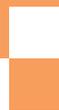


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# **AUDIT GUIDE FOR SMALL NONPROFIT ORGANIZATIONS**



# INTRODUCTION

This guide will help nonprofit boards of directors better provide oversight of financial activities until they reach the stage when an audit is required and/or funds are available. The board can also emphasize the importance of internal controls in safeguarding the assets of the nonprofit.

Periodically, nonprofit organizations must submit audited financial statements to their contributors, boards of directors, and lenders for various reasons. Many grantors commonly request audited financial statements if gross receipts exceed certain dollar thresholds.

At the state level, some agencies require audited financial statements if a nonprofit receives contributions more than a certain amount (which varies from state to state) and/or if the nonprofit hires a paid fundraiser. Generally, requirements will be stipulated in the grant contract. Nonprofits should contact the Secretary of State or Office of the Attorney General for regulations in those states where it raises money. See the Resources section on page 10 for Virginia laws governing charitable organizations.

At the federal level, nonprofits that expend federal grants of more than \$750,000 in any fiscal year are subject to single audit requirements (Uniform Guidance).

An audit provides the highest level of assurance that an organization's financial statements are fairly presented and free of misstatements. Only an independent CPA can perform an audit for a nonprofit, but a well-informed internal audit team can help make the process run more smoothly.

Some nonprofits may choose to obtain an audit even if not legally required to do so. Many grantors commonly request audited financial statements. In some cases, they will accept

statements prepared in-house. Alternatively, some grantors may accept an independent CPA review, which doesn't undertake the extensive testing performed by an audit, but will provide a limited assurance that the financial statements are fairly presented. A review costs less than an audit and, for some small nonprofits, the review may satisfy the state requirements.

In addition to these external requirements, the board may seek reassurance that the financial information they are considering as part of their oversight function is accurate and complete. An audit may also be desirable to protect new members joining the board from liability for any fraudulent activities that may have occurred prior to their appointment.

This audit guide is intended to assist the internal audit teams of small nonprofits to perform limited reviews of their organizations' financial statements and help prepare the organization for an audit. Understanding the audit process and following Generally Accepted Auditing Standards (GAAS) will allow for a more effective team. See <https://tinyurl.com/AICPAGAAS> (PDF) to view these standards.

In addition, for every museum, symphony foundation, or family service organization that has adequate funds to retain the services of a CPA, there are scores of small churches, service clubs, literary groups, and similar organizations that don't have external audit requirements or simply lack the funds for an audit.



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## SELECTING THE AUDIT TEAM

The audit team can play a critical role in maintaining the integrity of the nonprofit's financial reporting. Volunteers with the following qualities should be selected from the board or general membership:

- A familiarity with how organizational activities are reflected in the financial statements.
- Some understanding of the auditing process and GAAS.
- A willingness to match documents, such as expense vouchers to check numbers and donations to bank deposits.
- Some understanding of the organization's internal controls (safeguarding of assets, authorization policies, reconciliation processes, and segregation of duties).
- An understanding of the riskier areas of the organization's operations (where might fraud occur).

Consideration should be given to individuals with experience in business, such as bankers, internal auditors, CPAs and corporate officers. Executive officers from previous years are also a possibility. However, make sure the candidates being considered are not those engaged in the actual transactions being audited.



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## AUDIT TEAM TASKS

To help illustrate the tasks that will be required by an internal audit team, assume that you have been appointed to the audit team of Goodworks, Inc., a fictitious small nonprofit organization. You accept the assignment with some trepidation, as you understand the attention to detail required in preparing for an audit.

The organization may have a need for a variety of different examinations in the audit: finance, privacy, security, regulatory compliance, IT governance, "value for money," "value and ethics," and performance management, to name a few. Each of these examinations requires a different focus with different metrics and indicators to be gathered and analyzed.

You also understand that once the analysis is complete, reviewed and approved, you will need to help implement a set of corrective actions, which can be challenging. The audit team will need to work with Goodworks' management to implement the corrective actions or controls to address any issues found. Then the actions that have been incorporated will need to be reassessed in future program plans and future audits.

In addition, you'll need to keep in mind that as a small nonprofit, Goodworks has a limited budget of approximately \$50,000 a year and employs only one part-time administrative assistant. The board of directors may not see the merit in diverting funds from key programs that support its mission in order to engage a CPA to audit the records.

The above scenario is not uncommon, so be sure you know what you're getting into. At a minimum, the audit team should be concerned with the following things:



- The adequacy of internal control (a system in which the operating or recording function can be broken down into elements that are performed by different people, creating a separation that protects information and cross checks accuracy with the work of the others) and mitigating processes when there is limited staffing.
- The accuracy and completeness of the records and the reports to the governing body (usually the board of directors).
- The proper authorization of activities and expenditures (comparison of actual financials to the budgeted financials).
- The proper classification of activities to programs, management and fundraising, and federal grants, if applicable.
- The determination of the physical existence of assets.
- Verification that signature cards on the bank accounts are up to date (check annually).
- A review of the tax-exempt status and identification of any activities that may endanger the status.
- A review of all special events to determine if all the direct expenses were properly charged to the attendees.
- A review of all monitoring reports from funders (often staff tend not to update the audit committee or board of such items).
- Ascertaining that payroll taxes, licenses, sales taxes, Form 990, other taxes and corporate reports are properly filed in a timely manner.
- Determination that the organization's activities remain consistent with its established exempt purpose and that sufficient controls are in place to determine and assure continued compliance.
- Review of marketing materials and pledge cards etc. to ensure transparency related to donor restrictions and proper tracking of those restrictions.

## INTERNAL CONTROLS

In developing the procedures followed by the audit team or the audit program, internal controls are essential:

- To prevent loss through errors, misappropriation of funds or theft.
- To prevent an "honest" employee from making a mistake that can ruin his or her life.
- To document the responsibility of the board as it safeguards the assets of the nonprofit.
- To assure that all transactions are properly authorized and recorded. (See the Resources section on page 10 for examples of internal control for cash receipts and cash disbursements.)

The adequacy of internal controls should be of primary concern to the audit team. Lack or inadequacy of internal controls can make the task of even the CPA auditor extremely difficult and, in some cases, almost impossible. Therefore, all internal controls should be documented in a procedures manual. Volunteers often are dedicated to the mission of the nonprofit but may not know the appropriate procedures for running the organization in a businesslike fashion without a regularly updated manual.

Say, for example, Goodworks employed one part-time administrative assistant. Imagine this individual collecting the funds, disbursing the funds, recording the financial transactions, signing the checks, recording the minutes of the board meetings, and preparing financial reports. This would be an example of a complete lack of internal control. Each one of these functions really should be performed by a different volunteer.

Common sense must be applied in considering internal controls as well as the other areas being reviewed by the audit team. Frequently, there are not enough volunteers to perform all the desired internal controls. The organization is then challenged to write procedures that will best protect its assets, present its financial situation fairly, and be reviewable by the audit team. Whatever the situation, internal control must be examined and improved if found lacking.

See the Resources section on page 10 for additional information on developing internal controls.

**The audit team must assess the adequacy of the internal control environment, as this will greatly impact the set of procedures the audit team will follow. Audit procedures are either of a compliance nature or of a substantive nature.**



For example, if all disbursements in a small nonprofit are reviewed for application of exempt purpose and appropriateness, authorized separately by the board, recorded in the minutes by the secretary, supported with invoices approved by the president, and paid by checks signed by the treasurer and one other officer, the number of these transactions to be reviewed can be minimized. Nevertheless, the team would be required to satisfy itself that the internal control procedures outlined above were actually both documented in a procedures manual and being followed. If the nonprofit has a strong internal control environment, it will design tests of controls called "control tests" to verify the existence of internal control procedures and see if they are designed and operating effectively.

When a nonprofit does not have a good system of internal control, it is extremely difficult to determine that all transactions have been properly recorded. Under these circumstances, substantive tests should be performed. These tests are designed to identify errors or irregularities directly affecting the accuracy of balances. For example, executives of nonprofits have been known to inflate nonprofit incomes by failing to record all expenses or by manipulating performance metrics and misclassifying undesirable management expenses as desirable program expenses. Checking cash disbursements in the months following the end of the accrual period might uncover expenses and even campaign donations that should be reassigned to the audit period.

Confirmation of balances with creditors also would identify unrecorded liabilities. Tests of bank reconciliations, matching all donations (checks, cash, credit cards and in-kind) to deposit slips, matching all check numbers to expense vouchers, reviews of minutes, comparisons of current and previous financial reports and of the period's transactions with the budget are examples of substantive procedures that can prove evidence of the completeness of financial statement account balances.

## Some suggested controls for cash disbursements

- Checks should be pre-numbered and used in sequence, with adequate controls over supplies of blank checks. All check numbers, even destroyed checks for \$0, should be entered into the accounting program.
- Checks should be prepared by persons other than those who approve invoices. The supporting organizational invoices should be signed by the responsible committee chair for that type of funding.
- Checks should be prepared from original organizational invoices with attached copies of purchase orders, vendor invoices and receiving reports and presented for signature with these attached. The organizational invoices should be numbered (by the treasurer after receipt), include the originals of all receipts, and be retained in numerical order.
- Checks should be entered in the disbursement journal exactly as they have been prepared.
- The governing board should authorize all check signers. All checks for more than a certain amount should be signed by two persons.
- Signing of blank checks should not be permitted.
- An officer or executive director should receive the unopened bank statement before turning it over to a person, other than one who handles the receipt and disbursement of cash, for reconciliation. This officer should review the bank reconciliation, then date and initial it. The reconciliation should be retained for the audit team.
- Electronic bill pay should be utilized where possible to eliminate fraudulent check depositing associated with mobile check depositing apps with banks. (Different person depositing a check using mobile bank deposit app than the check was made to.)

## Some suggested controls for cash receipts

- Incoming mail should be opened and listed by persons other than those with access to cash receipts journals and accounts receivable records. If there is no donation form with the check, one should be prepared. All information on the check should be captured on the donation form. Restrictions should be clearly identified by the donor. If none, proper follow-up should occur and be documented.
- Pre-numbered receipts should be given for contributions, gifts, etc.
- A person with no access to cash should compare cash receipts records and authenticate deposit slips with mail listing. The deposit slip and the adding machine tape should be attached to the appropriate bundle of donation forms. The deposit should be numbered sequentially. The bundled donation forms, adding machine tape and deposit slip should be retained for the audit team.
- Checks should be stamped "For Deposit Only" by the person opening the mail.
- The nonprofit board should authorize bank accounts and the signers of checks annually. The best bank accounts will link each evening with the organization's accounting system and update the accounts with that day's bank transactions.
- Cash receipts should be entered in journals by persons other than those opening mail and listing receipts.
- Receipts of checks and cash should be deposited each day intact.
- Individuals handling cash should not make entries to the general ledger or subsidiary ledgers.
- Individuals handling cash should be bonded.
- A gift acceptance policy should be present, monitored for needed updates regularly, and reviewed to ensure it is being followed by those taking or receiving gifts on behalf of the organization. This policy should include non-cash contributions and treatment of those assets once received (will they be sold for cash immediately, or used in operations, etc.).

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## THE AUDIT PROGRAM

In developing the procedures followed by the audit team or program, the adequacy of the internal controls is an influencing factor. The audit program will vary with the type of nonprofit, its volume of income, and the complexity of its operations. The team should develop a written plan for each account balance or class of transaction selected for examination. The plan should indicate the relationship to the financial statement assertions and audit objectives.

Assume that Goodworks, Inc. has a museum store that maintains an inventory of merchandise. The audit team desires to gather evidence as to the existence of the inventory listed as an asset on the balance sheet. The chart on page 8 demonstrates how audit objectives are developed and linked to financial statement assertions.

Once the audit team develops audit objectives for the relevant accounts on the balance sheet (statement of financial position for a nonprofit) and income statement (statement of activities for a nonprofit), the team can then focus on specific audit procedures for the audit program. Below are three areas of emphasis to include in the audit program.

### 1. The proper authorization of activities and expenditures.

The budget and the board of directors' minutes are the usual source of verification of a nonprofits' activities. Generally, committee chairs are required to authorize any expenses from their budget funds. Employees often document their own timesheets and expense records, with a second party reviewing these documents each month. Additionally, the corporate charter and bylaws should be reviewed to determine that all activities comply, that the designated individuals are performing their proper functions, and that these functions are properly assigned to programs, management and fundraising. A review or test of specific transactions should be included in the audit program and performed at least annually. Manual journal entries should be reviewed regularly as well as unusual activity or access to the system (including at unusual times).

### 2. Determination of the physical existence of assets.

Verification of bank balances and current bank signatures, an actual count of securities owned, and a count of merchandise are procedures that help the audit team determine the physical existence of assets. An examination of deeds and tax assessments is another procedure applicable when real property is owned by a nonprofit. Securing appraisals of donated property might be appropriate in the case of unusual donations. All of these records — such as monthly bank statements, brokerage statements, deeds and donation forms — should be available to the audit team.

### 3. Ascertaining that returns and reports are filed in a timely fashion.

A nonprofit has the same obligation to file tax returns and corporate reports as a for-profit organization. Failure to comply with these requirements will expose the nonprofit to possible fines or penalties. The IRS has become especially harsh with any non-compliance with Form 990 filing dates. At its planning meeting, the audit team should prepare a list of these taxes and reports, including:

- Payroll taxes if wages are paid.
- Sales taxes and licenses.
- Annual corporate report, to be filed with the state.



- Form 990, Return of Organization Exempt From Income Tax, if gross receipts each year exceed or equal the filing threshold (currently \$200,000) or if total assets equal or exceed \$500,000.
- Form 990-EZ, if gross receipts each year are less than \$200,000 and total assets are less than \$500,000, but gross receipts are higher than \$50,000.
- Form 990-N (e-Postcard) if gross receipts are currently under the filing threshold limits (\$50,000); some donors and grantors may still prefer the transparency of Form 990 to the simplicity of Form 990-N or 990-EZ.
- Audit report, if applicable.

The preceding material is only a limited discussion, and there may be additional areas of consideration that a nonprofit will need to consider

## ACCOUNT: MUSEUM SHOP INVENTORY

FINANCIAL STATEMENT ASSERTION	AUDIT OBJECTIVE
Existence or occurrence	Inventories included in the balance sheet physically exist and transactions and events that have been recorded and disclosed have occurred.
Completeness	Inventory quantities include all products, materials and supplies on hand and all transactions and events have been recorded and are recorded in the proper period. Inventory quantities include all products, materials and supplies owned by the client that are in transit or stored at outside locations. Inventory listings are accurately compiled in the inventory accounts.
Rights and obligations	The entity has legal titles or similar rights of ownership to the inventory.
Valuation or allocation	Inventories are properly stated at cost or market value (if lower than cost).
Presentation and disclosure	Inventories are properly classified in the balance sheet as current assets. The assets are classified correctly.

## ACCOUNT: CASH DONATIONS

FINANCIAL STATEMENT ASSERTION	AUDIT OBJECTIVE
Existence or occurrence	Each donation has a donation form. The donation forms are for campaigns conducted during the fiscal year.
Completeness	Each donation is totaled on an adding tape. The sum of the adding tape matches a bank deposit (either a physical donation of checks or an automatic deposit of credit cards).
Rights and obligations	Each donation is marked as restricted or unrestricted in the accounts. If restricted, the donation is marked with the donor's choice of funds. There is documentation showing whether the restriction is permanent or temporary due to time or purpose or both and they are tracked accordingly. This relates to presentation as well.
Valuation or allocation	Cash donations are recorded at face value. Bank fees and credit card fees are also recorded.
Presentation and disclosure	No personal information is included in the public financial statements. No unencrypted credit card numbers are retained. Each donation is credited to the proper donor in the CRM system.

## CONCLUSION

The purpose of this guide is to aid the audit team to perform its review of the organization's financial statements and operations in a relevant manner. The team should satisfy itself that income and expenditures are being classified in a consistent manner; otherwise comparisons of financial reports over the years will have limited significance. Then when the time comes to engage an independent CPA to perform an audit for the organization, there should be no surprises.

The task of the audit team requires diplomacy with determination. The purpose is to assure accuracy and protection, not to find indiscretions by staff or officers. However, in assuring accuracy, misuse of funds may be uncovered and must be taken seriously. Nonprofits must protect the public's trust and assure that public funds are used effectively for the exempt purpose intended.

Irrespective of whether an audit is completed, establishing internal controls protects both the organization and the board members, officers and staff. There is nothing harder on an organization than a theft investigation of a volunteer or staff member, whether warranted or not. Internal controls protect assets and reputations. They are a must for even the smallest nonprofit.

## RESOURCES

### Virginia state law governing nonprofits and charitable contributions:

The Virginia Department of Agriculture and Consumer Services (VDACS) includes registration forms for charitable organizations that solicit donations and other required forms and information on state laws, including instances when an audit may be required.

- Virginia Solicitation of Contributions Law: <https://law.lis.virginia.gov/vacode/title57/chapter5/>
- VDACS forms page: <https://www.vdacs.virginia.gov/food-charitable-solicitation.shtml>

### American Institute of CPAs (AICPA) essential reading for any audit team:

- Generally Accepted Auditing Standards (GAAS): <https://tinyurl.com/AICPAGAAS>
- The Audit Committee Effectiveness Center, developed by the AICPA, explains the benefits that an effective audit committee can produce for organizations: <https://us.aicpa.org/forthepublic/auditcommitteeeffectiveness.html>
- “Not-for-Profit Entities: Audit & Accounting Guide” can be purchased here: <https://www.aicpa.org/cpe-learning/publication/not-for-profit-entities-audit-and-accounting-guide>

The VSCPA offers free resources for nonprofits at [vscpa.com/nonprofit-resources](https://vscpa.com/nonprofit-resources), including four resource guides, access to CPA speakers, and a tool to connect nonprofits with a CPA in their geographic location who can best meet their financial and business needs.

This guide was last updated in August 2022 by VSCPA member volunteers with nonprofit expertise from [PBMares](#). CPAs and nonprofits are freely encouraged to email or copy this guide to share with officers and directors serving on nonprofit boards. For permission to duplicate this guide or modify it for any other purpose, please contact the Virginia Society of CPAs at [vscpa@vscpa.com](mailto:vscpa@vscpa.com).





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