements present fairly the entity's financial position, changes in net assets, and cash flows in conformity with generally accepted accounting principles (GAAP). In order for auditors to express their opinion, they must perform certain procedures in accordance with generally accepted auditing standards (GAAS). Among other requirements, GAAS requires auditors to plan and perform their audit to obtain reasonable assurance (which is a high, but not absolute, level of assurance) that the financial statements are free of material misstatement, whether caused by error or fraud¹.

The auditor, therefore, provides a second set of eyes in the event that management has inadvertently (or intentionally) omitted or misstated important financial statement information. Additionally, the audit process tends to strengthen management's discipline towards improving internal control over financial reporting. It is imperative that the auditor be independent of management, the

¹ This document discusses audits performed in accordance with generally accepted auditing standards (GAAS). GAAS are the most prevalent auditing standards used. Additionally, *Government Auditing Standards*, promulgated by the GAO and commonly referred to as the Yellow Book, build on GAAS. These Generally Accepted Government Auditing Standards (GAGAS) generally apply to entities that expend \$750,000 or more of federal assistance or to other entities where GAGAS is required by a governmental entity. The federal government has a formal process for developing those standards and monitoring compliance with them.

entity, and others related to the entity, both in fact and in appearance, so the auditor has no incentive for the financial statements to be anything other than fairly presented.

The auditor performs extensive procedures in performing an audit. Among other things, the auditor obtains a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. Further audit procedures include: observing certain assets; verifying a sample of transactions with third parties; testing revenues, expenses, assets, and liabilities; searching for unreported liabilities; and performing other procedures to search for misstatements. In addition to performing certain required audit procedures, auditors use their judgment in determining additional needed procedures.

Byproducts to management of an audit may include some or all of the following:

- **Training and assistance.** Some entities, particularly smaller entities, may benefit from periodic assistance with their accounting processes and the drafting of the financial statements. The auditor may provide these services while maintaining their independence, as long as they don't make management decisions. In many cases, the audit is a time when the entity's financial staff receives a great deal of training and assistance.
- **Identification of control weaknesses and recommendations for improvements in control and operations.** As a result of the procedures performed during the audit, the auditor may become aware of weaknesses in an entity's internal control over financial reporting. The auditor is required to communicate internal control weaknesses identified as a result of the audit. Also, though not required, an audit may bring an evaluation of operations and controls that enables the auditor to provide input to the board and management. This helps the board and management understand risks, evaluate their internal control, and establish procedures to safeguard assets and to improve financial reporting in the future. All of these ultimately help the entity govern and operate more effectively and efficiently.
- **Reduced cost of capital.** Better, transparent, and more reliable financial reporting not only reduces the cost of capital in the traditional sense, such as lower interest rates on borrowings, but likely increases the NFP's ability to raise contributions. For example, many donors will not even consider contributing to an NFP if that NFP does not make available audited financial statements.

From the perspective of an external financial statement user, an audit provides reasonable confidence that the financial statements are materially correct. Audited financial statements can lend credibility to an NFP's financial status and demonstrate an entity's willingness to submit its financial affairs to independent scrutiny. In addition, it reduces the risk of fraud, and the risk that the NFP is not complying with donor restrictions.

From the perspective of an internal user, an audit tends to provide information to help the entity govern and operate effectively and efficiently. Also, it tends to add a self-imposed discipline to the NFP's finances and related activities, from requiring adequate backup for routine cash disbursements and preparing bank reconciliations; to designing and implementing effective accounting systems; to properly reporting the results of capital campaigns; making sure the NFP is complying with donor restrictions; and avoiding inappropriate conflicts of interest, private inurement, and prohibited transactions.

The Auditor's Report

The auditor's report is not a "clean bill of health." Although an unmodified (or clean) opinion from the auditor states that the financial statements – including the entity's assets, liabilities, net assets, revenues, expenses, cash flows, and note disclosures, – are fairly presented, it is not an opinion about the entity's policy decisions, effective use of assets, or programmatic outcomes and outputs.

Additionally, a clean audit opinion does not guarantee that the NFP will continue to operate in the future. The auditor does, however, have a responsibility to evaluate whether there is substantial doubt about the NFP's ability to continue as a going concern for a reasonable period of time. If the auditor concludes that substantial doubt does exist, the audit report should include an explanatory paragraph to reflect that conclusion.

Auditors Responsibility with Respect to Fraud

The auditor plans and performs the audit with an attitude of professional skepticism; that is, the auditor designs the audit to obtain reasonable assurance that material errors or fraud are detected. An audit, however, does not and cannot provide a guarantee that fraud does not exist. For example, the auditor may not find fraud concealed through forgery or collusion, because the auditor is not trained to catch forgeries, nor will customary audit procedures detect all conspiracies.

Two types of misstatements are relevant to the auditor's consideration of fraud; 1) intentional misstatements of the financial statements, and 2) misappropriation of assets. To address these, auditors brainstorm about how and where they believe the entity's financial statements might be susceptible to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. Additionally, as part of planning every audit, the auditor must interview or inquire of management and others as to whether any of them are aware of, or suspect, fraud. Auditors also perform analytical procedures designed to look for unusual ratios or amounts that are unexpected.

Based on these planning efforts, auditors design procedures that are responsive to the nature and significance of the fraud risks identified and the entity's programs and controls that address those identified risks. Because many financial frauds are perpetrated in revenue accounts, auditors are now required to ordinarily presume that improper revenue recognition is a risk in all audits. Of course, the first line of defense against fraud is management through the implementation of adequate internal controls and a management that sets a high tone at the top.

Discussion of an Audit, Review, and Compilation

An audit requires more extensive procedures than a review. As a result, an auditor obtains a higher level of assurance than does a CPA conducting a review. But because more procedures are performed, an audit is more expensive than a review. In determining whether to have an audit or a review, management and those responsible for governance must make a decision as to whether to expend more resources for a higher level of benefits. In situations in where there are no external requirements for the NFP to have an audit and a statement that the CPA is not aware of any material modifications that should be made to the financial statements is sufficient, a review may be an appropriate level of service.

Audit

The auditor plans and performs the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Though this is a reasonable or high level of assurance, an audit does not provide a guarantee of accuracy. The external auditor must not have a financial interest in the business being audited, as well as maintain the ability to carry out the work freely and in an objective manner.

Auditors make inquiries concerning financial statement related matters, such as accounting principles and practices; recordkeeping practices; accounting policies; actions of the governing board; and changes in business activities. Auditors apply analytical procedures designed to identify unusual items or trends in the financial statements that may need explanation. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

Typical audit procedures might include confirming balances with banks or creditors, donor promises to give, observing inventory counting, and testing selected transactions by examining supporting documents. As part of these procedures, the auditor may contact other sources outside of the client to gather information that may be more objective than that obtained from internal sources. While accumulating this type of evidence, the auditor tries to reduce the risk that the financial statements will be materially misstated.

Because an audit must be performed at a reasonable cost, an auditor tests a portion of the transactions and does not examine 100 percent of all transactions. The auditor must exercise skill and judgment in deciding what evidence to look at, when to look at it, and how much to look at. The auditor must also exercise skill and judgment in evaluating and interpreting the results of the tests performed.

The end product of an audit is the auditor's report which states the scope of the auditor's work (for example, which financial statements have been audited) and provides the auditor's opinion about whether the financial statements are presented fairly in conformity with GAAP².

Review

During a review performed in accordance with Statements on Standards for Accounting and Review Services (SSARSs), the CPA obtains limited assurance that material changes to the financial statements are not necessary in order for the financial statements to be in conformity with GAAP. With respect to the auditor's level of assurance that the financial statements are presented fairly, a review falls between a compilation, in which the CPA obtains no assurance (as discussed subsequently), and an audit, in which an auditor obtains a high level of assurance (as discussed previously).

As with all levels of service (e.g., audit, review or compilation) the financial statements are the responsibility of the NFP's management. The primary difference between a review and an audit is that in an audit, the auditor verifies management's amounts and disclosures with evidence provided by third parties. In a review, the CPA ordinarily does not verify management's amounts and disclosures with outside evidence unless the CPA believes that the amounts and disclosures are materially inaccurate.

In performing a review, the CPA makes inquiries and performs analytical procedures designed to identify unusual items or trends that may need further explanation by management. Essentially, the review is designed to determine whether the financial statements make sense without applying audit-like procedures. A review of financial statements does not require that the CPA obtain an understanding of an entity's internal control, assess control risk, test accounting records and responses to inquiries by obtaining corroborating evidential matter, or perform certain other procedures ordinarily performed during an audit. A review does include assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

The end product of a review is the CPA's report on the accompanying financial statements which states the scope of the CPA's work (for example, which financial statements have been reviewed) and provides a statement that the CPA is not aware of any material modifications that should be made to the financial statements in order for them to be in conformity with GAAP.

Compilation

A compilation performed in accordance with SSARSs does not provide a basis for obtaining or providing any assurance regarding the financial statements. The CPA does not obtain any assurance about whether material changes to the financial statements are necessary in order for the financial statements to be in conformity with GAAP. In a compilation, the CPA simply presents, in the form of financial statements, the client's financial data and does not probe beneath the surface unless he or she becomes aware

² This document discusses financial statements prepared in conformity with generally accepted accounting principles (GAAP). Entities may prepare their financial statements in accordance with a financial reporting framework other than GAAP, such as the cash basis or income tax basis.

that the information management provided is in error or is incomplete. As with an audit and a review, the compiled financial statements are the responsibility of the NFP’s management.

A compilation includes becoming familiar with the accounting principles and practices common to the client’s industry and obtaining a general understanding all of the client’s transactions and how they are recorded. As part of a compilation, the CPA takes a commonsense look at the entity’s accounting system to decide whether the client needs other accounting services, such as adjusting the accounting records. In addition, the CPA is obliged to read the financial statements and to consider whether they are appropriate in form and free from obvious material errors.

The end product of a compilation is the CPA’s report on the compiled financial statements which states that the financial statements were compiled, but because they were not audited or reviewed, the CPA expresses no opinion or any other form of assurance on them.

Comparison of an Audit, Review, and Compilation

| <i>Attribute</i> | <i>Audit</i> | <i>Review</i> | <i>Compilation</i> |
|--|---|--|--|
| Engagement performed for the purpose of providing an opinion or report about whether the financial statements are presented fairly in conformity with GAAP | The auditor obtains a high, but not absolute, level of assurance about whether the financial statements are free of material misstatement | CPA obtains limited assurance that there are no material modifications that should be made to the financial statements | CPA does not obtain or provide any assurance that there are no material modifications that should be made to the financial statements. |
| CPA obtains an understanding of internal control over financial statements | Yes | No | No |
| CPA tests the effectiveness of internal control | Frequently, but not always. The nature and extent of internal control testing depends on the auditor’s judgment and conclusions pertaining to risk assessment | No | No |
| CPA verifies certain balances and transactions with third parties | Yes | No | No |
| CPA performs procedures to obtain reasonable assurance that financial statements are free of | Yes | No | No |

material misstatements whether caused by fraud or error

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| Financial statements are the responsibility of management | Yes | Yes | Yes |
| Financial statements are prepared by and are the responsibility of management | Yes, but the CPA may assist in drafting | Yes, but the CPA may assist in drafting | Yes, but the CPA may assist in drafting |
| CPA guarantees that the financial statements are accurate and free of fraud | No | No | No |
| CPA evaluates the entity's policy decisions and use of resources | No | No | No |
| CPA reports material weaknesses in internal control over financial reporting noted during the engagement to management or audit committee | Yes | Not required, though may be done if matters come to the CPA's attention | Not required, though may be done if matters come to the CPA's attention |
| CPA acts as a whistleblower internally and reports identified fraud to management or audit committee | Yes | Yes, unless clearly inconsequential | Yes, unless clearly inconsequential |
| CPA acts as a whistleblower externally and reports fraud and other matters to third parties, such as the IRS or state attorneys general | No | No | No |

Cost

The cost of an audit, review or compilation will vary depending on many factors, including the quality of the NFP's financial records and financial statements (audit readiness), size and complexity of the NFP; its geographic market; and the CPA