

## **An Auditor's Recommendations on How Best to Prepare for a Nonprofit Audit**

Summer, considered by many to be their favorite season of the year, began little more than a few days ago! However, many nonprofit organizations, especially those with June 30<sup>th</sup> year-ends, may not share the same warm sentiments about another season that has just begun. The financial statement audit season is now upon us, and I am willing to bet that this falls among the least favorite of seasons on the nonprofit calendar. As an auditor, I'll admit that this hurts my pride. However, I know that there are several reasons why some might feel this way:

- First, auditors can be demanding and consume resources such as staff time, space and energy.
- It can also be uncomfortable to have someone examine everything your organization has done for the past year.
- And last but not least, there is the often-dreaded financial aspect of the audit.

Despite the aforementioned, there are several steps nonprofit organizations can take to help them dive, rather than freefall into the season.

As nonprofits approach an audit, it is important for them to remember that their best strategy is to be proactive and plan ahead. With resources at a premium for most organizations, nothing would be more frustrating, and adversely affect your ability to perform your services, than to be ill prepared in the face of an audit. The following are a few examples of simple steps that all organizations can take to improve their financial reporting process, which will in turn improve the audit process as well:

### Document the internal control structure

Many of you are probably familiar with the term, "risk based auditing standards". These new standards became effective on December 31, 2006 and significantly changed the way audits are performed. Auditors now must plan the audit to focus on identified areas of risk. To identify those areas of risk, a substantial amount of time may be spent gaining a complete understanding of the internal control structure and the operating effectiveness of those controls. Organizations that take time to understand what controls are in place will more easily facilitate this phase of the audit.

### Implement strategies to improve any identified deficiencies

Once you have a comprehensive understanding of the controls in place, every effort should be made to improve areas where deficiencies have been identified. This is important for reasons that extend well beyond the audit process. No organization wants to subject itself to the potential for material errors or, even worse, the misappropriation of assets. Such situations can devastate an organization's reputation.

### Understand the strengths of each Board Member and utilize them accordingly

Even in a strong economy it is difficult to staff an organization with enough qualified individuals to substantially improve upon every control weakness identified. If this is true for your organization, do not be afraid to ask specific Board Members for their help. While it is important to remember that the role of the Board is to govern, individual members of the Board can prove to be a valuable resource. Use the financial talents and expertise of your Board Members to assist in implementing good controls, reviewing audit schedules and drafting financial statements prior to the start of the audit.

### Invest time in educating yourself on the accounting principles applicable to nonprofits

There are several unique accounting concepts that apply only to nonprofit organizations. These areas are where the majority of financial misstatements occur. Taking some time to understand and to review the audit schedules related to the following areas is critical to the success of the audit:

- Unconditional promises to give – It is not uncommon for organizations to incorrectly record contributions at the time the funds are actually received. Generally accepted accounting principles require, however, that when a donor unconditionally promises to make a contribution, that amount is recorded as revenue in the year the promise is made. In addition, if the contribution is to be received over a period of more than one year, the entire amount is recorded in the year the promise is made. The amount to be received after one year should be recorded at a discounted value to account for the time value of money.
- Functional allocation of expenses – Nonprofit organizations are required to report expenses on a functional basis, classifying expenses into categories such as: Program, Management and General, and Fundraising. Properly allocating the expenses into these categories requires careful analysis of the key factors surrounding each specific expense. This analysis should be performed prior to the start of the audit and the methods used to arrive at the allocation should be properly documented.
- Restricted net assets – Donations, which contain restrictions on the use of the funds, should be classified as either permanently or temporarily restricted net assets, depending on the type of restriction imposed by the donor. Maintaining accurate records of the use of the funds received is critical in order to be able to properly report the balance of the restricted funds.

If these and similar accounting concepts are foreign to you and your organization does not have the in-house resources to properly record these items, consider seeking outside help or call upon your Board for their expertise in these areas. It is important to remember that accounting pronouncements continue to become more specific in requiring separation between accounting/bookkeeping services and the audit services. Therefore, the assistance that your auditors are permitted to provide may be limited.

Communicate with your accounting firm prior to the start of the audit and throughout the entire year

Start the audit process by having a planning meeting with your auditors. Request that they provide you with their timeline for the audit and ask them for a client to-do list. That is, request that they provide you with a detailed list of what they need, when they need it and let them know who the point person will be in your organization for each specific item. In addition, do not be afraid to call upon the auditors for their advice and to keep them informed of what is occurring within your organization throughout the year. They will appreciate the opportunity to address any issues with you before the start of the audit.

Taking the time to implement some of the ideas listed above will prove to be beneficial to your organization during the audit process. An added benefit is the potential reduction of management letter comments and significant deficiency or material weakness comments that are often reported to the Board at the conclusion of the audit. Understandably, no one likes receiving these letters. However, they are required in certain situations, and they should be used as a guide to improve upon the internal procedures. A final suggestion is that you pull out the letters received at the conclusion of your last audit and look to make sure the items have been properly addressed prior to the start of this year's audit. Auditors love that type of initiative.

With audit season heating up, we hope these tips help you stay relaxed and cool!

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