CAPLAW
Community Action Program Legal Services, Inc.

Section 2: Improving a CAA's Financial Capacity

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A Community Action Agency's purpose is to provide services and advocacy to move people from poverty to self-sufficiency, rather than to make profits, but like for-profit entities, CAAs cannot expect to be viable unless they are well-managed. This means that a CAA must have financial capacity. This toolkit examines the management and the board's role in financial management, board audit and finance committees, and the role of the independent auditor. It is aimed at the CAA's financial team, including those in management with day-to-day finance and accounting responsibilities, as well as members of the board who are interested in financial issues or who are members of the audit or finance committees. Other members of the executive team, such as the executive director, as well as other board members, will also benefit from reviewing portions of the toolkit.

Financial management is a complex and involved process. This toolkit does not address every aspect of financial capacity. It focuses on personnel—the CAA's internal financial staff, with a focus on the CFO, the independent auditor, and the board's audit committee.

CSBG ORGANIZATIONAL STANDARDS: This Section of the Toolkit will assist CAAs in complying with the numerous Standards related to an organization's finances. For example, Organizational Standards Category 8, Financial Operations and Oversight, includes several Standards related to audits (see Standards 8.1 through 8.5), and Parts II through IV of this Section address the role of an audit, how to get the most out of an audit, management's role in preparing for the audit, the audit committee, and management letters. Additionally, Standard 5.8 requires that board members be trained on their duties and responsibilities every two years, and this Section can help a board understand the various fiscal duties and responsibilities of CAA board members. See Compliance with the CSBG Organization Standards for a comprehensive guide to finding Organizational Standards resources in this Toolkit.

An Overview

One of a board's primary functions is to oversee a CAA's finances, deciding how limited resources are utilized and protecting those resources from misuse and misappropriation. The board is not required to conduct audits or design accounting or control systems. Those tasks belong to management. The board must, however, make sure that management is properly carrying out those tasks and fully and continuously engaged in detailed financial management. To discharge its oversight function, the board should:

Financial Statement Review

Review both interim and annual financial statements, a task that is covered by the toolkit section *Getting the Most Out of Your Financial Statements.*

Budget Oversight

Approve and monitor an annual organization-wide budget, as well as individual grant and contract budgets, a task addressed in Section 3 of this toolkit.. The extent to which the board does the latter may depend on the size of the organization, the number of grants and contracts, and funding source requirements. Some boards may delegate the detailed review of individual program budgets to committees. Some CAAs may separately list individual program budgets within their organization-wide budgets. At a minimum, with respect to individual program budgets, management should bring to the attention of the board any significant deviations between a program's budgeted and actual revenue and expenses. However, this detailed review should not come at the expense of a review of the larger financial picture of the CAA as a whole.

CFO Oversight

Provide input to the CAA's executive director on hiring and evaluating someone to manage the CAA's finances, which is the subject of Part I of this toolkit. This person preferably has skills typically associated with a chief financial officer (CFO), but due to size, resources, and sophistication, some CAAs will start with a bookkeeper. Hopefully over time, the CAA would increase its resources so as to enable the executive director to hire an additional person who is qualified to be a CFO or, if the CAA is not able to do so, the bookkeeper would obtain the formal training and skills necessary for the CFO role. Because the CFO (or person with comparable responsibilities) is considered an insider (or "disqualified person") under the Internal Revenue Code's "intermediate sanctions" rules, the board should consider following the process outlined in those rules in setting the CFO's compensation. For more information on this process, see the discussion of intermediate sanctions in the Conflict of Interest section of this toolkit.

Select the Auditor

Retain an outside auditor, a task that is often mistakenly delegated to management. This subject is addressed in Part II of this toolkit.

Review the Auditor's Conclusions

Review the outside auditor's progress, reports, and mandatory communications with the board, an effort that is covered in Part V of this toolkit.

Using Committees

The board should rely on committees to address financial and accounting issues because committees conserve valuable board meeting time and concentrate expertise.

■ **Two Committees** From the standpoint of best practices, the board should have separate finance and audit committees.

- **The Audit Committee.** Part IV of this toolkit addresses the role of the audit committee in detail. To summarize, the audit committee is charged with: (1) overseeing the board's relationship and interaction with the outside auditors; (2) monitoring the CAA's system of internal controls; (3) identifying and monitoring financial and related risks; and (4) conducting an in-depth review (with the auditor present) of the Single Audit and prepare a report to the board. The audit committee also is an appropriate recipient for whistleblower reports involving financial improprieties and other concerns.
- **The Finance Committee.** The finance committee is typically charged with addressing the following matters on behalf of the board: (1) assessing financial performance; (2) preparing and monitoring the operational budget(s); (3) preparing and monitoring capital budgets; (4) assessing lease-buy decisions (e.g., automobiles, equipment, and facilities); (5) planning long-term finances and allocation of resources; and (6) selecting lenders and developing the CAA's capital structure. Management is responsible for this work on a day-to-day basis, but the finance committee is the board committee charged with those efforts.

Many organizations place the tasks typically assigned to audit and finance committees to a combined audit and finance committee. This is not the preferred practice. The better practice is to utilize two separate committees, because the tasks traditionally assigned to each require distinct focuses. Overstating a bit, the finance committee plans while the audit committee monitors.

Management's Ongoing Role

The board's role is one of oversight while management's is operational. No two CAAs will set the dividing line between oversight and operations in the same place. That line will depend to some extent on the skills, expertise, interest, and personalties of the individuals involved, on both the board and management side, as well as the requirements of the funding sources (for example, the Head Start rules require board involvement in some very detailed levels of operations). But, as described in this toolkit and

Example

THE CALIFORNIA APPROACH

Section 12586(e)(2) of the California Government Code requires "charitable corporations" that are required to file reports with the California Attorney General to have an audit committee when the corporation accrues $2 million of more in gross revenue in any fiscal year.[1] The audit committee must be appointed by the organization's governing board. It cannot include the organization's staff members, the president, the CEO, the treasurer, or the CFO. If the organization has a finance committee, members of that committee can serve on the audit committee, but cannot comprise 50 percent or more of the audit committee's membership, nor may the chairman of the audit committee be a member of the finance committee. For additional details, CAAs subject to California law should consult with a lawyer.

as seen in the trends at all levels in the nonprofit world, including governance questions asked on the IRS Form 990, the needle has shifted towards more, rather than less, board oversight of financial matters, including review of certain basic financial topics that all nonprofit boards should oversee and some financial expertise of the board as a whole. However, even very sophisticated boards look to management to perform some of the more ministerial tasks involved in selecting an auditor and managing the audit. In all instances, the board should look to the management to prepare the CAA for the audit. Preparation is an operational task. Part III of this toolkit addresses how management should prepare for the audit.

Concluding Thoughts

As is true in all matters of governance, the board and management should function as a team. Do not be misled, however. There should be some constructive tension in the relationship. After all, the board acts as a watchdog. But the board is also responsible for shaping the CAA's mission and long-range planning. To be effective, the board must work in a cooperative manner with management to fulfill those aspects of its duties.

Part I: Defining, Hiring, and Evaluating the Financial Personnel, with a Focus on Hiring the CFO

Titles Shouldn't Be the Focus

What's in a name? CAAs assign any number of titles to their top financial officer, including CFO, treasurer, controller, accountant, fiscal officer, and bookkeeper. In some instances, people with the same title have widely differing levels of authority and responsibility. In others, those holding different titles perform similar tasks. The board should not be concerned with titles, but rather, on ensuring that vital financial management functions are being carried out by people with the appropriate training and experience.

Common Patterns

A CAA's size is probably the single most important determinant of what title is assigned to the person with chief responsibility for the CAA's finances.

- **Large CAAs.** A CAA with a $100 million of revenue should have more than one employee managing the CAA's accounting and finances. The senior person will most likely be referred to as the CFO, director of accounting and finance, or head of fiscal administration. This section will refer to this person at the top fiscal official.
- **Small CAAs.** A CAA with $1 or $2 million of revenue may rely on just one person to perform all accounting and finance tasks, including entering data into the CAA's accounting system, preparing checks, sending bills out, assembling financial reports, making bank deposits, and managing grants. This person is often referred to as the bookkeeper or the "numbers guy." This "jack-of-all-trades" approach may be dictated by practical reality, but it is far from optimal because it does not permit the segregation of incompatible duties. The board of a CAA with just one or two people handling the accounting and finance function should make building additional financial capacity a priority. Because of the lack of segregation of duties on the management side, more board involvement on the financial side, such as review of the bank statements, will likely be required.

What Comes With the Title: Duties

These are the duties that typically come with a given title:

- **Chief Financial Officer.** The person designated CFO is typically one of a CAA's top three executives. The title connotes authority and responsibility for overall financial planning, management, and reporting, as well as a variety of finance related functions. The CFO manages a team of professionals, often including both accounting professionals (controller, fiscal manager, chief accountant) and, in some instances, other business professionals such as the managers of information technology, human resources, and facilities.
- **Director of Finance and Administration.** The director of finance and administration often has duties similar to those typically associated with someone holding the title CFO. This person, however, may have slightly less authority than someone designated "CFO" and may be more directly involved in the supervision of staff accountants, bookkeepers, and administrative assistants than a CFO might be.
- **Fiscal Manager**. In large CAAs, the fiscal manager often functions as the head of all accounting functions, reporting to the CFO or director of finance and administration. In mid-sized and smaller organizations, the fiscal manager is often the top financial position, serving as a member of upper-level management. He may be the only financial professional in the organization, charged with managing a team of staff accountants, bookkeeper and administrative assistants.
- **Controller/Comptroller.** The controller/comptroller is often equivalent to the director of finance and administration or fiscal manager. The person holding this position is generally focused on accounting and financial reporting. His responsibilities generally will not include management of other business functions such as human resources, information technology, or facilities. In larger CAAs, this person is typically the top accounting professional, working under the direction of the CFO or the director of finance and administration.
- **Accountant.** Unlike someone designated CPA, in most states, anyone may refer to themselves as an "accountant" regardless of preparation or experience. The term typically refers to an individual with responsibilities for processing/recording financial transactions. In some organizations, the "accountant" is also responsible for preparation and presentation of financial statements and supporting managers in preparation of budgets. In general, the term "accountant" refers to a staff position rather than a managerial one.

- **Full Charge Bookkeeper.** Someone referred to as a "bookkeeper" has responsibility for posting financial transactions and closing the books or performing other ministerial tasks involved in the accounting function. There is wide variation in the skill levels of persons who identify themselves as bookkeepers. In larger CAAs, the term full-charge bookkeeper typically refers to a position requiring greater knowledge of the entire accounting process and more responsibility than is assigned to accounting clerks.
- **Accounting Clerk.** Those designated as accounting clerks generally perform routine tasks under the direction of a financial professional, such as processing receivables or payables. These individuals perform their duties by adhering to detailed procedures. They have little or no authority for independent decisionmaking.

Budget Size and Complexity Are Key Drivers Underlying the Need for Financial Personnel

While the size of the annual budget is often a good predictor of the sophistication required in the top fiscal position, complex funding requirements or the use of multiple entities to carry out the CAA's mission sometimes requires the skills of a high level financial professional even in smaller organizations. Let there be no doubt: Effective internal controls require that every CAA, no matter how small, have a least two persons on staff who are responsible for accounting and financial management tasks.

The Progression

The breadth of responsibilities assigned to the top fiscal officer is correlated with organizational size.

- **Small CAAs**. In CAAs with budgets below $2 million, the top fiscal officer frequently concentrates almost exclusively on budgeting, accounting, and financial reporting, with the executive director and other staff members handling other management functions.
- **Mid-Size CAAs.** As a CAA's budget begins to exceed somewhere between $1 million to $2 million, the CAA often assigns a broader spectrum of responsibilities to its top fiscal officer, including grant management and compliance, human resources, information technology, and facilities management.
- **Large CAAs.** As a CAA's budget begins to approach $10 million, CAAs will begin to hire professionals to head individual functions such as human resources, information technology, and facilities management. As the CAA begins to incorporate these individuals into its organizational structure, the person holding the duties assigned to the top fiscal position will become more conceptual and integrated with the other management functions spread throughout the organization. This person will focus on the more complex aspects of financial management, including managing relationships with bankers and structuring debt, overseeing investment management, developing internal audit capacity, and undertaking long-term financial planning.

The Fallacy Inherent in this Analysis

The foregoing analysis is useful because it explains how a CAA's financial function expands from one person to many. The analysis, however, is deeply flawed. It implies that all the other functions that show up on a large CAA's organizational chart are not taking place in a small CAA because the functions do not appear on the smaller agency's organizational chart. Every CAA, no matter its size, has the same administrative needs. Smaller CAAs may be addressing those needs less formally or totally ignoring them, but the need is still there. With the luxury of size comes the opportunity to systematically address organizational needs. Smaller CAAs that are successful have figured out how to address all these needs, but with fewer people. The boards overseeing these CAAs may have a more important role to play than the boards overseeing larger CAAs: a small CAA's board may need to engage in the sort of reflective and long-term planning that time-challenged managers are unable to engage in.

Core CFO Responsibilities

The top fiscal officer in most CAAs has ultimate responsibility for the core financial functions, which include:

- **Accounting.** The accounting function, which includes processing accounts payable and receivable, handling the payroll, and maintaining the general ledger and accounting journals.
- **Financial Reporting.** The financial reporting function, which includes preparing and assuring the accuracy of the monthly and annual financial statements. These statements include the statement of financial position (balance sheet), the statement of activities (income statement or profit and loss statement), and the statement of cash flows, together with footnotes and the statement of functional expenses. Included in this function is development of proper accruals, allowance for bad debt, and depreciation methodologies.

- **Budgeting.** The board may direct and should approve the CAA's annual budget, but the top fiscal officer and those who report to her should be the ones who prepare the annual budget. Equally important, the top fiscal officer and her staff should monitor adherence to the budget, providing the board with regular reports explaining how key income and expense categories vary from budget. Budgeting should include linking the budget to the CAA's long-term strategic planning. As just one example, those developing budgets should be prepared to show how expanding an existing program or adding a new one impacts the budget.
- **Grant Compliance.** The top fiscal officer and her staff should monitor compliance with grant terms, develop defensible overhead allocation methodologies, and prepare reports to the board for each grant.
- **Audit Preparation.** Management, not the auditors, is responsible for the financial statements and putting in place an accounting system that is self-correcting when information is initially input incorrectly. The auditors are looking for schedules, internal documentation, and responses to questions. The top fiscal officer is responsible for making sure that the auditors have what they need when they need it.
- **Fiscal Compliance.** The top fiscal officer bears ultimate responsibility for compliance with the CAA's funding agreements, IRS requirements, and any state nonprofit fiscal requirements. For organizations receiving federal funds, this includes responsibility for developing/implementing a cost allocation plan that complies with the Uniform Guidance or negotiating and implementing a federally negotiated indirect cost rate.[2]
- **Communication.** Financial information does not exist in a vacuum or for its own sake. It is meant to be used by decisionmakers throughout the CAA. The top fiscal officer is responsible for ensuring that the board, its finance committee, members of management, and other stakeholders have the financial information necessary for good decisionmaking.

CFO Responsibilities Beyond Just Accounting and Finance

In many organizations, the top fiscal position has a broader scope of responsibilities, including:

Procurement

Some top fiscal officers have responsibility for development and implementation of procurement policies and procedures that protect the CAA from fraud, waste, and abuse in the purchase of goods and services, and that meet the requirements of federal and state funding requirements.

Grants Management and Compliance

Beyond ensuring compliance with fiscal management requirements, some top fiscal officers are assigned responsibility for ensuring overall compliance with administrative, governance, and program requirements. The broad scope of these responsibilities generally requires employment of a skilled compliance officer or other quality assurance professional.

Some organizations choose to have the compliance officer report directly to the CEO or the board as part of a system of internal control.

Internal Audit

The internal audit function examines whether personnel are complying with policies and procedures and whether systems are working as specified. Responsibility for the internal audit function is frequently assigned to the top fiscal position. Internal auditors nevertheless should always have access to the CEO and the board in the event that an internal audit reveals potential compliance problems that involve the CEO or the top fiscal officer.

Technology

In small and mid-sized CAAs, the top fiscal officer is responsible for procurement and management of information technology (e.g., hardware, networking, software, and database management), probably because accounting is now driven by technology. In larger organizations—particularly in those that refer to top fiscal position as the director of finance and administration—an information technology manager frequently reports to the top fiscal officer. Larger organizations generally utilize technology in virtually every aspect of their operations. Consequently, successful management of the information technology function by the top financial official requires strong communication skills and continuing collaboration with all CAA managers.

Human Resources

In smaller CAAs, the human resources function is often limited to administrative and compliance activities pertaining to both employment practices and fringe benefits. In larger CAAs, the human resources function includes oversight over legal compliance, benefits negotiation and administration, but also a variety of staff and organizational development activities including training, supporting effective performance reviews, employee assistance programs, and team building. While the top fiscal official may have the expertise required to manage the administrative and compliance aspects of HR, relatively few fiscal officials are prepared to manage the developmental aspects of human resources at the granular level.

Facilities Management

The top fiscal official is often given overall responsibility for facilities management because skills in financial analysis are required to make lease-buy decisions. Moreover, the top financial official is best positioned to assess decisions that carry wide-ranging implications for the CAA. For example, the decision whether to lease or buy the building that houses the CAA's headquarters raises insurance, property tax, overhead allocation and reimbursement, and balance sheet issues. The top financial official probably has negotiation experience because of his continuous involvement in the procurement process.

Risk Management

Nonprofits have long realized the importance of risk management, a set of concerns that involves more than procuring insurance. Risk management is the systematic analysis and control of a wide variety of risks within an organization, including assessing and developing systems to manage workplace safety, assure compliance with employment laws, train and manage volunteers, protect children and other dependent people, anticipate and respond to disasters such as fires and floods, and respond to conditions that could result in litigation. Many of these issues have a financial component, making the top financial official the perfect person to oversee a CAA's risk management program.

CAAs that do not have comprehensive risk management programs may want to attend seminars or obtain material from the Nonprofit Risk Management Center (www.nonprofitrisk.org).

Progression into Strategic Leadership Role

In smaller CAAs, the top fiscal official is often asked to function primarily as a technician, completing technical accounting and reporting tasks. As the CAA's size grows, the top fiscal official must become an effective manager, delegating, supervising, synthesizing, and communicating the work of others. In larger CAAs, the top fiscal official must function as a strategic leader, identifying and testing strategic options, and facilitating effective board and executive decisionmaking.

One Viewpoint

This progression is reflected in one executive director's reflection on the ideal CFO for her mid-sized nonprofit organization:

> *"My dream CFO has strong strategic business planning expertise and is really interested in the strategic side of the position but also has a good technical accounting background, intellectual curiosity, and hands-on involvement."*

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Barriers

A CAA's top fiscal official may be unable to fulfill her strategic leadership function for any number of reasons, including:

- **Inadequate Investment in Key Management Functions.** Fiscal officials without professional level subordinates frequently lack time to engage in strategic thinking, planning, or effective communication with top managers.
- **Difficulty Managing or Delegating.** Many fiscal officials have never been trained to manage or supervise others. Some professionals attracted to fiscal roles exhibit a strong preference for hands-on activity and have trouble dealing with imperfections in the work of subordinates.

■ **Lack of Authority.** Some CEOs don't look to the top fiscal official for strategic input even though the top fiscal official has important insights that could and should be shared. When the receiving end for input doesn't expect it, input often is not forthcoming.

■ **Reluctance to Move Outside of Comfort Zones.** Some fiscal officials are more comfortable performing functions in which it is possible to achieve certainty and perfection. Planning, budget modeling, and other strategic skills often involve uncertainty, with the result that some fiscal officials assign low priority to these tasks.

Required Expertise and Skills

To be an effective fiscal official, an individual requires technical expertise, as well as management and communication skills. The following are among the recommended knowledge and skills:

■ **Accounting Skills**. Technical accounting and reporting expertise, including knowledge of:

- Generally Accepted Accounting Principles (GAAP), particularly as they apply to nonprofits.[3]
- Bookkeeping.
- Financial system design.
- Cost accounting.

■ **Regulatory Knowledge.** Regulatory knowledge, including a basic understanding of:

- The Uniform Guidance and federal grant requirements.
- Tax requirements for Section 501(c)(3) organizations.

■ **Risk Management**. Risk management, including how to develop and implement effective internal controls and how to design internal audit and monitoring procedures.

■ **Financial Management.** Finance and treasury management, including cash management, use of debt, and oversight of investment management.

■ **Quantitative Skills**. Quantitative analysis and facility with spread-sheets, and databases.

■ **Management Skills.** Management, supervisory, communication, and customer service skills.

Formal Education and Professional Certification Requirements

There are number of alternative pathways that individuals can take to prepare themselves to serve as a CAA's top fiscal official. One obvious educational pathway is study of business administration at the undergraduate and graduate levels, but there are many CFOs and other successful financial professionals who studied the humanities, social sciences, math, or science rather than business and finance during their undergraduate years. Financial professionals without business-related education have frequently completed mid-career professional development programs in finance and accounting. Many individuals take advantage of executive MBA programs offered by top universities.

Professional certifications such as CPA (certified public accountant), CMA (certified management accountant) or CIA (certified internal auditor) are often an excellent indicator of strong preparation for the role as top fiscal official.

Many CPAs, CMAs, and CIAs lack work experience in a nonprofit environment and the specialized knowledge that comes with that experience. Those charged with assessing candidates therefore should assess each candidate's willingness and demonstrated ability to adapt to new situations.

Note that the 2016 Head Start Program Performance Standards require that a fiscal officer of a Head Start grantee hired after November 7, 2016 must be a CPA or have at a minimum a baccalaureate degree in accounting, business, financial management or a related field.[4]

Compensation

The person holding the top fiscal position at most CAAs is usually one of the three highest-compensated individuals, reflecting the strategic importance of and responsibility associated with the position.

Obtaining Comparability Data

The demand for candidates is high, meaning that a CAA must review comparables to ensure it is offering a competitive and attractive package. Some large CAAs may enlist a consulting firm to assist in the search, but most CAAs will not have this luxury due to budgetary constraints. The majority of CAAs will need to develop their own comparables. The following are potential sources of information:

- **IRS Data**. Develop lists of comparable CAAs from state trade association directories. Then review the IRS Form 990,[5] which can be obtained through GuideStar.[6] CAAs should not rely on this data without a thorough review because organizations do not report information consistently.

- **Data from Non-CAAs.** A CAA looking for comparability data can consider the compensation paid to those holding comparable positions at non-CAAs. If the organization provides social services or relies heavily on government grants for funding, its top financial official may have the necessary skills. In assessing whether the position is comparable, the CAA should consider the organization's location (e.g. urban versus rural), budget size, and number of employees.

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- **Salary Surveys.** Trade associations and consultants publish salary surveys that may be useful. Once again, the numbers should not be accepted at face value. A CAA must screen for comparability, both in terms of the organization and the position.

- **Fee-Based Services.** Both GuideStar and ERI[7] charge relatively minor fees to access their nonprofit compensation databases. CAAs should consider taking advantage of one or both of these services.

Tip

Unless a CAA receives contrary advice from an antitrust lawyer, it should not ask other CAAs for salary data or discuss compensation levels at conferences or through other informal channels that result in an interaction between employers. Such discussions may violate federal and state antitrust laws. A salary survey based on public information (such as IRS Form 990s) is generally not a problem, provided that it has a legitimate purpose (e.g., regulatory compliance) and that every CAA involved makes all decisions on salaries independently and not in coordination with other CAAs. However, CAA associations considering developing salary surveys should consult an attorney experienced in antitrust law if the survey uses nonpublic information, as such surveys could raise antitrust concerns.

Finding the Right CFO for Your CAA

Plan First, Then Act

Before announcing the opening or initiating the search for the top financial official, a CAA should:

- **Step 1.** Review its current management structure and identify future needs relating to growth and program evolution.

- **Step 2**. Refine its management structure and the position's scope based on the information developed through Step 1.

- **Step 3**. Identify the necessary skills and expertise that the successful candidate must possess.

- **Step 4.** Using comparables, determine the appropriate compensation range for the position. Organizations often think in terms of placing an individual within ranges relative to industry-wide compensation. Many organizations, for example, want to pay their senior executives at a rate that places the executive in the top quartile of industry-wide compensation. This may be an acceptable consideration, but organizational pride sometimes results in the board failing to place a less experienced candidate in the bottom two quartiles, with the understanding that the new employee's compensation levels will be adjusted as the employee demonstrates his capacity to perform above average.

- **Step 5**. If the CAA has existing employees who might be qualified, it should consider the organizational politics and morale implications of whatever decision it makes with regard to seeking outside candidates.

- **Step 6**. The CAA should develop a position description. A sample that will require customization is included in Appendix A. Qualified candidates know that the title CFO or director of finance and administrative does not encompass a uniform set of duties. The job description accompanying the title should therefore include a high degree of specificity. To avoid wasting everybody's time, the description should describe:

- The CAA's size, employee and volunteer numbers, major funding, and number and types of programs.
- How the position fits within the CAA's organizational hierarchy, including a description of the direct reports (number, type, and qualification).
- The scope and responsibilities that come with the position

Qualifications

In addition to specifying formal educational requirements, the CAA should determine whether prior experience in the nonprofit sector is a requirement. The pros and cons of requiring nonprofit experience and the challenges and benefits of selecting CFOs with business or other relevant experience can be found in Appendix B.

Search Strategies

In addition to the CAA's standard approach to search, it should consider the following strategies, which are tailored to finding a top financial official:

- Make informal inquiries to CPA firms that perform Single Audits.[8]
- Notify state CPA societies of the position so that they can feature it in newsletters, on job boards, and on websites.
- Advise state nonprofit associations or nonprofit training and technical assistance providers of the opening so that they can notify appropriate candidates.
- Notify CAA trade associations operating at the national, regional, and state levels.
- Contact Bridgespan, a national consulting firm focusing on nonprofit issues, including extensive study of CFO positions.[9]
- Place an add in the Chronicle of Philanthropy or The NonProfit Times.
- Search job boards focused on the nonprofit sector, such as idealist.org and workforgood.org.

Using a Headhunter

Some CAAs may decide to retain a headhunter to help them organize their search and evaluate candidates. Many headhunters specialize, focusing on particular industries or positions, so CAAs considering a headhunter should ask about focus and expertise. A CAA should also make sure it understands the arrangement. In particular:

- What is the headhunter's fee?
- What happens if the new employee doesn't work out or quits shortly after starting work? Does the headhunter conduct a new search for free or refund any of its fee?
- Can the CAA exclude certain candidates (e.g. existing employees) from the fee arrangement?
- How involved will the headhunter be in checking background and references?

Screening and Selection

A CAA should undertake due diligence on likely hires before making a final decision. This can be time consuming and expensive, but it is necessary.

- **Step 1.** Both the CEO and the board chair or other designated representative from the board should interview the finalists. If the board has a finance or audit committee, committee representatives should be part of the interview process.
- **Step 2**. Someone with technical expertise should review credentials and interview the finalists. This person may be a board member with expertise in financial matters, a paid consultant, or a CFO with another organization who is willing to provide assistance. If the latter, be careful. The other organization may try to hire the exceptional candidate.
- **Step 3.** The CAA should check the references for all finalists, but only after obtaining written permission to do so. Many former employers will be reluctant to provide a candid assessment out of fear of a lawsuit. Organizations can take several steps to help cut through the gloss.
  - **Read Between the Lines.** Don't automatically reject the candidate, but if the employer gives a less than glowing report ("Oh, he was OK"), read between the lines. An employer may be sorry to see someone move on, but if the employee out grew the position and did a superlative job, many employers will not want to impede the employee's advancement.

- **Ask for Audit and Management Letters**. The CAA should ask former employers for the opportunity to review past management letters from the former employer's auditors, but this may be wishful thinking. The CAA should not be surprised if former employers refuse to make this information available and should draw no adverse implications if that is the case. The management letter often contains what the employer considers to be sensitive information.
- **Ask Audit Firms for Reviews.** The CAA should ask the candidate for references from audit firms that have direct knowledge of the candidate's work, but be cautious. Auditors obtain new work through referrals, which could make them reluctant to reveal unfavorable facts. If a CAA has a CPA on its board or finance committee who knows one of the auditors identified by the candidate, the CAA may want to ask that person to make an informal inquiry.
- **Ask Board Members for Reviews.** A former employer may be unwilling to provide a meaningful reference, but if someone knows a member of that employer's board or its finance committee, the CAA might ask its board member to informally contact the board member serving on the former employer's board.

■ **Step 4.** The CAA should perform a criminal background check and a credit check (taking care to comply with the requirements of the federal Fair Credit Reporting Act) on each finalist because the winning candidate will have access to organizational assets and will be supervising others who handle accounting and finance matters. There have been well-documented instances of nonprofits unsuspectfully hiring criminals to work in their accounting and finance departments. Nobody looks good when the media covers the subsequent theft or embezzlement. Moreover, tax-exempt organizations filing IRS Form 990 must now disclose significant thefts and embezzlements.[10] Some state charity regulators also require similar information to be disclosed in annual filings.

The Board's Role

In a properly functioning CAA, the top financial official should regularly interact with the CAA's board. For this reason alone, the CAA may want to consider some board involvement in the determination of the job requirements for the position. But the board may also become involved because the top financial official plays such an important strategic and leadership role in the CAA's organizational structure. Even if the board is not involved ahead of time, it is a good idea for the executive director to report to the board on the selection process and the qualifications of the candidate hired.

CFO Performance Evaluations

Like all professionals, the top financial official can benefit enormously from thoughtful performance evaluations, particularly ones that: (1) candidly examine whether clearly articulated performance goals have been satisfied; (2) discuss the official's strengths and weaknesses; (3) set concrete goals for professional development; and (4) identify priorities for the future. The CAA may want to look to board members and others with financial expertise to provide input regarding the official's technical skills and accomplishments. The CAA's outside auditors may be cautious about providing input into this process. Their independence may be compromised if they either are or are perceived to be playing an active role in the management of the organization, including participating in the selection or termination of a CFO. Recognizing these limits, the board and CEO should consider seeking the auditor's views on the strengths and limitations of the CFO as part of the closing interviews at the conclusion of the audit engagement.

...the board and CEO should consider seeking the auditor's views on the strengths and limitations of the CFO as part of the closing interviews at the conclusion of the audit engagement.

Professional Development Strategies

Continuing professional education is essential if the top financial official is to remain current on accounting, reporting, tax, and compliance issues. This official should be encouraged to participate in professional associations, conferences, and training. The following are just a few of the outside opportunities for professional development that are available:

■ CAPLAW's webinars, trainings, and conferences.[11]

■ Conferences sponsored by national Community Action partner organizations (e.g., CAPLAW, the national Community Action Partnership and the National Association for State Community Services Programs (NASCSP)) and state and regional Community Action associations.

■ The American Institute of CPAs (AICPA) annual Not-for-Profit Industry Conference (June in the Washington, D.C. area.[12]

- State Society of CPAs Not-for-Profit Conferences.
- WIPFLi Trainings for managers of federal funds.[13]

Part II: Understanding the Role of an Audit and How to Get the Most Out of It

Three Types of Audits

The External Financial Statement Audit

People are most familiar with an outside auditor's annual audit of the financial statements. This audit is performed to assure the board, grantmakers, and other stakeholders that the CAA's financial statements fairly present the organization's financial conditions and operating results in all material respects.

- **Independent CPA.** This audit must be performed by a certified public accountant who is independent.
- **Performed According to Prescribed Standards.** The auditor must adhere to generally accepted auditing standards (GAAS) and Generally Accepted Government Accounting Standards (GAGAS) in undertaking his work.
- **Performed on a Test Basis.** The auditor rarely examines every transaction. Typically the auditor develops a workplan that includes interviewing people throughout the CAA, evaluating and documenting the CAA's system of internal controls, performing tests on the data captured by the system, and making inquiries of certain third parties, including banks, other creditors, outside counsel, customers, and lenders.
- **The Output.** The auditor issues an opinion letter at the end of the audit. In the vast majority of the cases, the audit opinion—in and by itself—is a worthless piece of paper comprised of three or four standard-form paragraphs. Unless the auditor concludes that it can no longer assume the entity is a going concern (e.g., the entity is headed toward bankruptcy, insolvency, or liquidation) the opinion says nothing about the organization's financial capacity or performance. It provides no financial analysis or recommendations. In the past, many auditors also issued a management letter that contained observations about the CAA's accounting system. That letter is now mandatory and must be provided to the board.

The Internal Audit

Larger CAAs may have an internal auditor or an internal audit department. Internal auditors are usually CAA employees, although sometimes that function is outsourced to a firm other than the auditing firm. Their work is used by multiple persons and entities, including the CFO, the CEO, the board, and the external auditors. The internal auditors continuously review the CAA's accounting and internal control systems. They may also take on special projects, particularly ones that respond to problems that have arisen. Ideally every CAA will develop an internal audit function, but budgetary limitations place this option beyond the reach of many CAAs.

The Forensic Audit

Auditors are often retained following an embezzlement or other financial fraud to determine the extent of the damage and identify the failure in internal controls that allowed the fraud to occur. A forensic audit can be performed by either an external or internal auditor. Many organizations look to external auditors to perform forensic audits when the fraud is both material and highly visible. Forensic audits are complex and expensive.

The remaining discussion will be limited to the annual financial audit performed by an independent CPA.

Common Fallacies and Misconceptions about Audits

There are a number of common fallacies or misconceptions about audits that are worth dispelling from the outset.

Fallacy 1: Auditors Prepare the Financial Statements

The financial statements are management's responsibility. The auditors do not and are prohibited by professional standards from preparing the financial statements. During the course of an audit, the auditors may demand that the financial statements be adjusted because an accounting principle was incorrectly applied or because errors have been uncovered, but by and large, this is (and should be) the extent of the auditor's involvement in the preparation of the financial statements.

Fallacy 2: An Audit's Primary Purpose Is Detecting Fraud

The primary purpose of a financial statement audit is to certify the fairness of the financial statements. The professional standards applicable to financial statement audits require an auditor to consider the possibility of fraud to the extent it bears on the fairness of the financial statements, but detection of fraud is not the audit's primary objective.

- **Management's Responsibility.** Management is responsible for detecting and preventing fraud. Management discharges this responsibility by putting in place and continuously improving the CAA's system of internal controls.
- **The Audit Cycle**. Depending on the CAA's size, the auditors conduct an audit over a several week or month period following the close of the CAA's fiscal year. Even if the auditor shared responsibility for detecting fraud, the fraudster has ten or eleven months following the close of an audit to embezzle, steal, or otherwise defraud a CAA. That is more than enough time to do inflict significant harm.

Fallacy 3: An Audit Is Primarily For Management's Benefit

Let there be no doubt, management does benefit from an audit. The mere act of preparing for an audit requires the accounting staff to tie up loose ends and engage in a self-assessment. However, the board is the intended and primary beneficiary of an audit. The audit is an integral part of the good internal control and oversight. The board relies on the financial statements to allocate financial resources, evaluate management, and shape mission. The board looks to the auditor for assurance that it is prudent to rely on management's financial statements.

Example

IMPEDING ANY EFFORTS BY MANAGEMENT TO GAME THE SYSTEM

The board of Blue CAA (BCA) has set growth of the agency as its primary objective. It bases annual bonuses to top management on the year-over-year increase in grant revenue. Given its compensation package, management has an incentive to inflate grant revenue or report it in the incorrect accounting period. The annual audit of BCA's financial statements provides the board with assurance that management is not gaming the system or inflating grant revenue to increase its bonuses.

Fallacy 4: A High-Quality Audit is a Waste of Money That Could Be Better Spent on Mission.

There are two fallacies embedded in this statement.

- **Mission and Administration Are Inextricably Linked.** Any effort to distinguish between money spent on mission and money spent on administration is artificial. No entity can deliver goods or services without an administrative infrastructure. Administration is every bit as important to mission as teachers, hot meals, and housing. Without solid administration, money that is spent on mission will go to waste. The challenge is to strike the right balance between direct (e.g., teacher salaries) and indirect (e.g., accountant salaries) expenditures on mission.
- **An Audit Provides Concrete Benefits.** The culminating step in the audit is the issuance of an audit opinion, also referred to as an audit report. Although that piece of paper may provide little or no insight into the audit or the CAA's finances, a well-done audit nevertheless has great value to the CAA. As we will see, management and the board must be willing to work and communicate with the auditor to extract that value.

Example

AUDIT PROVIDES DISCIPLINE AND STRUCTURE

BCA's outside auditors have been on site for the last three weeks. Management must provide the audited financial statements to BCA's bank before next Wednesday in order to avoid violating loan covenants. The auditors have completed their on-site work, but are refusing to issue an audit opinion until management puts the financial statements in an acceptable format. Management is beginning to re-think its recalitrance given the deadline with the bank.

Benefits to be Derived from an Audit

The following are among the benefits to be derived from an audit:

Satisfies Certain External Requirements

The board and management may not always see the value in a good audit, but external stakeholders certainly do. Many grantmakers and donors, including the federal government, make an audit a condition to funding. Many lenders also require a CAA to agree to annual audits before agreeing to extend credit. This is particularly true in the case of tax-exempt bonds. Depending on state law, a CAA may be prohibited from soliciting charitable contributions unless it obtains an audit or a review by a certified public accountant and annually reports the results to a regulator.

Offers an Independent Review of Internal Controls

The audit opinion says virtually nothing about the adequacy of a CAA's internal controls. The auditor, however, spends considerable time evaluating and testing a CAA's internal controls. If the CAA is subject to The Audit Requirements in the Uniform Guidance,[14] as most are, the auditor is required to include a report on the CAA's internal controls. Most auditors are more than willing to share their observations with the board and management, and in certain instances, are required to report internal control deficiencies to the board. In Part V of this toolkit, we will examine the letter to the board that is now required under Generally Accepted Auditing Standards (GAAS) and GAGAS.

Improved Interim Financial Statements and Reports

Both management and the board must rely on interim financial statements throughout the year when making decisions. A poorly designed accounting system will produce interim financial statements that are riddled with errors, which can undercut decisions that are based on faulty information. By identifying deficiencies in a CAA's system of internal controls, the auditor offers the CAA an opportunity to strengthen the accounting system's ability to spot and correct errors at the time they occur, resulting in more accurate interim financial statements.

Example

CREATING A SELF-CORRECTING ACCOUNTING SYSTEM

BCA's board is reviewing the year-to-date financial statements at its March board meeting. The board is concerned that grant revenue is down 20 percent, causing it to consider whether it must lay off two employees to balance the budget. In actuality, revenue is up 10 percent, but the person entering the reimbursements in the system transposed an eight and a two, entering $280,000 rather than $820,000. If the board waits until next February for the outside auditors to discover the error, assuming that they do discover it, BCA may unnecessarily lay off two employees when BCA should have hired an additional person.

Assures Conformity to GAAP and Comparable Data

An auditor cannot issue an unqualified opinion unless the financial statements comply in all material respects with GAAP. By assuring that a CAA's financial statements satisfy this requirement, the audit assures that the board can compare the CAA's financial metrics with the metrics from comparable organizations that have undergone audits. This permits management and the board to undertake benchmarking studies with confidence.

Example

PERMITTING COMPARISONS

BCA's board has asked management to obtain publicly available financial data for 10 similarly-situated CAAs so that the board can better understand whether BCA's finances and approach to financial issues conforms with industry practice. On occasion the board has discovered that BCA's practices deviate significantly from the practices of other CAAs. For example, BCA had higher levels of payables relative to current assets than other CAAs. The board initially was concerned, but realized that it was negotiating more favorable payment terms than the other CAAs.

Recently the board became concerned when it saw that BCA's annual allowance for depreciation was larger on a relative basis than that of the benchmark group's. Following an investigation, the accounting department had to admit that it had been improperly expensing the cost of all assets at the time of acquisition.

Sends a Message to Stakeholders

A financial statement audit provides something akin to the "Good Housekeeping Seal of Approval." It imbues the CAA with credibility, something which is important when dealing with the IRS, the media, and funders.

The Audit as a Process

An audit is a multi-step process. Its objective is to assess whether the financial statements prepared by management present an accurate and fair portrayal of the nonprofit's financial condition, cash flows, and operating results. To do that, the auditor must test the assertions implicit in the financial statements.

Example

THE ASSERTIONS UNDERLYING REVENUE RECEIVABLE

BCA's balance sheet reports a $4.4 million balance for revenue receivable. The following are among the assertions embedded in the $4.4 million amount: (1) the receivables exist; (2) the CAA holds legal title to the receivables; (3) the conditions for payment have been satisfied; (4) the amount recorded for each receivable is the appropriate amount; (5) the balance includes only collectible receivables; and (6) the reported $4.4 million amount conforms to GAAP. The AICPA's Audit and Accounting Guide for Not-for-Profit Organizations summarizes the assertions that underlie other financial statements items.[15]

The audit is a systematic process designed to confirm that the assertions underlying the financial statement balances are correct. Given the complexity of the financial statements and practical limitations, the auditor cannot review every entry or event recorded in the accounting ledgers. This requires the auditor to make an assessment based on analysis, testing, and interviews rather than through brute force (i.e., examining every transaction). The auditor performs the following steps in conducting the audit:

Assessing the Environment

The auditor first must assess the environment and the entity. This entails becoming familiar with the CAA's mission, activities, and personnel. The auditor conducts interviews with key individuals, reviews tax returns, reads board meeting minutes, reviews promotional and marketing material, compares the organization's financial data with data from similar organizations, and considers other relevant information.

Example

MAKING INQUIRIES CONCERNING FRAUD

BCA is undergoing its annual audit. The auditors arrive on Monday, asking to speak to Mary, the receptionist, Joe, the janitor, and Larry, a Head Start teacher. The auditors asks each of these individuals what they do, who they interact with on a regular basis, whether they are aware of any fraud or wrongdoing, and whether they know of anything else that might be of interest to the auditors. When Mary sees Gloria Watson, BCA's executive director, she mentions the interview. Watson is at first surprised that the auditors asked to speak to these individuals because none of them work in the accounting department. She decides to ask Marsha Helmsley, the partner in charge of BCA's audit about the need for these interviews.

The auditors were smart to speak to employees who work outside of the accounting department. Joe told the auditors that his supplies have been disappearing lately and that he always receives more supplies than he requests. An investigation reveals that a clerk in the accounting department has been running a scam by selling the excess to outsiders. In addition to uncovering a fraud, the auditors concluded that management was not very interested in strong internal controls.

Assessing Risks of Misstatement

The auditor then must assess the potential risks of financial statement misstatements and their relative magnitude. If, for example, the CAA is highly dependent on grants to fund expenses, it likely will report large account receivable balances for grant reimbursements. One risk inherent with the reported balance is that the underlying expenditures may be ineligible for reimbursement. If the balance is high, the auditor will focus greater attention on receivables then on an immaterial account such as a $1,000 charitable pledge receivable balance.

Reviewing the System of Internal Controls

After the auditor has assessed the risks of financial statement misstatement, he will review the CAA's system of internal controls to gain an understanding of the steps that the CAA has taken to minimize those risks.

Example

INTERNAL CONTROLS OVER REIMBURSEMENTS RECEIVABLE

In the case of reimbursement receivables, the CAA's controls might require: (1) contemporaneous entry of the receivables data into the accounting system at the time the reimbursement request is made; (2) classification of reimbursable and unreimbursable expenses according to a schedule; (3) calculation and application of an overhead allocation formula; (4) tracking and aging outstanding reimbursement requests; (5) adjustments to the schedule distinguishing between reimbursable and unreimbursable expenses following a rejection of a request for reimbursement; and (6) use of supportable discount and disallowance factors. Each requirement furthers a business objective—ultimately collecting the receivable —but each one also (7) reduces the risk of misstatement in the financial statements and (8) supports the assertions underlying the financial statement balance. An auditor who encounters these controls will face far less audit risk than one who discovers that the CAA's personnel submit every expense for reimbursement and then toss the requests in a file cabinet without any further action.

Documenting and Testing Internal Controls

After reviewing the CAA's existing controls, the auditor will document and determine whether the controls are being applied consistently. Even if the controls are exemplary, the auditor will undertake substantive testing and gather evidence.

Example

SAMPLING AND TESTING TRANSACTIONS

Returning once again to BCA's reimbursement receivables, the auditor might: (1) examine several of the requests to determine that each one follows the prescribed form; (2) assess whether the individual expense items fall within the categories of reimbursable expenses; (3) contact one or more payers to confirm the amount of reimbursements that have been submitted, but remain unpaid; (4) compare several receivables with the corresponding journal entries; and (5) examine how several overdue receivables are valued. The extent of the testing and confirmation will correspond to the depth of the controls, the relative size of the account balance to the overall gross assets shown on the balance sheet, and any number of other considerations.

Evaluating Audit Evidence

Once testing is complete, the auditor will evaluate his findings and decide whether an unqualified opinion can be issued. The auditor will make that determination based on whether his assessment of the controls and audit evidence permits him to conclude that the assertions in the financial statements are supportable.

For pedagogical purposes, this overview treats the audit as a linear series of events. While there should be a separate planning phase and the auditor should review internal controls before beginning any substantive testing, the other steps can occur simultaneously. For example, the auditor may discover through testing that personnel routinely ignore or override certain controls. Following that discovery, the auditor must adjust his risk assessments and audit plan. Additional testing may be required.

A Closer Look at Fraud

Just before Enron, WorldCom, and Tyco hit the headlines in the early years of the last decade, the AICPA began development of an audit standard directed at the auditor's responsibility to detect fraud. Its timing couldn't have been better. Both Congress and the public were asking how corporate fraud on such a massive scale could go undetected by independent auditors who had been issuing unqualified audit opinions and receiving millions of dollars in fees for doing so. Some attributed the audit failures to management conspiracies: An auditor cannot be expected to uncover fraud when members of senior management collude to override what appear to be otherwise adequate internal controls. The audit community also reiterated its longstanding and

self-serving assertion that the purpose of an audit is to certify financial statements, not to detect fraud. The profession learned that technical distinctions and carefully crafted opinion language doesn't carry much weight with the Congress, the public, and sometimes even the courts.

Although the resulting pronouncement on financial statement audits and fraud still maintain that the purpose of an audit is not to detect fraud unless the fraud has a material impact on the financial statements, this pronouncement nevertheless attempts to heighten the auditor's sensitivities to fraud as he undertakes a financial statement audit. To accomplish its goal, this pronouncement describes and implores auditors to exercise professional skepticism. It also requires audit engagement personnel to: (1) discuss the risks of material misstatements due to fraud; (2) obtain information needed to identify risks of material misstatements due to fraud; (3) identify risks that may result in material misstatement due to fraud; (4) assess those risks in view of the entity's system of internal control; and (5) respond to those risks by designing an audit that adequately addresses those risks. The standard also requires auditors to communicate with management and those charged with governance. As is true throughout the AICPA's auditing standards, many of the actions required by the pronouncement are directed toward detecting "material misstatements" in the financial statements, revealing a continuing ambivalence about the auditor's role. This pronouncement has several important implications for CAA boards and management.

The board and management should expect the auditor to be focused on fraud during the course of the audit. This is likely to result in requests to interview both accounting and non-accounting personnel. No one should be surprised if an auditor asks them point blank, "Are you aware of any fraud?"

Nevertheless, the board and management must recognize that fraud can exist within a CAA even though an auditor provides an unqualified opinion regarding the financial statements. As noted, but worth repeating, management continues to be primarily responsible for the detection and prevention of fraud, not the auditors.

The Audit Opinion

The culminating step in the audit is the issuance of the audit report, which is often referred to as an opinion. The outside auditor can issue one of four types of opinions.

The Unmodified Audit Opinion

The first is referred to as the auditor's standard report or an unmodified opinion. It is usually four or five paragraphs in length. The typical opinion states that the financial statements present fairly, in all material respects, the entity's statement of financial position, the related statements of activities and cash flow, and the related notes to the financial statements in conformity with GAAP. There is a statement preceding this paragraph indicating that the auditor reached this conclusion after performing the audit in accordance with GAAS. Although the issuance of a clean opinion is significant, the opinion's four or five paragraphs offer no financial analysis or specific insights or ideas for improving controls. Both management and the board should be pleased that the CAA received an unmodified opinion, but they still must be diligent.

The Qualified Audit Opinion

On occasion, the auditor will issue a qualified opinion, which is similar to an unmodified opinion, but contains an exception "for the effects of the matter to which the qualification relates." An auditor must qualify his opinion if there is lack of sufficient audit evidence or the scope of the audit has been restricted and the auditor is unable to express an unmodified opinion. The auditor must also express a qualified opinion when there is a departure from GAAP which is material, but which doesn't require an adverse opinion. As part of a qualified opinion, the auditor must explain the qualification. A qualified opinion provides the board with more information than an unmodified opinion, but not much more.

Both the board and management must understand the qualification and its implications, but there is no need for alarm. The board (most likely its audit committee) should meet with the auditor without any members of management present. The board should ask the auditor how seriously he views the qualification, whether this is the tip of a much larger iceberg—evidence of a contentious relationship between management and the auditor—and what action the auditor recommends that the board take.

Example

SAMPLE LANGUAGE

The following are examples of how an auditor qualifies his opinion:

- **Qualification Because of Scope Limitation.** The following language contains a qualification based upon geographic limitations:

  Except as discussed in the following paragraph, we conducted our audits in accordance with auditing standards generally accepted in the United States…

  We were unable to obtain audited financial records related to the organization's activities related to one of its delegate agencies due to a fire in that agency, which are reported as accounting for 10 percent of its revenues and 9 percent of its expenses for the year ended 20X1 as described in Note X to the financial statements.

  In our opinion, except for the possible effects of the matter discussed in the Basis for Qualified Opinion paragraph, adjustments might have been determined to be necessary had we been able to examine evidence regarding the delegate agency's activities, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position….

- **Qualification Because of Departure from GAAP.** The following language contains a qualification based on a departure from GAAP in the financial statements:

  As more fully discussed in Note X to the financial statements, the Company reports its investment in Big Festival Inc., a majority-owned subsidiary, on the equity method of accounting. In our opinion, accounting principles generally accepted in the United States require that all majority-owned subsidiaries be accounted for as consolidated subsidiaries. As of June 30, 20X1, Big Festival Inc. was dissolved and its remaining cash and operating assets and liabilities were distributed to the Company, which are included in the accompanying financial statements. If the financial statements of the Big Festival Inc. had been consolidated with those of the Company, total assets and total liabilities would be unchanged as of June 30, 20X1 and would be increased by $XX,XXX as of June 30, 20X0; and revenues and expenses would be increased by $XXX,XXX and $XXX,XXX for the years ended June 30, 20X1 and 20X0.

  In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements referred to in the first paragraph present fairly, in all material respects….

The Adverse Audit Opinion

When the circumstances warrant, the auditor will issue an adverse opinion concluding that the financial statements do not present fairly the statement of financial position, the related statements of activities and cash flow, and the related notes to the financial statements in conformity with GAAP. The auditor must explain all the substantive reasons for the adverse opinion. An adverse opinion is undesirable and should cause serious reflection and a calculated response from the board.

Example

SAMPLE LANGUAGE

The following is language from an adverse opinion resulting from departures from GAAP:

[Same first and second paragraphs as the standard report]

As more fully described in Note X to the financial statements, the College does not recognize pledges from donors as revenue. Accounting principles generally accepted in the United States require that pledges be recognized as revenue in the year made. Because of the departures from accounting principles generally accepted in the United States identified above, as of December 31, 20X1 and 20X0, net assets have been understated by $XX,XXX,XXX and $X,XXX,XXX, and revenue for the years ending December 31, 20X1 and 20X0 have been understated by $X,XXX,XXX and $X,XXX,XXX.

In our opinion, because of the significance of the matters discussed in the Basis for Adverse Opinion paragraphs, the financial statements referred to above do not present fairly, in accordance with accounting principles generally accepted in the United States, the financial position of the College as of December 31, 20X1 and 20X0, or the results of its operations or its cash flows for the years then ended.

The board should consider the following response:

- **Meet with the Auditor.** It should meet with the auditor without members of management present. It should ask about the seriousness of the problem, alternative ways to address it, and whether the auditor has other unstated concerns about the statements or its relationship with management.

- **Meet with Management.** It should meet with management to hear management's side of the story.
- **Audit Committee.** If the qualification took the board and audit committee by surprise, they should reevaluate their role in the audit process.
- **Change.** The board should ask whether there needs to be a change in management or the auditor.

Disclaimer of Opinion

An auditor can refuse to express an opinion on the financial statements, which is referred to "disclaiming an opinion." This is appropriate if the auditor has not performed an audit sufficient in scope to permit an opinion to be rendered. The auditor must provide the substantive reasons for the disclaimer. Auditors often are asked to audit just a subsidiary or an internal operation of a larger entity. The auditor will disclaim an opinion with respect to the larger entity as part of the opinion covering the smaller one.

Example

SAMPLE LANGUAGE FROM A DISQUALIFIED AUDIT OPINION

The following is sample language disclaiming an opinion regarding the larger organization:

> *As discussed in Note 1 to the financial statements, the financial statements of Public Radio Station XXXX are intended to present the financial position of the station as of June 30, 20X3 and 20X2 and their changes in net assets and their cash flows of only that portion of the funds and account groups of Large University, that is attributable to the transactions of the Public Radio Station XXXX. They do not purport to, and do not, present fully the financial position of Large University as of June 30, 20X3 and 20X2, and the changes in its financial position and its cash flows, where applicable, for the years then ended in conformity with the accounting principles generally accepted in the United States of America.*

Withdrawal

On occasion, an auditor will withdraw from an engagement. The board should always be interested in understanding the circumstances surrounding the withdrawal. It may be that management is impeding the audit, which has obvious and serious implications. Surprisingly, neither GAAS nor the AICPA's Code of Professional Conduct requires that an auditor issue an opinion or disclaimer once the auditor has been engaged to perform an audit. Many stakeholders and regulators will want to know what circumstances caused an auditor to withdraw from an engagement, but the AICPA's code precludes the auditor from disclosing the circumstances surrounding withdrawal to anyone but the party engaging the auditor or persons contractually obligated to be notified under the terms of the engagement letter. The board should always specify in the engagement letter that the auditor must notify the board in the event the auditor withdraws from the engagement or decides not to issue an opinion, and provide the reasons and a discussion of the surrounding circumstances.

Retaining an Auditor

The board, not management, should retain the auditor. This is a practice that has been adopted as a legal requirement by the Securities and Exchange Commission for publicly traded companies.[16] As noted, the primary purpose of an audit is to provide the board with comfort that management has produced financial statements that present the CAA's financial results and position accurately in all material respects in accordance with GAAP. As the primary and intended beneficiary of the audit, the board should emphasize to both the auditor and management that it views the audit as an integral part of the board's oversight function. Taking charge of the selection process reinforces that message to all involved.

The board, not management, should retain the auditor.

Practical Considerations

CAA boards are compromised of volunteers who often face time constraints due to family and jobs. Moreover, many volunteers will lack the background needed to make an informed selection. For these reasons, management is often involved in the selection process. It may assemble the list of candidates and conduct the initial interviews. This approach is acceptable if:

- **A Report.** Management prepares a report discussing the results of the selection process.
- **A Discussion.** The board or its audit committee discusses the report and management's recommendations with management.

- **A Meeting.** The board or its audit committee meets with the finalists to conduct an interview and listen to presentations.
- **The Selection.** The board makes the final decision and the engagement letter indicates that auditor's duties run to the board.

Audit Requirements in the Uniform Guidance

Due to the federal funding they receive, CAAs are required to follow specific procurement procedures when retaining an outside auditor. For example, Subpart F of the Uniform Guidance establishes audit requirements for both nonprofit and public CAAs and requires that a CAA adhere to the procurement standards in the Uniform Guidance when procuring audit services. In requesting proposals for audit services, the objectives and scope of the audit must be made clear and the CAA must request a copy of the audit organization's peer review report which the auditor is required to provide under GAGAS.[17] Whenever possible, CAAs must "make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services as stated," as required by 2 C.F.R. § 200.321. In selecting an auditor, the CAA should take into account the "responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price."[18] State and local governments and foundations may impose other requirements.

Requests for Proposals

Whoever undertakes responsibility for the search process should prepare a request for proposal (RFP), which is then sent to perspective auditors. The RFP should be divided into three parts. One should describe the CAA and its accounting staff. The second should describe the requested services. The third should indicate what information the CAA wants the prospective auditor to include with its proposal. A checklist for preparing an RFP is included as Appendix C. Additional RFP resources are available from the American Institute of Certified Professional Accountants.[19]

Review References

Many regulators maintain online databases that can be used to confirm whether a CPA is in good standing and licensed. Some of these sites also permit access to or refer to disciplinary proceedings.

Tips

AS A MATTER OF ROUTINE, THE BOARD OR MANAGEMENT SHOULD REVIEW THESE DATABASES BEFORE ENGAGING AN AUDITOR.

The CAA should also request and then verify references provided by each firm that is under serious consideration. Unless counsel advises otherwise, the audit committee should refrain from discussing fees with references—the concern being potential violations of antitrust (e.g., price fixing or division of territories) laws. In lieu of such discussions, the committee should review published surveys.

EXAMINE PEER REVIEWS

The AICPA makes peer reviews available through its Peer Review Public File web page.[20] As part of the selection process, the appropriate member of management or the board should review the peer reviews for firms that are in contention for selection as the CAA's outside auditor. CAA's should also check the websites of state CPA societies, many of which address peer reviews.

The Engagement Letter

Engagement letters for audits are often based on templates developed by industry trade associations or by other audit firms or services that specialize in providing documents and audit plans to auditing firms. At one time the letters may have focused on price and been relatively short. Those days are long gone.

Engagement letters have become lengthy legal documents. Although the letters may be for the services of an auditing firm, lawyers often play a significant role in preparing the letters. This makes careful review of the letter imperative. CAAs and their audit committees should not hesitate to have a knowledgeable lawyer review the letter, particularly if the CAA is retaining the audit firm for the first time or there have been significant changes in the letter (e.g., it expands from two pages to 10 pages). Nor should CAAs hesitate to question or negotiate modifications to specific terms. Although engagement letters are often presented as contracts of adhesion ("take it or leave it"), they should not be viewed that way.

An engagement letter is a contract for services. As such, it should contain the basic terms of the agreement between the CAA and the auditor. A checklist of the basic provisions found in engagements is included as Appendix E.

In an effort to protect themselves, auditors are now adding a number of provisions to the engagement letter that are designed to protect the auditor from liability. A complete discussion of these provisions is beyond the scope of these materials. For the present purposes, CAAs should understand that some of these provisions, such as indemnification provisions, have the potential to invalidate the CAA's own insurance policies, like directors and officers coverage. This makes a review of the engagement letter by a knowledgeable lawyer especially prudent.

Management Representations

An auditor is required to verify certain facts or make an affirmative determination that those facts cannot be verified. The AICPA's auditing standards require the auditor to obtain written representations from management when facts cannot be verified by the auditor. The stated purpose of these representations is: "[to] ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations."[21]

Forcing Disclosure and Shifting Risk

Management's representations serve two important purposes. First, these representations correct information asymmetries by forcing management to disclose information that the auditor is unable to verify because either there is no system that assures that the information is captured by the accounting system or the cost of verifying the information is prohibitive. Second, these disclosures shift the risk of non-detection or non-verification back to management and the financial statement users.

Implications

Given those purposes, management's representations have important implications for the board, management and other financial statement users.

- **Undercutting the Audit.** The representations effectively create exceptions that are unstated in the standard auditor's opinion. The representations degrade the opinion's value. This may be necessary and justifiable, but it is nevertheless degradation. For this reason, the board and other financial statement users should demand to review the representation letter. As a practical matter, the board can make such demands and should, but other financial statement users may lack the power to force management to disclose the representations.

- **Reviewing the Representations**. Because the representations are drafted by the auditor for management to sign, both management and the board should carefully review the representations. Management must recognize that a false, incomplete, or inaccurate representation could preclude the CAA from suing the auditor if a failed audit results in damages to the CAA. In at least one case, a false representation prevented the organization from shifting the loss to the auditor. The court, in justifying the result it reached, offered a cautionary note to all organizations, including CAAs, when it wrote:

    The [client] dismisses the representation letter as mere boilerplate, drafted by the auditor in terms most favorable to it. The letter, however, basically memorializes the verbal representations made by Luhmann and Wagner in the meeting with [the] auditors on October 9, 1993. Moreover, Gary Seidleman, [the audit] engagement partner, testified that he delivered the audit report on October 16, 1993 only because [the auditor] had received a signed representation letter. Similar representations were made verbally by Wagner and Luhmann in a meeting with [the] auditors on October 9, 1993. This is the type of contributory fault described in National Surety. Thus, as a matter of law, we conclude that the [client] could properly be found comparatively negligent based on the evidence submitted to the jury.

    The question of whether the false representations contributed to [the auditor's] failure to identify and disclose violations of the Board's investment policies is a factual question for the jury to decide. [Citation omitted.] The evidence was sufficient for the jury to conclude that [the auditor] relied on the truth of the representations as a condition precedent to releasing its audit report.[22]

Standard Representations

Appendix E contains many of the representations that auditor's require management to make before the auditors will issue an opinion regarding the financial statements.

Examples

MINUTES REFLECT SIGNIFICANT ACTIONS

The auditors typically require management to make the following representation: "Management has provided minutes of the meetings of the governing body or summaries of actions of recent meetings for which minutes have not yet been prepared." The auditors look to the minutes to identify significant decisions that could affect financial statements, such as the incurrence of debt, acquisitions of property, and decisions to enter into partnerships. Without this representation, the auditors would be forced to prove or verify a negative: there wasn't anything else significant. Management and the board were at the board meetings, not the auditors, so the representation is a fair one.

NO VIOLATIONS OF LAW

The auditors also typically require management to make the following representation: "There are no violations of laws or regulations." Once again, the auditor has no way to prove a negative. Yet, if the financial statements (including the footnotes) do not appropriately reflect the appropriate liability for a violation of the law, the statements are most likely misleading.

If a CAA cannot make a representation, it should state so. It may be necessary to add language that clarifies the representation or that recognizes an exception. Before addressing the issue with the auditor or modifying or clarifying language, the CAA should confer with its legal counsel so as to avoid inarticulate admissions that could create legal liability where none exists or create other problems.

Special Representations

Depending on the circumstances, the auditor may require other representations.

Part III: Management's Role In Preparing for the Audit—A Step-by-Step Process

Overview

Part II focused on the board's role in the audit process and some of the legal issues that an audit poses. As indicated, management will be involved in those aspects of the audit either because the tasks requires collaboration or the CAA's board lacks the necessary knowledge. Despite Part II's emphasis on board involvement, management has a clear role in the audit that does not involve the board's active participation: preparing the CAA and its financial statements for the audit. This part provides guidance to management on its preparation, including the additional steps required to prepare for a Single Audit. It assumes the reader is generally familiar with terminology and the requirements under federal law.

preparing the CAA and its financial statements for the audit... Management has a clear role in the audit that does not involve the board's active participation:

Pre-Audit Planning With the Auditor

In planning for the audit:

- **Timing.** Management should ask the auditor for a timeline covering all phases of management's work on the audit. Management should work with the audit manager to achieve any timeline revisions needed to be certain that management can fulfill its responsibilities while leaving the auditor sufficient time to complete all portions of the audit on deadline. Management and the auditor should recognize that Single Audits must be submitted to the Federal Audit Clearinghouse (FAC) within the earlier of 30 calendar days after receipt of the auditor's report or nine months after the end of the audit period. Management and the auditors should also be aware of any funding sources that require shorter deadlines. While the auditor should be familiar with the requirements of specific funding sources, management is ultimately responsible for submission of the audit within specified time limits.
- **Understand Preferences for Electronic or Paper-based Versions of Information.** Management should discuss the auditor's preferences for information in electronic or paper form. Management and the auditor should agree on the documents that the auditor is prepared to accept and manage electronically, and those that must be provided as hard copies, either to review or to place in audit files.
- **Auditor Workpaper Format Preferences.** Management will prepare a variety of schedules and reconciliations for auditor review. The person responsible for these schedules should ask the auditor to provide samples of the workpaper format. If management prefers an alternative approach, management should discuss it with the auditor in advance to avoid demands to revise or reformat management's schedules.

- **Confirmation Procedure.** Management should review the list of confirmations which were sent to funders, depositories, and other outside sources as part of the prior year's audit, and then develop a proposed revised list for confirmation inquiries. Management should reach a clear agreement with the auditor about management's responsibility for preparing and sending the confirmation requests.
- **Standard Management Representations.** Management should review last year's "management representation" letter, and then ask the auditor to identify any items that it believes are likely to be added to this year's management representation letter. This preliminary planning conversation cannot be conclusive since the auditor may identify additional issues and concerns during the course of the audit.

Financial Statement Preparation

The financial statements reflect management's presentation of financial activity, results, and position and also serve as management's assertion that it has complied with law, regulation, and contractual requirements.

Given the requirements for obtaining an unqualified audit opinion, most CAAs prepare their year-end financial statements in a format which complies with GAAP, and therefore includes notes to the financial statements providing all GAAP required disclosure, as well as the statement of financial position (balance sheet), statement of activities (income statement), statement of cash flows, and statement of functional expenses. This may require the year-end statements to be prepared in formats which differ from those used for monthly reporting to the board or other purposes during the fiscal year.

The prior year's audited financial statements are the starting point for preparation of this year's statements, but management must consider whether there have been changes in GAAP requirements and/or changes in the nature of the CAA's activities, transactions, or other factors which require additional disclosures or possible changes in the format.

Some CAAs choose to work with a qualified outside accounting consultant to assist with the preparation of the year-end statements to be certain that they are complete and comply with GAAP requirements. However, the CAA must retain responsibility for the accuracy and completeness of the financial statements even when the statements are prepared with outside assistance.

In the past, some auditors were willing to assist with the preparation of the financial statements, most commonly with the notes or with the GAAP format of the financial information, but changes in auditing standards dealing with auditor independence have made many auditors extremely reluctant to become involved in preparing the statements. Those who are willing to provide such assistance will do so only when they have complete confidence that the organization has the capacity to form its own independent judgment about the financial statements after the auditor has provided such assistance.

Preliminary Financial Analysis

Before closing the books, management should compare: (1) all year-end balances with the prior year-end trial balances; and (2) year-end income and expense accounts to the annual annual budget. This review will help identify potential errors. The review is also useful for identifying the accounts that will require supporting schedules or work papers.

Trial Balance Account Schedules and Reconciliations

The trial balance produced by the accounting system following the closing of the book for the fiscal year provides balances for each asset, liability, net asset, support and revenue, and expense account.

As part of the audit planning process, management should discuss with the auditor the supporting schedules that the auditor would like for specified balances. Management should then use that information to prepare the schedules. Examples of such schedules include:

- **Bank Accounts.** The supporting schedule for each bank account takes the form of a standard bank reconciliation explaining the difference between the year-end general ledger balance and the balance reported by the bank.
- **Investment Accounts/Mutual Funds.** The financial statements must include the investment accounts, to the extent the accounts include readily marketable securities, at the fair market value of those securities as of year-end. The supporting schedule should therefore reconcile the year-end trial balance with the values reflected by brokerage firm accounts.
- **Accounts Receivable**. When multiple categories of receivables have been aggregated into one account balance, there should be a schedule that reflect the amounts receivable from each source. The schedule of accounts receivable will typically include aging schedules that report the time that each receivable has been outstanding.

- **Pledges or Grants Receivable.** When there are multi-year grants or pledges, there should be a supporting reporting the name of the entity making the commitment, the full amount of each commitment, the date each commitment was made, the payment schedule agreed upon, and the discount used to value the net present value of each commitment.
- **Prepaid Expenses.** The balance for prepaid expenses should be supported by a schedule detailing each prepayment, the time period covered, and the portion the prepaid expenses that are attributable to the fiscal year under audit.
- **Wages Payable.** There should be a schedule supporting the wages payable balance that lists each employee and the amount owed at the year-end date. During the planning phase of the audit, management should discuss its payroll processing software and the auditor's preferences for schedule format.

The work papers for the unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets are typically not prepared until management has completed its analysis of the support, revenue, and expense accounts. These work papers will reconcile the impact of releases from the temporarily restricted net assets into the unrestricted net assets, as well as the impact of additions to the temporarily restricted and permanently restricted net assets.

Management should prepare work papers to support all material revenue, support, and expense accounts. For most CAAs, work papers will be required for all grants and contracts, personnel-related expense items, professional services, sub-contracts, sub-recipient agreements, facilities and equipment lease accounts, and for depreciation or use allowance expense accounts.

Internal Controls

Management is responsible for ensuring the development and implementation of effective approaches to enterprise risk management, including analysis, systems, policies, and procedures to identify and control the risks inherent in operating a legal entity serving the public, employing staff, and entering into contracts.

In order to demonstrate to auditors that the policies are actually used and followed, these policies should be readily accessible. One method of doing so is posting them on the CAA's website, either the public portion or an internal page.

The auditor is required to gain an understanding of the CAA's business, the risks inherent in its operations, and the controls its has put in place to control those risks.

Auditor Risk Management/Internal Control Questionnaire

Many auditors provide a questionnaire or assessment tool for CAAs to complete that identifies risks and the controls that have been put in place to address risks. Other auditors prefer to gather this information by interviewing employees with specific responsibilities for risk assessment, and development and monitoring of controls. Most auditors find that a combination of written questionnaires and in-depth interviews yields the best results.

The auditor's review of internal controls is an important element of the audit. During this review, the auditor will ask senior management and other employees to identify weaknesses as well as strengths in the CAA's system of controls. By identifying weaknesses and implementing change in advance of the audit, management demonstrates that it understands the importance of controls to the integrity of the financial reporting process.

Risk Assessment Documentation

Management can demonstrate its commitment to internal controls by collecting reports and memos that reflect the CAA's effort to identify, evaluate, and control risks. As part of the audit planning process, management should ask the auditor to define the level of detail required.

Fiscal Policies and Procedures

Management should assemble written fiscal policies and procedures for review by the auditor. As part of the regular maintenance of these manuals, management should systematically date pages to assist the auditor in assessing whether the practice is in compliance with current policies and procedures.

The CAA's auditors will review the CAA's fiscal policies and procedures manual as part of their assessment of the overall system of controls. They will also use the manual as a guide for design of tests of compliance during the audit process. The compliance tests focus on determining whether personnel are following the CAA's fiscal policies and procedures. Failures to follow the CAA's fiscal policies and procedures may ultimately result in audit findings.

Other Policy Documents

The CAA's auditors may ask to review other policy documents including investment, whistleblower, conflict-of-interest, record retention, and other key policies.

Organization Chart

Management can save the auditor time by providing a detailed organization chart that includes all positions within the organization and illustrates the lines of authority within the organization. Management should also provide the auditor with a contact list for managers and others likely to be helpful during the audit, including names, titles, e-mail and phone contacts.

Accounting System Structure

Management should provide the audit team with a concise description or graphic depiction of the accounting system. The graphic should illustrate the structure incorporated into the general ledger to define cost centers and sub-cost centers. Management should describe any segmentation that is used in account coding. Typical segmentation includes line item, cost center, and sub-cost center. The description might also include designation of funding source in the expense line item codes as well as in revenue account codes. Explanations should be provided for each of the segments. For account segments relating to funding sources, management should provide the complete name of the source as well as explanation of how awards from multiple fiscal years or multiple awards from the same source are differentiated.

Data Security

Management should review any existing data security policy and procedures documents to be certain that they reflect current practice. Even if the CAA does not have a formal data security policy, management should assemble all data security related memos and instructions into a readily accessible location for review by the auditors. It should also identify the individuals who can best articulate data security practices. In larger CAAs this may be the director of information technology. In small CAAs, responsibility for data security may fall within the scope of the top fiscal officer position. Those responsible for security should be prepared to describe the major elements that ensure the security of financial, program, participant, and donor data.

Prior Audit and Monitoring Findings

Management should review any prior audit findings as well as any findings or issues for follow-up raised by funding source monitors. It should prepare a brief description of the strategies that have been undertaken to address the concerns raised in the findings or monitoring issues, and then describe the extent to which the CAA has implemented the strategies.

If some of the findings from the previous audit or from monitoring have not yet been addressed, management should prepare a concise explanation of the reasons for delay and/or rationale for declining to address them.

Grant Funding Schedules for Governmental Sources

A key element in every Single Audit report is the Schedule of Expenditures of Federal Awards (SEFA). Management should review each funding agreement to determine whether some or all of the funds have received are federal in origin. If an agreement does not clearly state the federal source but management believe the funds are federal in origin, management should ask the funder for clarification including the Catalog of Federal Domestic Assistance (CFDA) number for the source.

Management can save the auditors time and identify areas that may require additional audit prep work by preparing a draft of the schedule identifying:

- Each source of federal funds, including the name of the federal agency, the name of the program, CFDA numbers, and fiscal years of each award;
- The amount of each award;
- The accrued or deferred revenue at the beginning of the fiscal year;
- The receipts or revenues recognized for each award during the fiscal year;

- Federal disbursements/expenditures during the fiscal year; and
- Accrued or deferred revenue at the end of the fiscal year.

Each item on the schedule must be supported by financial records. Management should develop a clear map for the auditors to follow to verify the information on the schedule. Furthermore, management should compare the information on the schedule to documentation from each funding source and to any reports that have been submitted to the funding source. Finally, management should reconcile any discrepancies between what is reported on the schedule and agreements and reports.

Grant Funding Schedule for Foundation Grants

Management should prepare a schedule of each foundation award received during the fiscal year, identifying:

- Name and contact information for each foundation;
- Public charity or private foundation status of each source. This information is generally included in the award letter. If it is not, management should contact the foundation or use the IRS's online Exempt Organizations Select Check, an electronic database that provides information about the tax status of charities;[23]
- Amount of the total award;
- Unrestricted or restricted character of the award, including what purpose, time, or other restrictions have been applied by the funder;
- Time period in which the funds may be used;
- Payment schedule;
- Amount received during your fiscal year;
- Qualifying expenditures of the award during your fiscal year;
- Any amount still receivable from the award; and
- Amounts received but not yet expended that are included in temporarily restricted net assets.

Management should be prepared to provide the auditors with copies of the applications submitted for each award and other correspondence with each foundation. It should make sure the financial records used to prepare the schedule agree with the records maintained and any reports submitted to the foundations by the CAA's fund development and/or program managers relating to each award.

Understanding the Auditor's Approach to the Single Audit

The hallmark of the Single Audit is the auditor's opinion regarding compliance with myriad requirements for the management of federal dollars. In planning a Single Audit, the auditors must include procedures and analysis that will enable them to express an opinion on the CAA's compliance in addition to expressing their overall opinion regarding whether the financial statements fairly present the CAA's financial condition and results of activities.

The auditor's work on a Single Audit is guided by principles and procedures described in Subpart F of the Uniform Guidance, which addresses the auditor's responsibilities and reporting requirements. In addition to the core standards and approaches described in the Uniform Guidance, the Office of Management and Budget (OMB) has issued a Compliance Supplement which is updated at least annually to the OMB website.[24] It is not feasible for the auditor to test compliance with each regulation. Instead the auditor is trained to identify and examine issues with the greatest potential impact on the CAA's major programs. The Compliance Supplement and its updates identify key compliance issues in various programs and suggest effective methods to test and evaluate compliance with those requirements. Management's audit preparation should include review of the audit requirements in the Uniform Guidance, and the Compliance Supplement and updates.

Federal Cost Principles Compliance

The Cost Principles in Subpart E of the Uniform Guidance (the Cost Principles) establish principles for determining costs of grants, contracts, and other agreements with nonprofit organizations.[25] They require that costs charged to federal sources must be reasonable, allowable and allocable. A substantial portion of preparation for the Single Audit audit will be helping the auditor

understand what systems have been put in place to ensure compliance with the Cost Principles. A first step in this process is demonstrating that management has reviewed the Cost Principles and incorporated it into all aspects of its grants management and internal control systems.

Cost Allocation Plans

Management should begin audit preparation by reviewing the CAA's cost allocation plan and testing the cost allocation approaches used in the CAA's accounting system for compliance with the plan.

Federally Negotiated Indirect Cost Rates

If the CAA has obtained a federally negotiated indirect cost rate, the auditor will review both the proposal the CAA submitted to its cognizant agency and the letter approving the rate which the CAA received. As part of the audit preparation, management should enter year-end financial information into the same format it used to submit its proposed rate to calculate the actual indirect rate. If there is a significant variance between the CAA's indirect cost rate and the actual indirect costs incurred, management should determine how it plans to resolve the differences.

10% De Minimis Indirect Cost Rate

If a CAA has never received a negotiated indirect cost rate, it may elect to charge a de minimis rate of 10 percent of modified total direct costs (MTDC). Such a rate may be used indefinitely or until the CAA chooses to negotiate a rate, which the CAA may do at any time. If the CAA has elected to used the 10% deminmis rate, auditors will first attempt to obtain an understanding of internal control, assess risk, and test internal control as required the Uniform Guidance. The auditors will then determine whether the de minimis rate is applied to the appropriate base amount and whether the de minimis rate is used consistently by the CAA under its federal awards.

Allocation of Personnel Costs

Auditors are encouraged to pay close attention to the methods the organization utilizes to ensure that personnel costs are properly allocated to the appropriate cost centers. The Cost Principles require that charges to federal awards for salaries and wages must be based on records that accurately reflect the work performed. These records must meet a number of criteria, including that the records are supported by a system of internal control which provides reasonable assurance that the charges are accurate, allowable, and properly allocated, and that the records are incorporated into the grantee's official records.[26]

Management's audit prep should include review of the time records maintained by both exempt and non-exempt employees and some testing to determine whether the allocations of salary and related payroll costs in the accounting records are consistent with the underlying detail on the time records.

Allocation of Other Costs

Management should identify other significant non-personnel cost line items that involve shared costs that are allocated utilizing the methods described in the CAA's cost allocation plan. For many CAAs, these line items will include facilities costs. Management should review year-end balances by cost center for each of these accounts to determine whether the allocation methods described in the cost allocation plan have been applied consistently.

Uniform Administrative Requirements Compliance

The Uniform Administrative Requirements in Subparts A-D of the Uniform Guidance (the Uniform Administrative Requirements), provide the overall framework for management of federal funds.

A key element in every Single Audit is determining whether the CAA has established and maintained the fiscal systems, policies and procedures required in the Uniform Administrative Requirements. Management should be prepared to explain its procurement policies, cash management requirements, accounting for and use of program income, handling of in-kind contributions, cost sharing and matching fund methodologies, and management of property acquired with federal funds. As part of that process, management should collect and organize its policies and supporting documentation pertaining to these matters.

Governance Issues in Single Audits

Standard audits of financial statements include the auditor's review of key governance issues, including review of board minutes, bylaws, policies, and other key documents. The auditor's goal in reviewing these documents is ensuring board authorization for the annual budget, borrowing, investment of funds, and other key organizational decisions.

In Single Audits of CAAs, the auditor must also determine whether the organization has complied with the specific governance requirements for recipients of CSBG funding, including board composition, and the board's full participation in the development, planning, implementation, and evaluation of the program to serve low-income communities. For CAAs receiving Head Start funding, the auditor must also find evidence of adoption and implementation of policies which comply with Head Start specific conflict of interest requirements and ensure that Policy Councils are functioning within the parameters required for organizations receiving Head Start funding. With this in mind, management should prepare schedules or discussions that demonstrate that management has complied with applicable requirements.

Conclusion

As should be apparent, preparing for a financial statement audit is an involved process. In order to efficiently provide the auditor with what the auditor needs, management should place a premium on thorough pre-audit planning and meetings with the auditor. From a longer-term perspective, management should be focused on putting in place a solid system of internal controls and supporting documentation, together with effective record retention policies. A CAA with poor systems is going to struggle as it attempts to meets the demands that the auditor places on it. CAAs that have placed a premium on good systems will have far less trouble preparing for the audit. Those systems will reduce the burden on both the CAA and its auditor.

Part IV: The Audit Committee Generally

The function of the audit committee is to act on behalf of the board in connection with the audit. The audit committee must work closely with management, because both have a role in the process. How required tasks are allocated between management and the board depends in part on the depth of the audit committee's knowledge and experience, the time its members are willing to commit to what can be an involved process, and appropriateness of the division. For example, the audit committee should review the management representations, but management must sign the letter, placing primary responsibility for this aspect of the audit on management.

In order to efficiently provide the auditor with what the auditor needs, management should place a premium on thorough pre-audit planning and meetings with the auditor.

Overview

A CAA's financial statements guide and influence the board's decisions regarding program size and scope, operating and capital budgeting, compensation, fundraising, and financing. The CAA's system of internal controls directly affects the quality of interim information that the board relies on. Internal controls also serve to protect against fraud and financial mismanagement. As is true of all organizations, CAAs face an array of regulatory and financial risks, which the board must oversee.

A CAA's board requires a formal means for: (1) addressing the accuracy of the financial information that the board relies on; (2) assuring that management has adopted necessary internal controls; (3) monitoring financial and other risks; and (4) managing the board's relationship with auditors. For an organization such as CAA, that obtains audits of its financial statements, an audit committee provides that structure, as the following clause from the American Red Cross' audit committee charter demonstrates:

> *The Audit and Risk Management Committee (the "Committee") is appointed by the Board of Governors (the "Board") of The American National Red Cross (the "Corporation"). The purpose of the Committee is to assist the Board in oversight of (1) the integrity of the financial statements of the Corporation, (2) the qualifications and independence of the Corporation's independent auditors, (3) the performance of the Corporation's independent auditors and internal audit function, (4) the processes by which the Corporation's management assesses and manages risk, and (5) the Corporation's compliance with legal and regulatory requirements.*[27]

Committee Duties

Audit committees perform a number of important tasks, including:

- **Retaining the Independent Auditor.** As previously noted, the audit committee should make recommendations to the full board on or bear primary responsibility for selecting, retaining, managing the services of, and, when necessary, terminating the relationship with the outside auditor.

- **Assuring Auditor Independence.** In adhering to professional codes of conduct, the outside auditor should be continuously evaluating its independence, particularly when the auditor also will be providing non-attest services to the CAA.

  Notwithstanding those efforts, the audit committee should also assess the auditor's independence. The committee may decide to impose a higher standard for independence than required under applicable professional codes of conduct. Some audit committees may require that all non-attest services (e.g., consulting services) be pre-approved by the committee, particularly if the CAA's management will contract for and direct the non-attest services. There is a natural conflict once an auditor is providing both attest and non-attest services. Can an auditor remain objective when the cumulative fees received from the non-attest services exceed audit fees? Even though the full board audit or the audit committee may control the audit engagement, the fees generated by non-attest services provide the auditor with an incentive to protect those fees by keeping management happy.

- **Communicating with the Auditor.** Statement of Auditing Standards (SAS) No. 114, The Auditor's Communication with Those Charged with Governance,[28] addresses communications between the auditor and the board or the audit committee. As is true of most audit standards, it is written from the perspective of the auditor. In this particular case, the focus on the auditor is a bit surprising given the recurring reference to the importance of two-way communications to the process. The auditor is required to communicate: (1) the auditor's responsibilities under GAAS; (2) an overview of the planned scope and timing of the audit; and (3) significant findings from the audit. The auditing standards contemplate a formal communication process, specifying which communication must be written or oral. SAS No. 115 requires the auditor to communicate significant control deficiencies and material weaknesses in the system of internal controls, something we will consider in Part V.

  The audit committee should have members who are capable of upholding the committee's end of the two-way discussions. These members must understand the implications of the communications and be in a position to demand that management respond appropriately.

  The central question: How much is enough? A Grant Thornton 2009 Nonprofit Governance survey found that 52 percent of the nonprofit audit committees met with the outside auditors two or three times a year.[29] According to commentary accompanying the survey, the audit committees should meet with the organization's auditors at least twice a year: once to discuss the auditor's work plan and once to review the audit findings before they are presented to the board. In fact, it is not unusual for the auditor to meet with the audit committee four times or more per year, particularly among larger organizations.

- **Overseeing the Integrity of Internal Controls.** Management, not the audit committee, is charged with designing and implementing the CAA's system of internal controls. The audit committee, however, should "periodically consider the integrity and effectiveness of the [organization's] internal controls, including any significant deficiencies or changes in internal controls."[30] At a minimum, this oversight function requires the committee to review the outside auditor's written communication regarding control deficiencies. The review should be followed first by discussion with management about the deficiencies and the need to make changes in systems and then with periodic progress reports from management.

Example

RESPONDING TO THE AUDITOR'S COMMENTS

In a letter to the board following its audit engagement, BCA's outside auditors advise the board that BCA does not have sufficient controls in place to monitor the executive director's discretionary spending on travel, meals, and other reimbursable items. The board or its audit committee should discuss this matter with the executive director and other members of management, asking that appropriate controls be put in place. The board or its audit committee should ask BCA's auditors whether they have any suggestions or are aware of any inappropriate behavior on the part of the executive director. The board or its audit committee should then follow up with management to ensure that the deficiency is addressed.

■ **Supervising the Internal Audit Function.** Large publicly traded corporations have internal audit staffs that continually monitor, test, and improve controls. Although large nonprofit hospitals and educational institutions often rely on internal audit staff, far too many nonprofits have chosen to rely on their outside auditors and luck, often viewing internal auditors as administrative overhead that drain resources from mission.

If a CAA does have an in-house internal audit function, the audit committee should periodically review the independence and professional qualifications of internal auditor(s). The committee should also be involved in hiring the internal auditor, or the head of the internal audit team if there is more than one internal auditor, (most appropriately, making a recommendation to the full board after a thorough search process). Finally, it should review reports annually from the in-house auditor(s) regarding the state of the existing system of internal controls and suggestions for improving it.

■ **Assessing Risk.** The board's role in organizational risk management could be the topic of an entire toolkit. The following are among the areas that the audit committee should be reviewing or monitoring:

- Maintaining and protecting the CAA's tax-exempt status.
- Assuring proper treatment of taxable (unrelated business taxable income) income streams, if any.
- Monitoring the timely payment of payroll taxes (employee income tax withholding, FICA and Medicare taxes).
- Assuring that the CAA is claiming and protecting appropriate property tax exemptions.
- Assuring that the CAA qualifies for all claimed exemptions from sales and use tax.
- Monitoring compliance with bond and debt covenants.
- Addressing other appropriate risks.
- The audit committee need not address each of these issues at every committee meeting. Depending on a board's structure, some of these issues might better be assigned to other committees (e.g., the fundraising or finance committees), or the board might ask that management make direct reports to the board. Each of these issues ultimately is management's responsibility, but the board and its committees have an oversight role.

■ **Responding to Whistleblowers.** Another section of this toolkit focuses on whistleblower policies. A critical issue under any whistleblower policy is identifying whom the whistleblower should notify about concerns. The policy need not designate the same recipient for all notifications. The audit committee is a logical choice in the case of whistleblower concerns regarding financial matters. Those matters include suspected fraud or embezzlement, financial statement inaccuracies, inadequate or improper administration of grants, and potential tax law violations.

Committee Composition

Audit committees and financial expertise go hand in hand, or at least that is the conventional wisdom. CAAs are not subject to the SEC's rules applicable to public companies, but consideration of those rules is useful. This is particularly true for CAAs that are Head Start grantees since the Head Start Act generally requires their boards to have a member with financial expertise.[31] The SEC doesn't require that a certain number of audit committee members possess financial expertise, but it does require public companies to identify an expert on the committee, or explain why there are no such experts. The SEC does offer an elaborate definition for the term "audit committee financial expert." A qualifying expert includes someone who has: (1) an understanding of GAAP; (2) experience preparing, auditing, analyzing, or evaluating financial statements; (3) an understanding of internal controls; and (4) an understanding of the audit committee's role.[32] Each of these attributes is a relevant one. Although CAAs will find this definition useful, they need not formally adopt it.

Difficulty Finding Qualified Committee Members

Many CAAs will have difficulty finding more than one or two committee members who satisfy the SEC's definition. This is not a problem because most CAA financial statements will not be nearly as complex as the statements for publicly traded corporations. Most CAA audit committees should be able to discharge their duties if they have a banker, accountant, or other person familiar with financial statements and internal controls as a member.

Non-Board Members

Some CAAs will not have any board members with financial expertise. If state law permits, the board should consider appointing a non-CAA member to the committee. California, for example, permits non-board members to serve on the audit committee,[33]

but California prohibits staff members and key officers from serving on the committee, which makes perfect sense given the committee's oversight function. CAAs operating Head Start programs should be mindful of the prohibition in the Head Start Act that precludes staff members from serving on a CAA's governing board, which could be interpreted to include committees.[34]

CAAs seeking volunteers with financial expertise should contact local or state CPA societies.

Other Ways to Obtain Expertise

CAAs seeking volunteers with financial expertise should contact local or state CPA societies. Nonprofit audit committees governed by laws that prohibit non-board members from serving on committees might consider utilizing someone in an advisory capacity, but who is not a formal committee member. This could be a volunteer or a paid consultant. Some caution is warranted if the committee has otherwise privileged discussions with an attorney, because the presence of an outsider might jeopardize attorney-client privilege depending on the circumstances and the laws of the applicable jurisdiction.

Audit Committee Charter

As is true of all standing board committees, the audit committee should operate pursuant to a written charter.[35] At a minimum, the charter should contain a purposes clause, define the committee's responsibilities and duties, and address the following issues:

Authority to Act for the Board

The charter should address whether the committee is an advisory committee, or whether the committee has decisionmaking authority to act for the full board. If the committee has such authority, the charter should clearly specify the areas where the committee is free to act and the areas where the board reserves decisionmaking authority. It might, for example, be appropriate for the committee, without prior consultation with the board, to make decisions in conjunction with management to implement the outside auditor's recommendations in its SAS No. 115 letter (discussed in Part V). On the other hand, if the committee were to become aware of fraud involving the CFO, the committee might be charged with conducting the investigation, but the board might retain authority over any resulting disciplinary action.

Reports to the Board

The charter should specify when and how the committee should inform the board about its activities, findings, and concerns. Given the audit committee's importance, the agenda for each board meeting should call for a report from the audit committee chair on developments that merit the board's attention. Boards should consider requiring the audit committee to make an annual written report discussing the outside auditor's findings, changes that have been made to the CAA's internal controls, and an assessment of risks that the committee monitors. Alternatively, in addition to exigent matters, the committee might report on one or two routine issues at each board meeting, thereby permitting it to spread out its tasks and perform its work more efficiently.

Authority to Retain Legal Counsel and Expend Funds

The audit committee may learn of fraud or be required to conduct investigations. As a consequence, the charter should address whether the committee has authority in such circumstances to expend funds and retain legal counsel. The board should decide whether to place dollar caps on the authority of the committee to spend money without first obtaining board approval. If the committee's annual expenditures are foreseeable or recurring, the board and the committee should consider an annual budget.

Number of Meetings

The charter should specify the regular committee meetings each year, the procedure for noticing meetings, and the circumstances that require special meetings. At a minimum, the audit committee should meet twice a year. Preferably, the committee will meet at least quarterly.

Meetings, Quorums, and Minutes

Like the CAA's bylaws, the committee's charter should define quorums and procedures, and require that meeting minutes be maintained. Committee meetings should be conducted pursuant to an agenda distributed in advance of each meeting. If possible, meetings should be conducted in person, but if state law permits, meetings can be conducted by telephone or video conference.[36] It would be best if meetings conducted through technology were limited to interim or emergency ones.

■ **Quorum Requirements.** Meetings should only be convened if a specified quorum is obtained. At a minimum, the charter should set the quorum at a majority of committee members.

■ **Meeting Minutes.** Someone should be appointed to record and maintain meeting minutes. Minutes serve at least three important functions: first, minutes provide evidence that the committee exercised business judgment during its deliberations and in its decisions. This can be important evidence in the event someone alleges that the board or committee members breached their fiduciary duties. Second, minutes provide the committee and the board with a permanent record of the committee's past decisions and actions. This record provides the committee with institutional memory, avoiding reconsideration of issues simply because the committee doesn't recall precisely what it decided. Third, new committee members can review minutes for the last several years to speed their understanding of the type of issues that the committee considers. For a relevant discussion of meeting minutes, see the toolkit section, Making Board Meetings Matter..

■ **Member Qualifications.** The charter should specify member qualifications, if any. If at all possible, several members should be financially literate and familiar with financial statement basics or able and willing to become so, but members need not be CPAs.

If at all possible, several members should be financially literate and familiar with financial statement basics or able and willing to become so, but members need not be CPAs.

■ **Chairperson.** The charter should provide for a committee chair and define his role. Every committee needs a leader to provide structure and direction.

■ **Member Terms.** Subject to applicable corporate law statutes and the CAA's bylaws, the charter should address membership terms and whether a committee member may serve successive terms. Some boards favor term limits, but given the difficulty in finding individuals qualified to serve on the audit committee, term limits may not be practical. More important, terms limits deny boards and committees talented people who still may be enthusiastic. There is no need for artificial limits if the board retains the decision over whether an individual should be re-appointed and the board is attentive. The charter might provide for staggered terms so that only one or two committee members rotate off the committee in any given year.

■ **Committee Size.** The committee should have at least three members and probably no more than five. This is a working group that needs to roll up its sleeves. The cohesiveness that often comes with smaller groups warrants limiting the number of members. As a practical matter, most CAAs are more likely to have trouble finding people to serve on the audit committee rather than to find themselves overwhelmed by the number of people volunteering for service.

Part V: Management Letters

Context

Audit clients and auditors have long recognized the limitations of the standard audit opinion. To provider further information, some auditors historically provided the board and management with what is customarily referred to as a management letter.

Mandatory Nature of the Communications

This letter, or at least a portion of the communications that might have appeared in this letter, are now governed by two auditing standards: SAS No. 114, *The Auditor's Communication with Those Charged with Governance*[37] and SAS No. 115, *Communicating Internal Related Matters Identified in an Audit*.[38] These standards require the auditor to communicate certain information to management and the board.[39] It does not necessarily need to be communicated in the same letter.

A Desirable and Valuable Communication

Given the deep understanding of systems and controls that the auditor develops during the course of an audit, a CAA's management and board can derive significant value from auditor communications, but only if the board and management take the time to review the communications and the auditor treats the exercise as an opportunity rather than a pro forma necessity.

SAS No. 115, Communicating Control Deficiencies

SAS No. 115, *Communicating Internal Control Related Matters in an Audit*, requires the auditor to communicate to management and the board[40] all control deficiencies identified during the audit that are significant or that represent material weaknesses, but only if the deficiencies could result in a material misstatement to the financial statements.

The Focus

SAS No. 115 focuses on whether the deficiency has the potential to lead to a misstatement, not on whether the failure could lead to fraud. The bulk of the statement is devoted to defining control deficiencies, material weaknesses, and significant deficiencies.

Examples

For present purposes, the definitions are largely irrelevant, and are best left to the auditors, but here are some examples of control deficiencies:

Examples

PERFORMING INCOMPATIBLE DUTIES

BCA's bookkeeper writes checks and reviews the bank statement each month. No one else reviews the bank statement. This is a control deficiency. Incompatible duties are not adequately segregated: The bookkeeper has authority to disburse funds, but he also records the corresponding disbursements. These two functions should be performed by different people. Whether this deficiency is classified as a significant deficiency or a material weakness is a question of materiality.

PERFORMING INCOMPATIBLE DUTIES

An afterschool teacher collects fees from parents, counts the money, and then deposits the receipts in BCA's bank account. This is a control deficiency. Incompatible duties are not adequately segregated. The teacher has recordkeeping and custody over the funds. Those two functions should be performed by different people. (examples continued on next page)

FAILURE TO TAKE PHYSICAL INVENTORY

BCA's thrift shops tracks its inventory by computer, but BCA never takes a physical inventory. The failure to take a physical inventory, particularly in a retail operation, is a deficiency. Accounting records should be periodically reconciled with physical reality.

FAILURE TO CODE RESTRICTED ACCOUNTS

BCA receives both temporarily and permanently restricted grants. It does not distinguish in its accounting records between temporarily restricted and permanently restricted assets. This is a control deficiency. The failure to code accounts could adversely affect the preparation of BCA's financial statements.

BOARD MEMBER PRE-SIGNS CHECKS

BCA's board imposed a two-signature requirement on BCA's checking account. BCA's CFO and a designated board member must sign each check that exceeds $1,000. After a few months, the board-designated co-signer concludes that the process is cumbersome. He decides to pre-sign ten checks and gives them to the CFO. This is a deficiency in how the two-signature requirement operates.

The Board's Concerns

The board should take notice of any reported significant deficiencies or material weaknesses in control. These items indicate weaknesses in the system of internal controls that could lead to incorrect financial reports and statements. Of equal importance to the board, these deficiencies could also lead to loss due to theft or fraud, violations of the law, or noncompliance with board directives and policy, but those concerns are not the auditor's primary focus when examining the system of internal controls.

The board should be aware that items characterized by the auditor as "material weaknesses" are considered to pose more significant problems than those characterized as "significant deficiencies" but the board should expect management to present carefully thought out responses to both types of findings, and most importantly, hold management accountable for implementing the changes needed to resolve the finding.

The Communication

The auditor must communicate the significant deficiencies and material weaknesses in a writing to the board within 60 days of the issuance of the auditor's report.

- **Prior Knowledge is Irrelevant.** The auditor is encouraged to communicate significant deficiencies and material weaknesses during the audit if warranted. For example, the auditor should communicate a fraud and the related control deficiencies immediately following discovery. Despite these more informal communications, the auditor still must communicate these deficiencies in the SAS No. 115 letter even if remediated during the audit.
- **Content.** To satisfy SAS No. 115's requirements, the written communication must: (1) state that the audit's purpose was to express an opinion on the financial statements; (2) define a significant deficiency and, if applicable, a material weakness; (3) identify each significant control deficiency and material weakness; and (4) indicate that the communication is solely for the benefit of management, the board, and others within the CAA. If the CAA is required to provide the SAS No. 115 letter to a regulator, then the letter should refer to the regulator as a permitted recipient.
- **The CAA May Make a Request.** An auditor, if requested, can provide the CAA with a letter indicating that the auditor identified no material weaknesses during the audit if a regulator or other government agency so requires. The auditor, however, is prohibited from issuing a letter indicating that no significant deficiencies were identified during the audit because such a statement is open to misinterpretation.
- **The Board Should Be on the Lookout for Recurring Deficiencies.** The auditor must discuss each material weakness or significant deficiency in the current communication even though the auditor flagged the problem in the prior year's letter. If there are recurrences, the board should ask management why it is ignoring what are in effect recommendations from the auditors.
- **Appendix G.** Several examples of deficiencies identified in SAS No. 115 communications are included in Appendix G.

Communicating Other Information

A second auditing standard, SAS No. 114, *The Auditor's Communication with Those Charged with Governance*, requires the auditor to communicate a number of other matters to the board.

Matters to Be Communicated

The following are among the subjects that must be communicated to the board:

- **Significant Difficulties Encountered During the Audit.** Any significant difficulties that the auditor encountered during the audit. These could include management's failure to timely respond to the auditor's request for information, limited time to complete the audit, missing information, the need to expend more effort than expected to perform audit, any restrictions imposed by management on the auditor's efforts, and management's unwillingness to provide information.
- **Consultation with Other Accountants**. Whether the auditor is aware of any consultations between management and another accounting firm regarding auditing and accounting issues. Such communications may be sign of a disagreement between management and the current auditors.
- **Management's Representations.** The auditor should provide the board with a copy of the representations that the auditor is requesting from management. Although the language in SAS No. 114 does not require this, the auditor also should provide the board with the representations actually made by management, particularly when there are significant deviations between what was requested and what was represented.
- **Uncorrected Misstatements**. The auditor should address uncorrected misstatements in the financial statements with the board.
- **Independence.** The auditor should consider whether the circumstances warrant communicating with the board about the auditor's independence. SAS No. 114 suggests that such communications may be appropriate when the auditor provides nonaudit services to a nonprofit that is subject to the Single Audit Act.

Example

AUDITOR INDEPENDENCE

BCA's auditor prepares BCA's annual tax return for $5,000 and also undertakes information technology work for $15,000. The auditor receives a $30,000 annual fee for its BCA audit. The auditor might include a discussion of how the fees for non-audit services affect its independence.

Form of Communications

The auditor must report significant findings to the board in writing if oral communication would prove inadequate. In addition to written communications from the auditor, SAS No. 114 envisions formal presentations and discussions. In certain instances, written communications will be insufficient. The auditor, for example, may find himself in a dispute with management over a material adjustment. Informing the board of the disagreement in writing has its allure: It avoids a potentially uncomfortable confrontation with management. Yet, the seriousness of the dispute may be best communicated during a meeting with the board. A meeting gives the board the opportunity to ask questions, assess the auditor's demeanor, and resolve the dispute if management is present.

In addition to written communications from the auditor, SAS No. 114 envisions formal presentations and discussions.

Timing

Auditors often send what is best described as a SAS No. 114 letter to audited organizations at the conclusion of the audit. This practice makes sense for many of the required written communications. Many matters will require earlier communication so that the board can take timely action. Moreover, some of the matters discussed in SAS No. 114 are best communicated during the planning stage. In sum, the communications contemplated by SAS No. 114 are ongoing and interactive ones.

A Pragmatic Examination of Required Communications Between the Auditor and Those Charged with Governance

SAS Nos. 114 and 115 lend themselves to boilerplate communications. SAS No. 115 encourages that practice, as do many other auditing standards, by providing suggested language for the required written communications. Auditors take comfort in this language, but all too frequently to the detriment of effective communication. The standard form language does not account for each recipient's circumstances or knowledge.

What the Board and the CAA Should Demand

Even though the auditor may not be required to communicate certain matters, the board should demand much more information than is necessarily required by SAS Nos. 114 and 115. What is disturbing is the discretion that these standards provide to the auditor. The board should use the engagement letter as a tool to force complete and candid disclosure from the auditor. The following two examples illustrate the problem with SAS No. 115:

Examples

CONTROL DEFICIENCIES LEADING TO FRAUD

BCA's treasurer has wire transfer authority over BCA's checking account. He can wire any amount without a second person notifying the bank. The treasurer's authority over the checking account is a deficiency in BCA's internal controls, but if there are compensating controls, the auditor need not report this deficiency as a significant one or a material weakness. In this case, the auditor decides a second control requiring a board member to review the monthly bank statements is a compensating control that protects the integrity of the financial statements.

The auditor delivers its audit opinion and the SAS No. 115 letter within 60 days following the close of the audit. The auditor's letter does not make reference to the control deficiency because of the compensating controls. Moreover, the auditor received a confirmation of the year-end checking account balance from the bank. On the same day that the auditor issues his opinion, the treasurer wires $5 million to a foreign bank account and leaves the country.

DEFICIENCY AFFECTING INTERIM FINANCIAL STATEMENTS

BCA's board meets monthly to review interim financial statements. The accounting system is unable to process accruals until year-end. As a consequence, the interim financial statements consistently underreport expenses. At year-end, the accounting staff makes all the adjustments to properly accrue all expenses. The auditor has reviewed the accrual process and found it to be 100 percent accurate over the years.

Arguably there is no potential for misstatement in the audited financial statements given the year-end procedures that are employed before the auditor commences the audit. The board nevertheless is reviewing inaccurate financial information when it reviews the interim financial statements, which could lead to bad decisions. Despite that fact, BCA's inability to accrue certain expenses before the close of the year arguably is not a reportable control deficiency because it has no impact on the audited financial statements.

If for no other reason than to justify the cost of the audit, auditors should be communicating all relevant observations for improving the CAA's accounting system and internal controls. What is puzzling about SAS No. 115 is why auditors need to be told to do this. The board should want to know more rather less, but SAS No. 115 provides a framework for reporting less than the board might like to know.

The board should demand more from its auditor than the minimum required communications., including:

- **A List of All Control Deficiencies.** A list of all control deficiencies that the auditor observed during the audit, regardless of whether the deficiencies represent significant ones or material weaknesses. Trivial deficiencies can be excluded. The engagement letter should prohibit the auditor from merely copying descriptions from audit workpapers. Too many SAS No. 115 letters are jargon-laden and filled with what often are incomplete thoughts copied from workpapers.
- **A List of Recommended Audit Adjustments.** A list of all recommended audit adjustments, divided between those that management made and those that it did not make. The auditor also should offer his understanding of why management chose not to make any recommended adjustments.

If for no other reason than to justify the cost of the audit, auditors should be communicating all relevant observations for improving the CAA's accounting system and internal controls.

- **A List of Management Representations.** A copy of the initially requested management representations and the representations as made.
- **A Description of the Materiality Standard.** A description of the materiality threshold that guided the auditor's work and an explanation why that standard is the appropriate one.
- **An Initial Meeting.** An initial meeting between the full board and the auditor prior to the commencement of the audit. This can occur as part of the regular board meeting.
- **Periodic Reports.** Periodic reports by the auditor to the audit committee or other designated board members during the audit.
- **Notification of Disagreements.** Immediate verbal notification of any disagreements between the auditor and management or significant difficulties encountered during the audit.
- **Debriefing.** A debriefing conducted for the audit committee at the conclusion of the audit.
- **Presentation.** A presentation by the auditor to the full board when the auditor delivers its opinion and related written communications. This can occur as part of a regular board meeting. During part of this meeting, the auditor should meet with the board without management or other members of the CAA's staff present.
- **Plain Language Communications.** Plain language descriptions, discussions, and analysis in all written communications whenever possible rather than reliance on boilerplate language or language that simply repeats language from the auditing standards.

Some auditors may argue that some of these recommendations are outside of industry practice, causing them to resist the request. As a practical matter, the board may be required compromise some of its requests, but the overarching point is critical: the auditor is performing a service for a fee. The board should be proactive in assuring that the CAA derives maximum benefit for the fees it is paying for the auditor.

Endnotes:

1. http://ag.ca.gov/charities/publications/nonprofit_integrity_act_nov04.pdf
2. CAAs have two choices in how the federal government reimburses them for shared costs, i.e. overhead. Broadly speaking, they can develop an appropriate allocation methodology for allocating shared costs across each grant, or they can obtain approval of one indirect cost rate that is used to calculate the reimbursable indirect costs under each grant.
3. Generally Accepted Accounting Principles, or GAAP, govern how financial information is categorized, summarized, and presented in audited financial statements. GAAP is promulgated by a number of rulemaking bodies, including the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA).
4. 45 C.F.R. 1302.91(c)
5. Part VII of the Core Form 990 and Schedule J.
6. http://www.guidestar.org.
7. http://www.eri-nonprofit-salaries.com.
8. The Uniform Guidance requires CAAs expending more than $750,000 or more in Federal awards during a year to undergo an audit that meets certain requirements. This audit can be used satisfy the audit requirements imposed by all the federal agencies providing funds to the CAA. Many states and local governments also permit a CAA to satisfy audit requirements with such an audit.
9. https://www.bridgespan.org/.
10. See Question 5 in Section A of Part VI to the IRS Form 990, referring to significant diversions of assets.
11. http://www.caplaw.org.
12. http://www.aicpaconferencematerials.com/notforprofit.
13. http://www.wipfli.com/Industry_NonProfitandGovernment.aspx.
14. See 2 C.F.R. part 200, Subpart F -- Audit Requirements.
15. This guide is described in detail at http://www.aicpastore.com/AST/AICPA_CPA2BIZ_Specials/Bestsellers/Bestsellers_Publications/PRDOVR~PC-012645/PC-012645.jsp.
16. See Standards Relating to Listed Company Audit Committees, 68 Fed. Reg. 18788 (2003).
17. 2 C.F.R. § 200.509.
18. 2 C.F.R. § 200.509.
19. http://www.aicpastore.com/AST/Main/CPA2BIZ_Primary/ManagementAccounting/Management/AuditCommittee/PRDOVR~PC-991004/PC-991004.jsp.
20. http://www.aicpa.org/interestareas/peerreview/Pages/default.aspx.
21. AICPA, Management Representations, as codified at AU §333.02
22. The Board of Trustees of Community College District No. 508, County Of Cook, v. Coopers & Lybrand, 803 N.E.2d 460 (Illinois 2003).
23. https://www.irs.gov/charities-non-profits/exempt-organizations-select-check.
24. https://obamawhitehouse.archives.gov/omb/circulars/a133_compliance_supplement_2016. Note that the OMB still refers to the Compliance Supplement by its pre-Uniform Guidance name, "OMB Circular A-133 Compliance Supplement."
25. 2 C.F.R. Part 200, Subpart E--Cost Principles
26. 2 C.F.R. 200.430(i)
27. American Red Cross, Audit Committee Charter (undated) available at http://www.redcross.org/images/MEDIA_CustomProductCatalog/m40940143_Audit_and_Risk_Management_Committee_Charter_-_MASTER.pdf.
28. AICPA, The Auditor's Communication, codified as AU §380.
29. Grant Thornton, The 2009 Grant Thornton Survey, available at http://www.boardoptions.com/nonprofitgovernance.pdf.
30. Smithsonian Institution, Charter of the Audit and Review Committee, 5 (Jan. 2015), available at https://www.si.edu/Content/Governance/pdf/AR_Charter_2015-01.pdf.
31. 42 U.S.C. 9837(c)(1))B)(i).
32. SEC, Form 20-F.
33. Calif. Gov. Code 12586(e)(2). See also California Registry of Charitable Trusts, Nonprofit Integrity Act of 2004: Summary of Key Provisions, available at http://ag.ca.gov/charities/publications/nonprofit_integrity_act_nov04.pdf.
34. 42 U.S.C. 9837(c)(1)(C)(iii).
35. AICPA's Not-for Profit Audit Committee Toolkit is an excellent resource for a sample charter and a variety of checklists; available at: http://www.aicpastore.com/AST/Main/CPA2BIZ_Primary/ManagementAccounting/Management/AuditCommittee/PRDOVR~PC-991004/PC-991004.jsp.
36. See for example, Cal. Corp. Code §5211(a)(6); Minn. Stats., §317A.239; and N.Y. Consol. L., Chapter 35, §708.
37. AICPA, SAS No. 114, The Auditor's Communication With Those Charged With Governance, codified at AU §380.
38. AICPA, SAS No. 115, Communicating Internal Control Related Matters in an Audit, codified at AU §325.
39. SAS Nos. 114 and 115 provide that the outlined procedures should be undertaken, which suggests a strong recommendation rather than a requirement. The auditing standards indicate that when an SAS uses the word should, the enumerated action, procedure, or communication is presumptively mandatory.
40. As noted in the prior section, SAS No. 114 defines the phrase those charged with governance for purposes of SAS Nos. 114 and 115. For purposes of this toolkit, these individuals are referred to as the board of directors.