SAS 104-111 For Non-Profits Teleconference

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Internal Controls And Risk Assessment Issues

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Risk assessment standards and internal controls

- Requires auditor to understand the organization and its environment, including its internal controls
  - Important increase in scope of understanding of controls
  - A better focus on recognizing where the risks are that the financial statements will not fairly present
  - The key is that controls can exist without a separation of duties
    - How you hire, train and supervise personnel is a key control

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Risk assessment standards and internal controls

- **Components of internal controls include:**
  - **Entity culture**
    - **The "tone at the top" is key, as is communication from the organization's leadership**
      - **E.g., e-mail employees info on board meetings**
    - **Mission-orientation focus is on purpose, not profit**
      - **May call for education of non-management leadership (board, volunteers, etc.)**

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Risk assessment standards and internal controls

- **Components of internal controls include:**
  - **Entity culture**
    - **Outside leadership is important part of organization's culture**
      - **Should be visible to employees, constituencies and other interested parties**
    - **2008 IRS Form 990 includes more questions on governance**

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Risk assessment standards and internal controls

- Components of internal controls include:
  - Risk assessment by management
    - Risk assessment is an ongoing process for:
      - Identification of relevant risks to achieving goals
        - Current economic environment, certainly
        - Capable employees
        - Changes in tax law
      - Analysis of risks identified
      - Management of risks identified
        - Consider a team approach
      - Allocating resources to address threats to goals

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Risk assessment standards and internal controls

- **Components of internal controls include:**
  - **Risk assessment by management**
    - **Unique risks faced by non-profits**
      - **Contributors are not customers**
      - **Customers are not resource-providers**
      - **Over and under-commitment of available resources**
      - **Inadequate funding of organization's administrative costs**

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Risk assessment standards and internal controls

- **Components of internal controls include:**
  - **Risk assessment by management**
    - **Assessing non-profit business risks calls for:**
      - **Strategic plan to provide a framework**
      - **Budget to provide a roadmap**
      - **Response to uncertainty must be proactive**
      - **SWOTs should be well understood at all levels**
      - **Considering fraud (theft) risks**

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Risk assessment standards and internal controls

- **Components of internal controls include:**
  - **Risk assessment by management**
    - **Financial reporting risks – are users getting information that is:**
      - **Complete**
      - **Clear**
      - **Transparent**
      - **Relevant**
      - **Timely**
      - **Free of fraud (financial reporting)**

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Risk assessment standards and internal controls

- **Components of internal controls include:**
  - **Effective accounting systems**
    - **Ensures transactions are identified, captured and communicated**
    - **Provides appropriate documentation to facilitate oversight**
    - **Appropriate measurements and adequate comparison**
    - **Identifies and communicates exceptions**
    - **Effectiveness is the result of the first two components**

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Risk assessment standards and internal controls

- **Components of internal controls include:**
  - **Controls to insure the above are done**
    - **What you've always known**
      - **Reconciliations of details to reports**
      - **The "identifier" of exceptions may not be the best "fixer"**

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Risk assessment standards and internal controls

- Components of internal controls include:
  - Monitoring to insure the above are operating effectively
    - Not just internal audit
    - The proof is in the results
      - Does the organization (unknowingly) overdraw the bank accounts?
      - Do contributors ever say “Why isn’t my name on the list” or “When are you going to send me a bill”?

Components of internal controls

- **Auditors are required to understand how the non-profit handles each component and to design audit procedures to address risk of material misstatement, whether caused by error or fraud**

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Risk areas in non-profit financial reporting

- **Overview**
  - **Risk standards focus on material transactions and ask "What can go wrong?"**
  - **Answers to WCGW questions consider all the components of internal control, with a focus on the capability of the organization's people**

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Risk areas in non-profit financial reporting

- **Unconditional promises to give (aka pledges)**
  - **Focus is on: Do they exist? Are they complete? Are they collectible?**
    - **Existence requires process for documentation**
    - **Completeness requires process for communication**
    - **Collectible requires historical records and knowledge of current situation**

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Risk areas in non-profit financial reporting

- **Unconditional promises to give (aka pledges)**
  - **Focus for recognition is on initiation of pledge, not collections**
    - **Do you control, capture and follow up on solicitations?**
  - **Business risk for pledges includes IRS requirements regarding providing donor documentation of contributions**
    - **Needs an accounting department control**

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Risk areas in non-profit financial reporting

- **Restricted contributions: The 3 Rs**
  - **Recognizing**
    - **Same as for any pledge**
  - **Recording**
    - **Requires continuing identification of restricted purpose until spent**
  - **Reporting**
    - **Fund accounting vs. GAAP**
    - **Internal user vs. external user**

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Risk areas in non-profit financial reporting

- **Endowment fund income**
  - **Accounting driven by donor stipulation**
    - **Documentation for each contribution**
    - **Recordkeeping for each purpose**
  - **Trust law (generally)**
    - **Changes in fair value stay in endowment**
    - **Income is transferred out to trust purpose**

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Risk Areas in non-profit financial reporting

- **Endowment fund income**
  - **Uniform Prudent Management of Institutional Funds Act (UPMIFA)**
    - **Changes in fair value are spendable**
    - **Accounting can be complex, particularly in loss periods**
    - **FASB Staff Position FAS 117-1 re: accounting for endowment funds**
    - **May be able to add part of income and unrealized gains to endowment balance**
    - **Requires action by governance, and documentation**

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Risk areas in non-profit financial reporting

- **Grant funds, including A133**
  - **Accrual basis of accounting generally applies to recognition**
    - **How it is "earned"**
  - **Fund accounting principles useful for tracking**
    - **At least use separate revenue and expense accounts**
  - **Internal controls are integral to A-133 funds**
    - **Consider separate documentation for each major program**
    - **Special auditor's report required for major programs**

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Risk areas in non-profit financial reporting

- **Special events**
  - **Part fundraising (i.e. contribution), part exchange (i.e. event revenue); for example, dinners and balls**
    - **Need general ledger accounts to track and report all components**
    - **Internal reporting and financial statement presentation have numerous options; both should be useful**

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Risk areas in non-profit financial reporting

- **Special events**
  - **Timing of revenue and expense recognition**
    - **Consider "matching" revenues and expenses on internal statements**
  - **General ledger accounts should track each special event**
    - **Consider using sub-ledgers for details**

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Risk areas in non-profit financial reporting

- **Functional allocation of expenses**
  - **Requirement to report program and non-program costs separately**
    - **Allocation process should be documented to help ensure accuracy and consistency**
  - **Required to report fundraising costs separately**
    - **Subject to special GAAP (see *Audit and Accounting Guide*)**
  - **Recordkeeping**
    - **Consider different internal and external financial statement presentations**

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Risk areas in non-profit financial reporting

- **Agency transactions – back to school**
  - **Donor amounts designated for another non-profit are a liability, not contributions/revenues**
  - **Recognition**
    - **Similar to restricted contributions**
  - **Recording**
    - **General ledger tracking is of liability, not contribution**
  - **Reporting**
    - **Similar to restricted net assets**

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Risk areas in non-profit financial reporting

- **Compensation**
  - **Special rules for non-profits in recently effective IRS regulations**
    - **2008 IRS Form 990 includes an expansion of compensation disclosures**
  - **Requires some different general ledger accounts**
    - **IRS reporting is different than internal and external reporting**
  - **Requires board involvement**
    - **Review and approval of compensation for certain employees**

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Risk areas in non-profit financial reporting

- **Unrelated business income tax**
  - **The 3 Rs, again**
  - **Accounting standards regarding income taxes are applicable to non-profits**
    - **See FASB Interpretation No. 48 (uncertain tax positions)**
    - **Requires evaluation of any non-contribution, non-grant or award revenue for exempt purpose status**
  - **Some investment vehicles trigger UBIT**

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Risk areas in non-profit financial reporting

- **Fair value accounting**
  - **New accounting standard on how (not when) to account for fair value**
  - **Three "levels," or methods**
    - **Public market**
    - **Public market for similar securities**
    - **No active public market**
  - **Auditor <u>cannot</u> rely on custodian valuation for any level method**
    - **Management should review all custodian statements for investments requiring special consideration**

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Risk areas in non-profit financial reporting

- **Fair value accounting**
  - **Applicable to supporting foundations, including in consolidated financials**
    - **Requires more oversight by sponsoring organization**
  - **Outsourcing Level 3 valuation may not provide adequate audit evidence**
    - **Appraisal assumptions are management's responsibility**

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Risk areas in non-profit financial reporting

- **Fund accounting vs. GAAP**
  - **Fund accounting is an other comprehensive basis of accounting (OCBOA)**
    - **Most useful for internal reporting**
    - **Consider using fund accounting on statement of activity (could still comply with GAAP)**
  - **Would receive modified GAAP or clean OCBOA auditor report**
    - **Consider whether funding sources will accept**

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Risk areas in non-profit financial reporting

- **Others for consideration (see AICPA *Audit and Accounting Guide*)**
  - **Exchange transactions**
  - **Split-interest agreements**
  - **Conditional contributions**
  - **Contributed services**

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Documentation of internal controls

- **Not just accounting processes (see above components)**
- **Auditor has practice aids used to document not-for-profit internal controls**
- **Resources available online**
  - **Try www.notforprofitaccounting.net**

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Documentation of internal controls

- **Auditor must communicate significant deficiencies and material weaknesses to management and those charged with governance**
  - **Significant deficiencies – reasonably possible to result in an error that is more than inconsequential**
    - **Controls over selecting and applying GAAP**
  - **Material weakness – reasonably possible to result in an error that is material**
    - **Ineffective oversight of financial reporting and internal control by those charged with governance**
    - **Restatements of prior financial statements**

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Documentation of internal controls

- **Auditor must communicate significant deficiencies and material weaknesses to management and those charged with governance**
  - **Material weakness – reasonably possible to result in an error that is material**
    - **Ineffective risk assessment or monitoring functions**
    - **Ineffective regulatory compliance (grants and awards)**
    - **Fraud by senior management**
    - **Failure to correct previously identified SDs or MWs**
    - **Ineffective control environment**

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Educating the board and audit committee

- **Organization's business, accounting and financial reporting**
  - **Governance has responsibilities**
  - **Governance can provide effective counsel to management**

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Educating the board and audit committee

- New audit standards require auditor to communicate with those charged with governance
  - Risk standards encourage meetings as method of communicating
  - Requires communication of:
    - Auditor's responsibility under GAAS
    - Organization's documents that include audited financials
    - Planned scope and timing of audit
    - Qualitative aspects of organization's significant accounting policies

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Educating the board and audit committee

- New audit standards require auditor to communicate with those charged with governance
  - Requires communication of:
    - Significant difficulties encountered during the audit
    - Uncorrected and corrected misstatements
    - Disagreements with management
    - Representations requested from management
    - Other significant findings or issues

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Educating the board and audit committee

- **Other resources at www.boardsource.org**