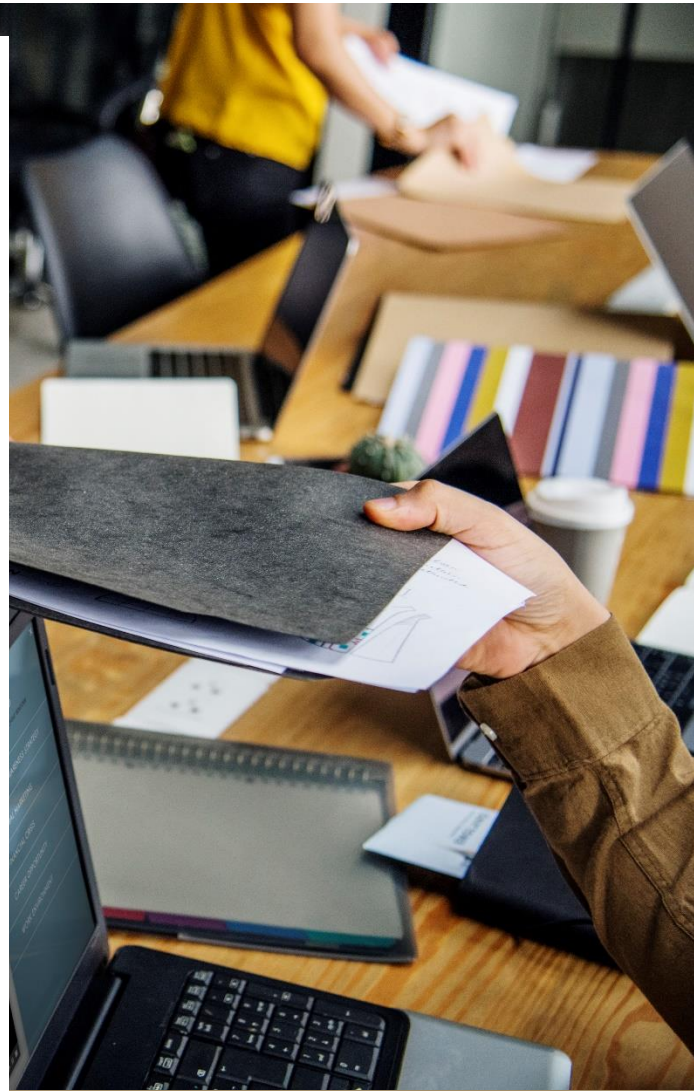


# Nonprofit Audits: A Complete Guide to Financial Auditing

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**ATOP FINANCIAL SERVICES**  
We specialize in the details.



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# Nonprofit Audits: A Complete Guide to Financial Auditing & Monitoring for Government/Publicly Funded Programs

When you were first approved to receive government or public funding for your non-profit or for-profit organization, you were immediately held responsible and accountable for how those funds would be spent and whether or not all expenses were allowable.

Most government funded organizations are nonprofits who have attained a 501c3 status. This would make them exempt from paying taxes, but not exempt from audits.

Many states require an independent audit of non-profits who have received government funds of a certain amount in a specific year, rules vary by state, [click here](#) to check your state's requirement. The federal government requires a single independent audit for organizations that expend \$750k or more in federal grant funding in any given year.

Government funded organizations are also most likely to be monitored/audited by their funding source(s) regularly. A monitoring or sometimes called desk review is usually conducted by the funding source(s). If a nonprofit receives funding from multiple funding sources, this could result in multiple audit-like reviews conducted several times a year.

Talk to an experienced nonprofit accountant about how to be prepared for your next nonprofit financial audit.

These multiple accountability measures are conducted to demonstrate an organization's fiscal responsibility and can be used to determine consideration for additional government funding. In most cases failing to follow government regulations can result in significant adverse consequences.

## Let's Start with the Basics:

### What is an independent audit & a single audit?

An independent audit occurs when an auditor or auditing firm outside of your organization examines your nonprofit's financial statements, records, transactions, accounting practices, and internal controls. During the independent audit, the auditor will review the organization's financial statements to determine whether they adhere to "generally accepted accounting

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principles " (commonly referred to as "GAAP"). These accounting principles are created by the "Financial Accounting Standards Board," known as "FASB."

The single audit previously known as the OMB Circular A-133 audit, is an organization-wide financial statement and federal awards' audit of a non-federal entity that expends \$750,000 or more in federal funds in one year. The single audit will involve looking at aspects of compliance with grants and internal controls, it is substantially more detailed than a regular independent audit and requires higher levels of testing by the independent auditor.

Here at ATOP, we take a proactive approach to audit readiness. *We assist nonprofits and government funded organizations with being prepared at all times for an audit, monitoring or desk review.* We start each fiscal year off with the end of the year in mind. With over 25 years' experience, we have developed a process (ATOP Certified™) that will help you to ensure favorable audit outcomes for your organization. This guide will help you gain a basic understanding of the audit preparation process for government funding. Here are the topics that will be covered in this guide:

1. Is my organization required to have an audit
2. Types of Nonprofits Audits
3. Finding a Nonprofit Auditing Firm
4. Nonprofit Audit Prep Work
5. After Your Nonprofit Audit

The word "audit" in general can sound intimidating, but audits can actually be very helpful in helping you pinpoint areas to improve in your organization's internal controls, financial practices, measurable objectives and more.

## **1. Is My Organization Required to Have an Audit?**

It's not often that small to mid-sized organizations are required to conduct an audit, unless your organization has received Government funding. When you're deciding whether or not to conduct an audit at your organization, you should check:

- Your bylaws. At the onset of opening the doors to your organization, one of the founders may have written it into your bylaws that regular nonprofit audits should be conducted in order to ensure financial security and transparency.
- State requirements. You may be required to conduct a nonprofit audit depending on the state you operate in and dollars received. Nonprofits that spend or earn more than a certain amount (usually around \$500,000) may be required to complete a financial audit.
- Your federal funding. Organizations that receive more than \$750,000 in federal funding or federal funding passed through the state are required to have an audit.
- Grant application requirements. Some grant funders require nonprofits to conduct audits to ensure their financial systems are trustworthy, transparent, and well-managed.

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Even if granting institutions don't require an audit, they may require other proof of financial management before they're willing to provide funding.

These options all describe circumstances in which you may be required to conduct an audit. If you find that you're not required to conduct an audit, it may be in your best interest to consider having one done regardless.

You'll still want to practice financial responsibility and accountability by carefully reviewing your financial statements or hiring a nonprofit accountant to do it for you. Internal review procedures and internal audits will help protect your nonprofit from scams, overspending, and other financial missteps you may encounter.

Even if you think you're doing everything right, it can still be worth conducting a nonprofit audit. There are plenty of benefits that result from conducting one.

### The Purpose of Nonprofit Auditing

The purpose of a nonprofit audit, according to [The Alliance for Nonprofit Management](#) is, "for testing the accuracy and completeness of [the] information presented in an organization's financial statements. This testing process enables an independent certified public accountant (CPA) to issue what is referred to as an opinion on how fairly the agency's financial statements represent its financial position and whether they comply with generally accepted accounting principles (GAAP)."

Nonprofits who may not be required to conduct an audit may still consider doing so in order to make sure their financial records and internal controls are up-to-par and to find potential opportunities for improvement.

The benefits you'll encounter when you conduct an audit include:

- Increased transparency. You may decide to communicate that a nonprofit audit took place and even the improvements that you're making as a result of this deep financial analysis with your supporters. This way they'll know that you take your funding and your financial management seriously and will effectively protect and use their contributions.
- Regular accountability. If you conduct a financial audit regularly (whether that's every year, two years, or even five), you'll find that you're held accountable to the same high standards of controls and financial reporting over time. Even as your organization changes and expands, you'll be confident that your finances are always secure and well-allocated.
- Find opportunities for improvement. Your nonprofit audit may not be perfect but keep in mind, one of the great things about auditing is that it can help identify opportunities for your organization to improve upon its policies and procedures.

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In addition to all of the inherent benefits of conducting a nonprofit financial audit, there are also charity watchdogs who provide information about charities to potential donors. These watchdogs may rank your organization higher if you've conducted an audit. This also increases the element of transparency with your supporters who do their research before contributing, assuring them that you're a trustworthy organization.

## 2. Types of Nonprofit Audits

The term "audit" does not necessarily refer only to financial matters. Audits can refer to internal analysis of operations, external parties reviewing your finances, the analysis of your adherence to compliance requirements, and more. Therefore, it's essential to understand the types of nonprofit audits.

### External Audit

External audits are our recommendation to ensure your organization has effective internal controls and financial practices. These nonprofit audits are conducted by third-party organizations and individuals, providing an outsider's perspective of your organization. The experts at ATOP can help your nonprofit find an auditor to review your various financial statements and documents to determine the best course of action forward.

### Internal Audit

Internal audits are conducted by your organization's management team. The purpose is to discover opportunities for improvement and determine if there are better ways to do things than how they're currently being done. Essentially, internal nonprofit audits allow your organization to take a step back from everyday tasks and determine the best course of action to move the nonprofit forward.

### Financial Audit

During these audits, your auditor will review your organization's various financial statements and reporting to determine opportunities that will help improve the financial health of your organization. They'll also examine your internal controls to ensure the security of your finances.

### Compliance Audit

It's important to remember that financial audits are not the only types of audits you may encounter. Compliance audits review your organization's adherence to regulations and requirements set by the federal, state, and local governing entities as well as your bylaws and other compliance requirements.

### Operational Audit

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Operational audits assess your organization's operation systems, productivity, staffing, IT, HR, and other functions. This type of nonprofit audit can provide insight into why your organization is hitting or missing your goals and how to create a more efficient and effective organization.

In this guide, we'll primarily focus on independent external financial audits and how your organization can find an auditor, prepare your documentation, and determine your overall financial health.

### **3. Finding a Nonprofit Auditing Firm**

If there is an audit committee, one of its primary responsibilities is to select an auditor who has the expertise and knowledge to perform an audit for a tax-exempt charitable nonprofit. (If there is no audit committee then the responsibility to recommend the retention of an auditor may fall to the executive director and the full board.) Before meeting with CPAs and/or audit firms, the audit committee should develop goals and objectives to help narrow the search to only those CPAs and/or audit firms that have the skills and experience to provide the services your organization needs. It is essential to make sure the CPA or audit firm is licensed in your state!

#### **When you determine that it's time to find a CPA or audit firm for your charitable nonprofit**

- Contact your state association of nonprofits, or your state society of CPAs.
- Check with other professional service providers and organizations similar to your own for recommendations on CPAs and/or audit firms.
- Not all auditors have nonprofit experience, so you should check references and ask for a copy of their Peer Review (most states require auditors to be audited themselves by a third party, which is called a "peer review").
- Before you decide on an auditor, do enough due diligence to know whether there are any conflicts of interest. Don't forget to check with your board members as part of that investigation.
- Sometimes free consultations can be an opportunity to interview potential CPAs or audit firms.
- Don't hesitate to ask for references and/or resumes of individual CPAs within larger firms.



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- If you are obtaining a federal single audit, be aware of the requirements of 2 CFR Part 200.509 – Auditor Selection

## Practice Pointers

- Look for a CPA or auditing firm that understands accounting for charitable nonprofits and has expressed interest in your mission. Be sure to ask how the CPA or firm will educate your staff on how to *prepare* for the audit since that will be the most time-consuming process for your staff, and can most directly impact the time it takes for the auditors to investigate and complete their report. This is where the nonprofit can help control some of the costs of the audit!
- Research organizations that represent the accounting profession in your state, such as your State Board of Accountancy, to help you determine how to evaluate the CPA/audit firm, based on standards that CPAs are expected to follow in your state. (Memberships in some professional associations require CPAs to adhere to certain ethical standards of service. For example, the American Institute of Certified Accountants requires its CPA members to follow its Code of Professional Conduct.)
- Use a “request for proposals” process. Request a proposal letter from qualified CPA firms. When requesting a proposal for audit services, the objectives and scope of the audit should be clear. Ask them to meet with you, provide a quote, as well as their credentials and references. Be sure to ask for references from tax-exempt charitable organization clients.
- Auditors are required by their own professional standards to document their agreements with clients in writing. A signed written agreement is a legal contract, enforceable by either the audit firm/CPA or the nonprofit. For that reason, consider enlisting professional guidance from a lawyer to review the agreement.
- When evaluating a proposal for audit services, the audit committee should consider the following:
  - 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
  - References from other nonprofit clients, and
  - Of course, costs.

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## Resources for choosing an auditor

- [Hiring a quality auditor](#) (AICPA)
- [How to hire an auditor: a brief primer](#) (Grantsmanship Center)
- [Nonprofit Auditor-Selection Guide](#) (Wallace Foundation)
- [Sample Request for Proposal \(RFP\)](#) for audit services (Propel Nonprofits)
- [Procuring government audit services](#) (AICPA)
- [How much should an independent audit cost?](#) (National Council of Nonprofits)
- [Nonprofits, Choose your auditors well](#) (Curtis Klotz, CLA)

## Conflicts of interests and auditor independence

Inevitably staff members are involved in the audit field work and in preparing the documents that are reviewed by the auditors. There is always the potential for a conflict in that staff are implementing the internal controls and because they are often the people with the most opportunity to mask financial irregularities.

The AICPA and the individual state governments require auditors to be independent. The Sarbanes-Oxley Act requires *publicly traded companies* to rotate lead auditors -- not necessarily audit firms -- every five years. While this provision of the [Sarbanes-Oxley Act of 2002](#) does not apply directly to nonprofits, it is still a wise practice for a nonprofit to consider how to ensure that fresh eyes are periodically looking at its financial records. The rotation of the individual lead auditor periodically can ensure that the eyes of those examining the nonprofit's financial records are fresh, and less likely to be overlooking something just because of a long-standing relationship with the nonprofit as a client. Auditor independence may also be compromised if the audit firm provides consulting services to a client-nonprofit, while at the same time performing an audit (or a financial review, or a compilation). (AICPA's Code of Professional Conduct). As a result, it is considered "best practice" to refrain from engaging the same individual or firm for both auditing and non-auditing services (other than filing their IRS annual reports, such as the IRS Form 990). This will help avoid conflicts of interest.

Remember that CPAs and auditing firms work with their clients to improve financial practices and ensure accountability. In this sense, they are responsible to the public as well as to their clients. Therefore, CPAs and auditing firms, as licensed professionals with their own professional code of conduct and regulations, are charged with remaining independent and objective, regardless of the level of financial review they provide to the nonprofit client.



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## Background

- [Independence and Conflicts of Interest](#) (AICPA)
- [AICPA Code of Professional Conduct](#) (AICPA)
- [Rule 102-2 Conflicts of Interest](#) (AICPA)

## Make a Final Decision

Congrats! You've decided who you'll be working with for your nonprofit financial audit. You've put in the work and the research necessary to be sure you're working with a reliable firm that understands your organization's needs. You know what you'll be receiving from them and can rest assured that everything is taken care of.

Now, it's time to prep for your audit.

## 4. Nonprofit Audit Prep Work

You'll need to do some preparation before your nonprofit audit can take place. Usually, auditors will send an audit checklist list that tells your organization what information the auditor will be requesting.

This means you'll need to pull together some documentation and reports that your auditor will be using during the auditing process. Having these ready to go will help them analyze these documents quickly and find actionable information for improvements.

As you finish up the fiscal year, your organization should be sure that all of your bookkeeping and accounting activities are accomplished before you close up the books. Make sure that your organization does the following:

### Audit Preparation Checklist

- ✓ Reconcile all bank accounts
- ✓ Review your nonprofit's vendors
- ✓ Review uncleared transactions
- ✓ Review your nonprofit's vendors
- ✓ Review your customers' or members' payments
- ✓ Review undeposited funds
- ✓ Look for coding errors
- ✓ Review your capitalization

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✓ Review your account balances

- Reconcile all bank accounts. It's recommended that you reconcile your bank accounts on a monthly basis. Reconciling accounts on a regular basis ensures errors are identified and can be attributed to a specific timeframe. Otherwise, errors may accumulate and make future reconciliations more challenging.
- Review uncleared transactions. If transactions have not cleared, your organization should be aware of it before bank reconciliations. Addressing uncleared transactions will ensure you have an accurate understanding of your cash balance in your financial statements. Plus, it will allow you to follow up about these transactions.
- Review your nonprofit's vendors. You should never have several vendors with negative or zero balances. Ensure your organization is effectively applying for vendor credits and review your accounts payable for vendors and your vendor lists to remove any inactive ones.
- Review your customers' or members' payments. If your organization relies on service fees or membership dues to operate, you should make sure there aren't too many outstanding payments or individuals with negative or zero balances. If there are a lot of negative or zero balances, you should check to ensure receivables are properly applied and correctly recorded.
- Review undeposited funds. Large amounts of undeposited funds make it challenging to maximize your cash availability. Depositing cash in a timely manner is essential to improve cash flow and it reduces the risk of theft or misappropriation of funds.
- Look for coding errors. Duplicate entries, entries missing information, and entries with incorrect information can all make a mess of your organization's accounting statements and reports. Address any discrepancies or errors right away to provide a clear picture of your organization's finances.
- Review your capitalization. Nonprofits need to categorize material and immaterial assets properly. It's important to comb through these assets periodically to ensure updated records. Plus, keeping past immaterial assets that no longer exist creates additional recordkeeping work for your team.
- Review your account balances. Account balances should accurately reflect the amounts designated in your nonprofit's various records and financial statements. This accuracy allows users of nonprofit financial statements an additional level of clarity in decision-making processes.
- Review your accounts receivable and payable. If many payables and receivables have not cleared in the past 90 days, you should immediately review these issues. This will help you determine any cash obligations, potential vendor disputes, and overall cash management strategies.

As you're going through this year-end financial data, keep in mind that if you find discrepancies, your auditor will also likely find the same ones. Do some work ahead of time to figure out what might be off. Assemble supporting documents for balance sheets, as well as

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clear and accurate records for payments, etc., which help prove that you're adhering to organizational policy.

If you've had an audit before, you might already have access to a past audit checklist of items that your auditor will need from you. If you're new to the audit process, you can request one of these documents from your auditing firm so that you can prepare the information your auditor needs.

An audit checklist can include anywhere between 40 and 120 items depending on the scope of the nonprofit audit and the complexity of your organization. Some of the items that are likely to be on the checklist may include:

- Copies of bank reconciliations
- Bank statements
- Investment statements
- Schedule of prepaid items
- Invoices that have not yet been paid
- Schedule of accrued wages and vacation
- Details of grants received
- Details of fundraising contributions received
- Payroll information

The best thing your organization can do (if you know you'll need a nonprofit financial audit) is to keep these items in mind throughout the year. You can keep your data organized and ready to pull into these reports. This way you'll be able to pull them quickly and easily when it's time to prepare for your upcoming audit.

## 5. After Your Nonprofit Audit

After your nonprofit audit is complete, the auditor will create a "letter to management," also known as the "management letter" which outlines the recommendations the auditor has for the organization to incorporate into their activities and processes.

The management letter contains two parts: material internal control issues and operating inefficiencies. The material internal control issues outline the processes and procedures that need to be adjusted to ensure proper recording of financial information in the future. Meanwhile, operating inefficiencies are more like red flags that indicate potential issues that could arise.

After your audit committee has reviewed the management letter, they should have a discussion with the auditor to gain more information about the audit process and results. In this discussion, the committee may ask questions like:

- Were internal controls for financial reporting adequate?

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- Could you expand on the most material recommendations from the audit?
  - Are there any legal or regulatory issues that may impact our finances?
  - Did you find the management team cooperative?
  - Are there any items that could be disputed by the IRS?
  - Did management follow suggestions from past audits?
  - How does our nonprofit compare with other organizations?
  - Did you find anything that needs to be brought to the attention of the board?
  - Do you have further suggestions about ways to improve accounting, reporting, and operating procedures?

The auditor isn't the only one owed a conversation by your team after the audit is complete. You'll also need to start a conversation with your executive director. In this conversation, you might ask questions like:

- Are you satisfied with the auditor chosen to conduct the nonprofit financial audit?
- Did you notice or hear about any challenges or disputes among staff during the audit?
- Was the presence of the auditor disruptive to regular organizational activities?

These discussions can help your committee and organization leaders learn more about the audit itself and prepare for any questions that may arise from the board when you present the management letter to them. You should make sure you have as much information upfront as possible to assure board members that you're taking the audit seriously and determine the next steps coming out of it.

Keep in mind that your nonprofit audit isn't an opportunity for the auditor to sit back and accuse your organization of doing things incorrectly. Rather, it's an opportunity to learn about how your organization can continue to improve its processes. These improvements may be simple actions that amplify to create a major impact, or they may be more complex changes that will take hard work and focus.

Either way, the purpose of conducting the nonprofit audit is to help your organization. Your auditor is in your corner to help you improve.

However, nonprofit audits aren't the only way to improve your financial management. We can help you learn more about budget management and audit preparation. To learn more about our services and how we can help you, click here: <https://www.atopservices.com/contact-us-form>

**TIP:**

Keep your budget management up to date. Your nonprofit should be frequently forecasting and analyzing your budget to monitor your compliance and progress throughout the year.