



Simply Auditing Not-For-Profits Efficiently

SAN4/26/V1

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Section 1

Look Before You Leap



Section 1 – Look Before You Leap

Our objective for this section is to understand how distinctive funding sources, different operating purposes, and lack of ownership interests affect risk assessment and other key aspects of an audit of a not-for-profit (NFP)



How Are We Ever Going To Do This?

- To perform an efficient and effective audit of an NFP, both management of the NFP and the auditor need to fulfill their professional responsibilities
- In addition to providing an opinion, the independent auditor's report describes both NFP **management's** and the **auditor's** responsibilities for the audit



Management's Responsibilities for the Financial Statements (as Described in the Audit Report)

- Management is responsible for
 - **The preparation and fair presentation of the financial statements** in accordance with accounting principles generally accepted in the United States of America (or a special-purpose framework)
 - **The design, implementation, and maintenance of internal control** relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error
 - Evaluating whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the NFP's ability to continue as a going concern



Auditor's Responsibilities for the Audit of the Financial Statements (as Described in the Audit Report)

- Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion
 - Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists
 - The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control
 - Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements



Auditor's Responsibilities for the Audit of the Financial Statements (as Described in the Audit Report)

- In performing an audit in accordance with GAAS, we:
 - Exercise professional judgment and maintain professional skepticism throughout the audit
 - Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements
 - Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the NFP's internal control. Accordingly, no such opinion is expressed



Auditor's Responsibilities for the Audit of the Financial Statements (as Described in the Audit Report)

- In performing an audit in accordance with GAAS, we:
 - Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements
 - Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about the NFP's ability to continue as a going concern for a reasonable period of time
- We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit



So, What's Different?

- The auditor and management responsibilities we just reviewed also exist for a GAAS audit of a for-profit entity, **so what's the real difference in auditing an NFP?** The answer primarily relates to **the uniqueness of the entity we are auditing**
- FASB ASC 958 defines an NFP as an entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity
 - **Contributions** of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return;
 - **Operating purposes other than to provide goods or services at a profit;** and
 - **Absence of ownership interests** like those of business entities



Three Common Characteristics of NFPs and How They Affect the Risk of Material Misstatement – **Contributions**

- Contributions may have donor-imposed conditions and/or restrictions
 - Contributions with conditions and/or restrictions require a good deal of initial professional judgment and subsequent monitoring. NFPs may also face pressure to misreport amounts
- Contribution revenues can be inherently unpredictable and are often highly dependent on the overall state of the economy
- Contributions can arise from many activities (e.g., telemarketing campaigns, snail mail and e-mail solicitations, door-to-door solicitations, telethons, different kinds of special events, and other activities) which carry different associated risks
- The FASB has developed special accounting, reporting, and disclosure requirements for contributions



Three Common Characteristics of NFPs and How They Affect the Risk of Material Misstatement – **Operating Purpose**

- NFPs have a mission-fulfillment mindset instead of a bottom-line mindset and this mentality can often be seen throughout the organization
 - Accounting/financial personnel can often be stretched thin and often have limited resources available to them
 - Controls can perhaps take a backseat to getting payroll/payables out the door
 - Organization leadership may lack financial expertise
- The FASB has developed special accounting, reporting, and disclosure requirements related to the mission-fulfillment operating purpose
 - NFPs have a statement of activities instead of an income statement
 - NFPs report changes in net assets classes instead of net income
 - NFPs provide expense information by function and nature



Three Common Characteristics of NFPs and How They Affect the Risk of Material Misstatement – **Absence of Ownership Interests**

- The lack of traditional ownership interests can result in weaker operational and financial oversight
 - NFPs boards and leadership may have limited business or accounting backgrounds
 - Some boards may forget their oversight role or just want to focus on the fun stuff
 - In some NFPs, employees can be tempted into falling into the mindset that they are unappreciated and that no one really knows what is going on (due to the lack of an owner/investor role in the organization)
- The FASB has developed special accounting, reporting, and disclosure requirements related to the absence of ownership interests
 - NFPs use net asset classes instead of traditional equity accounts
 - Net assets are affected by donor-imposed restrictions and board designations



As Mentioned in the Prior Slides, the FASB Has Developed Special Accounting and Reporting Requirements for NFPs

Know thy client, what they are capable of and what they are not capable of...

Luca Pacioli

(Note. The inventor of double-entry accounting did not actually say this, but he might have thought it if he audited NFPs and considered the high level of judgment, subjectivity, and/or estimation involved in applying FASB ASC 958)





Examples of Issues Related to **Contributions** Involving a High Level of NFP Judgment, Subjectivity, and/or Estimation

- Whether donor communications are promises to give **or** intentions to give
- Whether contributions are conditional **or** unconditional
- Whether donor stipulations are restrictions **or** conditions
- Whether the NFP has satisfied conditions related to conditional contributions
- Whether donated services meet the recognition criteria for contributed services



Examples of Issues Related to **Contributions** Involving a High Level of NFP Judgment, Subjectivity, and/or Estimation

- Whether transfers are contributions **or** agency transactions
- The presence of inherent contributions in exchange transactions
- The bifurcation of transactions that are part contribution and part exchange in nature
- The fair value measurement of noncash contributions
- The allowance for uncollectible promises to give
- The present value calculations for promises to give and split-interest agreements



Examples of Issues Related to **Expenses** Involving a High Level of NFP Judgment, Subjectivity, and/or Estimation

- The allocation of expenses to functional categories (including the reasonableness of the allocation bases and percentages used)
- The allocation of costs of joint activities (including whether the FASB ASC 958-720 criteria for allocation are met and reasonable allocation methods to be utilized)
- Whether expenditures satisfy donor conditions and/or donor restrictions



Examples of Issues Related to **Other Items** Involving a High Level of NFP Judgment, Subjectivity, and/or Estimation

- The treatment and requirements of collections and the treatment of items that fail to qualify for collections
- The valuation of assets with limited future use (e.g., theatre sets, props and costumes)



The Uniqueness of NFPs Is Reflected in the Financial Statements They Prepare

- Under FASB ASC 958, NFPs will prepare the following financial statements that are designed to reflect the uniqueness of the industry
 - Statement of Financial Position (**Note.** It's okay to call it the balance sheet)
 - Statement of Activities
 - Statement of Cash Flows
 - Statement of Functional Expenses (or comparable information in a disclosure)
- A basic tenet of financial reporting is that the financial statements should provide information that is useful to financial statement users
 - As we saw earlier, the audit report discusses that misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements



Users of NFP Financial Statements Typically Have the Following Questions...

?	What are the services that the NFP provides, what efforts has it made in providing those services, and what is the NFP's ability to continue to provide those services?
?	How has the NFP's management satisfied its stewardship responsibilities and other aspects of its performance?
?	What are the amounts and nature of the NFP's assets, liabilities, and net assets?
?	What are the effects of transactions and other events and circumstances that change the amount and nature of net assets?
?	What are the amounts and kinds of inflows and outflows of economic resources during the period and the relationship between the inflows and outflows?
?	How does the NFP obtain and spend cash, its borrowing and repayment of borrowing, and other factors that may affect its liquidity?



The Unique Control Environment of NFPs

- **As part of risk assessment**, the auditor obtains an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances
- Since NFPs lack the characteristic of ownership oversight of management that for-profits have, the makeup and role of the governing board can be crucial to the NFP's control environment
- Examples of unique characteristics of an NFP's control environment that the auditor may consider obtaining an understanding of include
 - The role of management and the governing board (e.g., does the board actively oversee management)
 - The frequency of board meetings and the level of financial curiosity exercised during meetings
 - The qualifications of management and governing board members (e.g., does the board have financial, operational, and fundraising expertise)
 - Board member involvement in the NFP's operations
 - The NFP's organizational structure



When It Comes to Controls, It's More Than Just the Control Environment That Is Unique in NFPs...

- On the prior slide, we discussed aspects of how the absence of traditional ownership interests can affect the **control environment** (i.e., the tone at the top of the NFP)
- The other COSO components (i.e., the entity's **risk assessment process**, the entity's **process to monitor the system of internal control**, the **information system and communication**, and **control activities**) are also affected by the uniqueness of NFPs
- The following slides provide examples of key control areas that are unique to NFPs and why they are important
 - The control areas on the following slides primarily relate to the **control activities** component as they address risks of material misstatement at the assertion level



Key Internal Control Areas That Are Unique to NFPs and Why They Are Important

Internal Control Area	Allows the NFP to assert that...
Controls only allow unconditional contributions to be recognized in the f/s (e.g., controls ensure the NFP can properly distinguish unconditional/conditional contributions, contributions/intentions to give, etc.)	Contribution revenues/receivables presented actually occurred/exist
Controls ensure that all unconditional contributions are recognized in the f/s (including conditional contributions that have become unconditional)	Contribution revenues/receivables presented are complete
Controls ensure the proper valuation of contributions at initial recognition (e.g., controls to ensure proper assessment of collectibility, discount rates, etc.)	Contribution revenues/receivables presented are accurate and properly valued
Controls ensure that contributions received near year end are recorded in the correct period	Contribution revenues/receivables were recognized in the correct period (i.e., proper cut-off occurred)
Controls ensure that contributions are reviewed for donor-imposed restrictions	Contribution revenues are properly classified and presented by net asset class



Key Internal Control Areas That Are Unique to NFPs and Why They Are Important

Internal Control Area	Allows the NFP to assert that...
Controls ensure that contributed services, utilities, facilities, and use of long-lived assets that meet the proper criteria are recognized and correctly measured	Contribution revenue from contributed services, utilities, facilities, and use of long-lived assets occurred , are completely presented, and accurately valued
Controls ensure that promises to give are periodically reviewed for collectibility issues (e.g., write-offs of uncollectible balances are identified and processed following the NFP's policy)	Contribution receivable balances are properly valued
Controls ensure that agency transactions are not treated as contributions and that the related assets and liabilities are properly presented	The rights to hold the assets and obligations related to the liabilities from agency transactions are completely presented in the f/s
For NFPs with collections meeting the FASB ASC 958 criteria, controls ensure that the NFP is following the option selected under GAAP, additions and deletions are properly authorized and supported, non-collection items are properly treated, etc.	Collections exist and are accurately presented



Key Internal Control Areas That Are Unique to NFPs and Why They Are Important

Internal Control Area	Allows the NFP to assert that...
Controls ensure that the NFP is actively monitoring compliance with donor restrictions and reclassifying net assets when donor-imposed restrictions (explicit or implicit) have been fulfilled/expire	Net assets with donor restrictions are completely presented . Reclassifications of amounts in the statement of activities are properly classified and presented
Controls ensure that board designations of net assets without donor restriction are monitored and properly presented	Board-designated net assets without donor restriction are properly classified and presented
Controls ensure that revenue from exchange transactions is identified (i.e., not treated as a contribution) and recognized at/over the appropriate time	Revenue from exchange transactions occurred and are properly classified/presented
Controls ensure that a proper functionalization of expenses occurs	Expenses are properly classified and presented
Controls ensure that items/events are properly presented via either gross or net presentation in the statement of activities	Items/events are properly classified and presented in the statement of activities
Controls ensure that the NFP complies with laws, regulations, contracts and grant agreements	The effects of compliance requirements have been completely and accurately presented in the f/s



Let's Look At Some Key Aspects of the Risk Assessment Process

- Under AU-C section 315, the auditor **identifies and assesses the risks of material misstatement (RMM)**, whether due to fraud or error, **at the financial statement and assertion levels**, thereby providing a basis for designing and performing audit procedures responsive to those risks under AU-C section 330
 - Risk assessment procedures (e.g., inquiries, analytical procedures, observations and inspections) supply the evidence necessary to support the auditor's risk assessments, which, in turn, supports the auditor's determination of the nature, timing, and extent of further audit procedures performed (i.e., we are creating a nexus between the risks we see and our responses)
 - Said another way, our risk assessment procedures provide support for why we did what we did during the audit



What Are Some Specific Examples of Risk Assessment Procedures?

- Inquiring about the design and application of a control
- Inquiring about the closing process
- Inquiring about fraud, litigation, compliance with laws and regulations
- Inquiring about how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed
- Performing analytical procedures to help identify inconsistencies, variances, changes from prior periods, unusual transactions or events, amounts, ratios and trends with potential audit implications
- Using automated analytical procedures (data analytics) to extract data from the client's information system to identify items warranting further consideration



What Are Some Specific Examples of Risk Assessment Procedures?

- Observing an operation/facility/asset (in-person or potentially using video cameras/drones)
- Observing a segregation of duties
- Observing passwords being entered
- Observing/inspecting documents
- Inspecting interim financial statements
- Inspecting minutes of board of directors' meetings
- Performing walk-throughs of processes and controls
- Brainstorming risks



Is the Risk Assessment Process a Good Place To Cut Corners? Uh...No!

- Ann & Andy CPAs has a portfolio of ten small to medium NFPs that are fairly predictable and not overly complex, so on the surface cutting corners on the risk assessment process and primarily relying on a third-party practice aid might sound tempting
- However, if Ann & Andy CPAs audit all ten NFPs the same they could miss certain unique reporting issues/risks depending upon
 - Whether the NFPs are primarily funded by grants, contributions, fees, or membership dues;
 - How the NFPs have changed from the prior year;
 - The level of leasing each NFP is involved in;
 - Cash flow concerns, debt covenant issues, going concern, etc.



Why Do We Identify and Assess the RMM At Both the Financial Statement and Assertion Levels?

- Because risk assessment is supposed to drive the design and performance of the audit, and we respond differently to the two different levels of risk
 - **RMM at the financial statement level** (e.g., management override of controls, a weak/absent governance structure over management, etc.) are pervasive to the financial statements and may affect many different assertions. Financial statement level risks are addressed by a more overall response (e.g., staffing the audit with a more experienced/specialized engagement team)
 - **RMM at the assertion level** (e.g., the existence of receivables) relate to one or more relevant assertions in a class of transactions, account balance, or disclosure. Assertion level risks are addressed by the nature, timing, and extent of further audit procedures applied (e.g., sending external confirmations to test the existence of receivables)



Speaking of Assertions, Here Are the Categories of Assertions as Described in AU-C Section 315 Paragraph .A219 (With Minor Modifications for the NFP Environment)

Assertion	Classes of Transactions and Events, and Related Disclosures During the Period	Account Balances and Related Disclosures at Period End
Occurrence/ existence	Transactions and events that have been recorded or disclosed occurred and pertain to the NFP	Assets, liabilities, and net assets exist
Rights and obligations	-	The NFP holds or controls the rights to assets, and liabilities are the obligations of the NFP
Completeness	All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the f/s have been included	All assets, liabilities, and net assets that should have been recorded have been recorded, and all related disclosures that should have been included in the f/s have been included
Accuracy/ valuation, and allocation	Amounts and other data relating to recorded transactions and events have been recorded properly, and related disclosures have been properly measured and described	Assets, liabilities, and net assets have been included in the f/s at proper amounts and any resulting valuation or allocation adjustments have been properly recorded, and related disclosures have been properly measured and described
Cutoff	Transactions and events have been recorded in the correct accounting period	-
Classification	Transactions and events have been recorded in the proper accounts	Assets, liabilities, and net assets have been recorded in the proper accounts
Presentation	Transactions and events are properly aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the reporting framework utilized	Assets, liabilities, and net assets are properly aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the reporting framework utilized



Exercise 1

- Sometimes, there is an uneasiness in discussing **assertions** as we tend to want to focus just on materiality. However, not all classes of transactions, account balances, or disclosures are the same when it comes to risks or how we test them
 - While PP&E and investments might both be material, we audit them differently
- Think of assertions as being **tools** to help us focus on the nature of a class of transactions, account balance, or disclosure **and** drive how we test it
 - Perhaps the year-end accounts payable listed on a trial balance is not material, due to the nature of accounts payable and its tendency to be understated (i.e., the completeness assertion) we still would likely do a robust response (e.g., a search for unrecorded liabilities) targeted at the completeness assertion
- In the left column on the next slide are three NFPs with different forms of contributions. **For each NFP listed, match the contribution to the assertion that the auditor would likely be most concerned with in the right column**



Exercise 1

Auditor A is looking at contribution revenue. NFP A received significant amounts of contributions during the year from checks and cash mailed in by donors.

Valuation

Auditor B is looking at contributions receivable. NFP B is primarily a fee-based NFP. However, four years ago board member B made a significant unconditional promise to give NFP B a building and surrounding land in five years when he planned to retire from his business. In the intervening years, property values in the area around the promised building have declined substantially and are not expected to recover in the foreseeable future.

Completeness

Auditor C is looking at contribution revenue. NFP C has recorded significant amounts of promises to give in response to a fundraising campaign conducted in the last three months of the year.

Occurrence



Solution to Exercise 1

Auditor A is looking at contribution revenue. NFP A received significant amounts of contributions during the year from checks and cash mailed in by donors.

Valuation

Auditor B is looking at contributions receivable. NFP B is primarily a fee-based NFP. However, four years ago board member B made a significant unconditional promise to give NFP B a building and surrounding land in five years when he planned to retire from his business. In the intervening years, property values in the area around the promised building have declined substantially and are not expected to recover in the foreseeable future.

Completeness

Auditor C is looking at contribution revenue. NFP C has recorded significant amounts of promises to give in response to a fundraising campaign conducted in the last three months of the year.

Occurrence



Taking a Deeper Look At RMM and Its Components

- **RMM** is the risk that the financial statements are materially misstated prior to the audit due to error or fraud
- **RMM** consists of **inherent risk (IR)** and **control risk (CR)**
 - **IR** is essentially the risk that a misstatement exists irrespective of the entity's controls (i.e., it incorporates everything except **CR**)
 - **CR** is essentially the risk that the entity's controls will not prevent or detect and correct the misstatement
- From a practical perspective, since auditors seldom test the effectiveness of internal controls in a GAAS audit (under AU-C section 330), the substantive audit procedures selected in response to risk assessment will typically be based upon **both**
 - The **relevant assertions** that we are assessing/testing; and
 - The **inherent risk** level we assigned



As We Saw On the Previous Slide, **Relevant Assertions** and **Inherent Risk** Are Critical to Risk Assessment as They Drive Our Response

- A **relevant assertion** exists when, based on the **inherent risk**, there is an **assertion** with a **more than remote possibility** (considering **both** the **likelihood** and **magnitude**) of a material misstatement occurring
 - For example, the trial balance of a resale store indicates that it has a material amount of inventory so the valuation assertion (along with other assertions) would be a relevant assertion
- A class of transactions, account balance, or disclosure with a **relevant assertion** is a **significant class of transactions, account balance, or disclosure**
 - For example, inventory at the resale store would be a significant account balance as it has a relevant assertion
- Under AU-C section 330, auditors are required to perform **substantive procedures** (i.e., substantive analytical procedures and/or tests of details) for each **relevant assertion** of each **significant class of transactions, account balance, and disclosure**, regardless of the assessed level of control risk

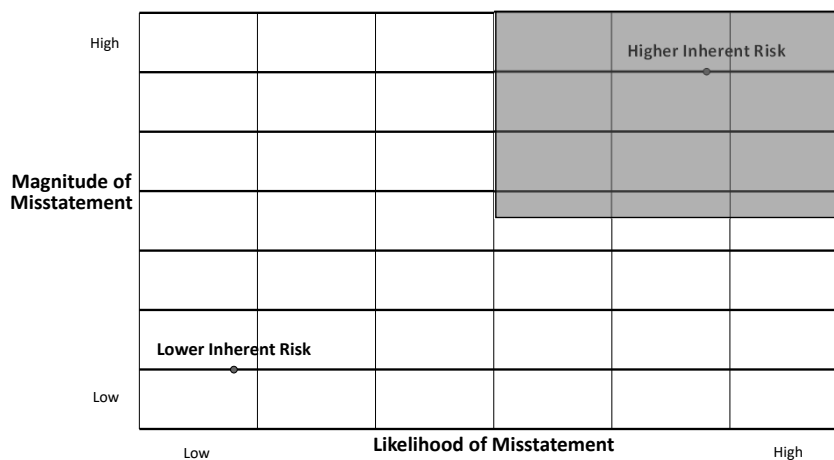


As We are Assessing Risks, We Will Also Be Looking Out for Significant Risks

- A **significant risk** is defined as being an identified risk of material misstatement...
 - For which the assessment of **inherent risk** is close to the **upper end of the spectrum of inherent risk** due to the degree to which inherent risk factors affect the **combination** of the **likelihood of a misstatement occurring** and the **magnitude of the potential misstatement** should that misstatement occur, **or**
 - That is to be treated as a significant risk in accordance with the requirements of other AU-C sections (e.g., assessed risks of material misstatement due to fraud under AU-C section 240, related party transactions that are also significant unusual transactions under AU-C section 550)



A Visual Way To Think of the Spectrum of Inherent Risk

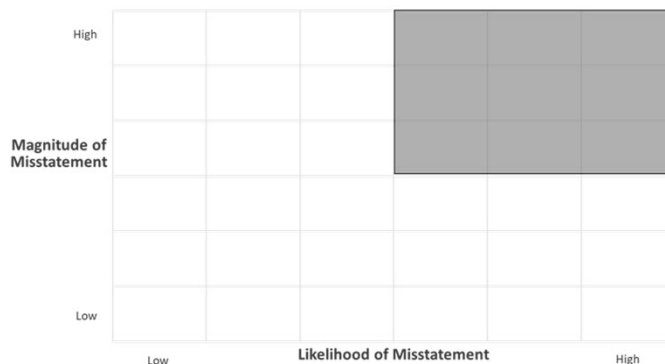




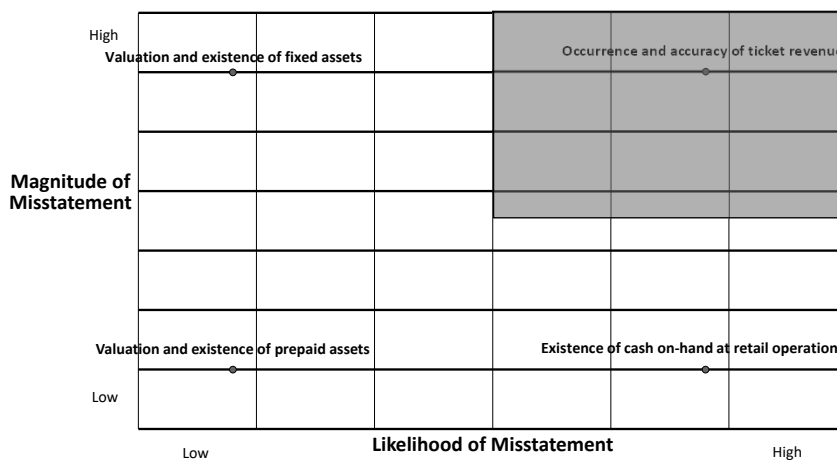
Exercise 2

Please consider where you would assess the below items on the spectrum of inherent risk at Zoo Z

- **The valuation and existence of fixed assets.** Zoo Z has a material amount of fixed assets. The risk assessment procedures, however, indicate that little activity occurred in the current year
- **The valuation and existence of prepaid assets.** Consistent with the prior year, Zoo Z has an immaterial amount of prepaid assets
- **The occurrence and accuracy of ticket revenue.** Zoo Z has a material amount of ticket revenue and the revenue originates from multiple sources (i.e., online sales, kiosks outside the zoo, and ticket booths), some of which are individual ticket sales and others of which are season passes
- **The existence of cash on-hand at retail operation.** Zoo Z operates a gift shop. However, as most customers purchase with credit/debit cards only an immaterial amount of cash is involved in the operation



The Author's Solution to Exercise 2





The Determination of Significant Risks Allows for the Auditor To Focus More Attention On Those Risk Areas

- AU-C section 315 requires auditors to identify controls that address significant risks and to **evaluate whether the controls have been designed effectively and implemented**
- AU-C section 330 requires controls that address significant risks to be tested in the current period **if the auditor plans to rely on the operating effectiveness of such controls**
- AU-C section 330 requires that when the approach to a significant risk consists only of substantive procedures (i.e., we are not in part relying on the operating effectiveness of controls) those procedures are **required to include tests of details** (i.e., substantive analytical procedures alone are not sufficient to test significant risks so we do things like vouching, tracing, searching, testing, confirming, agreeing, reconciling, etc.)
- AU-C section 260 requires communicating with those charged with governance about the significant risks identified by the auditor



Let's Talk About Internal Control

- On the prior slide we saw that AU-C section 315 requires auditors to identify controls that address significant risks and to evaluate whether the controls have been designed effectively and implemented
- We also discussed earlier that as part of risk assessment, the auditor obtains an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances
- Under AU-C section 315, the auditor is required to perform risk assessment procedures to obtain an understanding of the components of the entity's system of internal control



How Do We Achieve an Understanding of the System of Internal Control?

Under AU-C section 315, the overall understanding of the entity's system of internal control is achieved through understanding, and evaluating certain aspects of, each of the following components of the system of internal control (and by performing the required risk assessment procedures to obtain such an understanding):

	The control environment;
	The entity's risk assessment process;
	The entity's process to monitor the system of internal control;
	The information system and communication; and
	Control activities.



AU-C Section 315 Provides Special Attention to the Control Activities Component

When identifying controls that address the risks of material misstatement, AU-C section 315 clarifies the requirement to **evaluate the design** and **determine the implementation** of **certain controls within the control activities** component. These controls include the following:

	Controls that address a risk that is determined to be a significant risk;
	Controls over journal entries and other adjustments as required by AU-C section 240;
	Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures (including controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence); and
	Other controls that, based on the auditor's professional judgment, the auditor considers appropriate to enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures.

Note. AU-C section 315 also requires the auditor to identify general IT controls that address the risks arising from the use of IT and to **evaluate their design** and **determine their implementation**.



A Generalized Way To Think of Our Responsibilities for Understanding the Different Components of the System of Internal Control

- For the **control environment**, the **entity's risk assessment process**, the **entity's process for monitoring the system of internal control**, and the **information system and communication** components
 - We are required, through risk assessment procedures, to understand and evaluate aspects of these components (see paragraphs 21-25 of AU-C section 315)
- For the **control activities component (including general IT controls that address risks arising from the use of IT)**
 - We are required, through risk assessment procedures, to understand and identify aspects of certain controls within this component that address **RMM at the assertion level** (see paragraphs 26-29 of AU-C section 315). Identified controls include those general IT controls that address risks arising from the use of IT
 - For these controls we are required to **evaluate the design** and
 - **Determine the implementation** of the controls by performing procedures **in addition to inquiry** of the entity's personnel



Examples of Controls in the Control Activities Component Include...

- Authorizations and approvals
- Reconciliations
- Verifications (e.g., edit and validation checks or automated calculations)
- Segregation of duties
- Physical or logical controls



The Concept of a Control Can Be Broad



Try to think about a control relative to financial reporting as being any policy or procedure that's directed to preventing a misstatement or detecting and correcting a misstatement. The concept of a control can be broad and for even a smaller entity could include things like: [1] the monitoring of financial results by management; [2] the performance of reconciliations of accounts (e.g., cash, receivables and payables); [3] computer log-in credentials; and [4] limitation of physical access to cash and inventory.



What Are Some Examples of Controls That Even Smaller NFPs May Have?

- Some level of segregation of duties (perhaps supplemented with compensatory controls)
- Cross-training/job rotation policies
- Fraud reporting mechanisms
- Use of passwords for hardware/software
- Reconciliations of bank statements, receivables, payables
- Monthly budget/actual reviews
- Reviewing payrolls and 941 reporting
- Basic controls over check payments (e.g., securing checks, dual signatures, limited check signors, etc.)



What Are Some Examples of Controls That Even Smaller NFPs May Have?

- Basic controls over checks/cash received (e.g., stamping checks “for deposit only”, securing items, limiting cash on hand, etc.)
- Reviewing agings/write-offs of receivables
- Reasonable credit/purchase card controls/reviews
- Reviewing bank account activity online
- Security cameras
- Locks on doors
- Tagging/securing/inventorying assets
- Background checks



In Assessing Risks of Material Misstatement at the Assertion Level, AU-C Section 315 Bifurcates the Requirements Related to Assessing **Inherent Risk** and **Control Risk**

Under AU-C section 315, for identified risks of material misstatement at the assertion level...

Inherent risk requirements

The auditor is required to assess inherent risk by assessing the likelihood and magnitude of misstatement. In doing so, the auditor is required to take into account how, and the degree to which: (1) inherent risk factors affect the susceptibility of relevant assertions to misstatement, and (2) the risks of material misstatement at the financial statement level affect the assessment of inherent risk for risks of material misstatement at the assertion level.

The auditor is required to determine whether any of the assessed risks of material misstatement are significant risks.

The auditor is required to determine whether substantive procedures alone cannot provide sufficient appropriate audit evidence for any of the risks of material misstatement at the assertion level.

Control risk requirements

The auditor is required to assess control risk based on the auditor's understanding of controls and the auditor's plan to test the operating effectiveness of controls.



Why Does AU-C Section 315 Bifurcate the Inherent Risk and Control Risk Assessments? Well, Separately Assessing Inherent Risk At the Assertion Level...

- Provides a more focused identification of risks of material misstatement
- Assists the auditor in considering the proper approach for designing and performing further audit procedures as certain audit procedures are more effective for one type of assertion than another
 - For example, **confirmations** often provide evidence related to the **existence of receivables** but are less effective with regard to the **valuation of receivables** (where testing the subsequent receipts and the application of analytical procedures to the allowance for doubtful accounts are likely more effective)
 - An experienced auditor should be able to look at our documentation and see that for the higher risk assertions we identified (under AU-C section 315) we selected substantive audit procedures in response (under AU-C section 330) that deliver more persuasive evidence



An Important Concept About Assessing Control Risk

- As discussed two slides ago, for identified RMM at the assertion level, the auditor is required to assess control risk based on the auditor's understanding of controls **and the auditor's plan to test the operating effectiveness of controls**
- Thus, a key factor in control risk assessment is the auditor's plan to test the effectiveness of controls. For example, if a walk-through shows that a control related to an assertion is properly designed and implemented, the auditor generally can select either of the following responses **based on audit efficiency**
 - Assess control risk **below high** and test the effectiveness of the control under AU-C section 330 (which may allow us to reduce our substantive testing if the control effectiveness testing shows promise); **or**
 - Assess control risk **at high** and take a fully substantive response under AU-C section 330



A Critical Concept Related to Assessing Control Risk At the Assertion Level



Under AU-C section 315, if the auditor does not plan to test the operating effectiveness of controls, the auditor is required to assess control risk at the maximum level such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk.



Exercise 3

Since auditors rarely test the effectiveness of controls in a GAAS audit (in an effort to reduce substantive testing), **isn't time spent on controls in risk assessment a waste of time?**



Solution to Exercise 3

- **No.** Even if the auditor is planning a fully substantive audit, there are still benefits to spending time on internal controls in risk assessment. For example, by doing so we are...
 - **Fulfilling the requirements in AU-C section 315**
 - Gaining information about the client that will assist us in designing our substantive procedures (e.g., do you feel differently about an NFP that actually reconciles cash on a monthly basis than an NFP that has not reconciled cash since last year's audit?)
 - Obtaining information about financial statement level risks (e.g., if we observe a lack of qualified personnel in financial reporting roles that is indicative of problems in the control environment)
 - **Potentially identifying control deficiencies that we are required to communicate under AU-C section 265**



Speaking of Control Deficiencies That We Are Required To Communicate Under AU-C Section 265...

- AU-C section 265 does not impose additional responsibilities on the auditor regarding obtaining an understanding of internal control or designing and performing tests of controls beyond the requirements found in AU-C sections 315 and 330
- The auditor's adherence to AU-C sections 315 and 330 will drive the majority of items communicated under AU-C section 265
 - AU-C section 315 requires the auditor to determine whether one or more control deficiencies have been identified based on the auditor's understanding and evaluation of the components of the entity's system of internal control as required by AU-C section 315

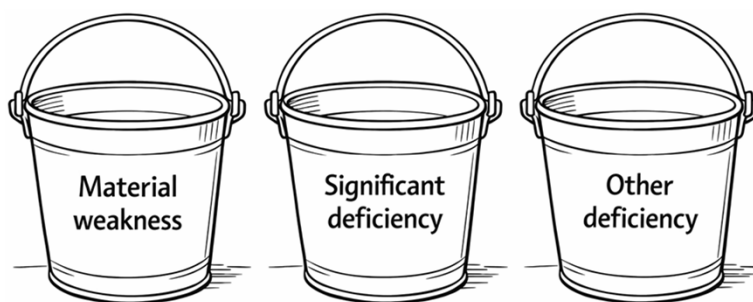


So, What Does AU-C Section 265 Require Us To Do?

- In a nutshell, AU-C section 265 requires the auditor to
 - Determine whether deficiencies in internal control have been identified during the audit
 - Evaluate the identified deficiencies (individually or in the aggregate) to determine if they are significant deficiencies or material weaknesses
 - Communicate deficiencies in internal control
 - Included among the communication requirements in AU-C section 265 is a specific requirement to **communicate in writing to those charged with governance** on a timely basis **significant deficiencies** and **material weaknesses** identified during the audit, including those that were remediated during the audit
 - AU-C section 265 discusses that the above communication should be made no later than 60 days following the report release date
 - **The communication to those charged with governance is critical in the NFP environment due to the characteristics of NFP management/governance we discussed earlier**



Under AU-C Section 265, the Auditor Will Classify Identified Deficiencies in Internal Control Into One of Three Categories (i.e., Buckets) of Deficiencies



A deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis.

A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

A deficiency in internal control that is not a material weakness or a significant deficiency but, in the auditor's professional judgment, is of sufficient importance to merit management's attention.



The Evaluation and Classification of Identified Deficiencies in Internal Control Requires a Great Deal of Professional Judgment

A simplified checklist to determine whether an identified deficiency is a material weakness

(Note. If the answer to both of the following is “yes” we have a material weakness by definition)

Yes	No	
☐	☐	Is there a reasonable (i.e., more than remote) possibility that a misstatement could occur without detection and correction?
☐	☐	Could the misstatement be material?

- **Note.** If we did not answer “yes” to both of the above, but believe that the deficiency is important enough to merit attention by those charged with governance, we would have a significant deficiency



AU-C Section 265 Provides Four Indicators of Material Weaknesses in Internal Control

1	Identification of fraud, whether or not material, on the part of senior management;
2	Restatement of previously issued financial statements to reflect the correction of a material misstatement due to fraud or error;
3	Identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected and corrected by the entity's internal control; and
4	Ineffective oversight of the entity's financial reporting and internal control by those charged with governance.



For a GAAS Audit, Does the Auditor Have Responsibilities Related to the NFP's Compliance With Laws and Regulations?

- **Yes**, AU-C section 250 provides requirements related to the auditor's consideration of compliance with laws and regulations including
 - Obtaining sufficient appropriate audit evidence regarding **material** amounts and disclosures in the financial statements that are **determined by the provisions of those laws and regulations generally recognized to have a direct effect on their determination**
 - Performing the following audit procedures that may identify instances of noncompliance with **other laws and regulations that may have a material effect on the financial statements**
 - Inquiring of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations
 - Inspecting correspondence, if any, with the relevant licensing or regulatory authorities
- An NFP's compliance with tax laws and regulations is an example area of AU-C section 250 applicability (see following slides)



Examples of Audit Procedures Related to an NFP's Compliance With Tax Laws and Regulations Include...

- Ascertaining that the NFP has been granted tax-exempt status
- Inquiring of NFP management and reviewing board meetings for possible changes in the NFP's governing instruments that could affect its tax-exempt status. Also, considering the effect of new, expanded, or unusual activities on the NFP's tax-exempt status
- Inquiring of management regarding the NFP's compliance with laws and regulations and tax filing requirements
- Reviewing the NFP's tax returns/filings (e.g., 990s, 941s) and correspondence with tax authorities for liabilities or contingencies needing possible accrual or disclosure



Examples of Audit Procedures Related to an NFP's Compliance With Tax Laws and Regulations Include...

- Reviewing board minutes and accounting records for evidence of significant unrelated business income. Also, if applicable, reviewing the reasonableness of the computation of any unrelated business income tax liability
- Determining whether the NFP's tax-exempt status, any tax contingencies, and unrecognized tax benefits for uncertain tax positions are properly disclosed in the notes to the financial statements



Are Related Party Transactions an Issue for NFPs?

- Related party transactions are an issue for NFP audits just as they are for audits of non-NFP entities
- Auditors have responsibilities to consider the presence of related party transactions under AU-C sections 240, 315, 330, and 550
 - AU-C section 550 discusses significant risks and related party transactions that are also significant unusual transactions
- The lack of ownership interests in NFPs and the importance of those charged with governance to some degree increases the focus on those charged with governance for the NFP (e.g., some states require NFPs/board members to report the details of their transactions/other business involvements with the NFP, in addition to their other board memberships)



Examples of NFP Related Parties Could Include...

- Officers, board members, and founders
- Substantial contributors
- Parties providing concentrations in revenues and receivables
- Supporting organizations [e.g., IRS Section 509(a)(3) organizations]
- Financially interrelated entities
- Some national and local affiliates
- Other entities whose officers, governing board members, owners, or employees are members of the NFP's governing board or senior management
- Immediate family members of any related party



Exercise 4

What types of related party disclosures have you seen in NFPs?



Solution to Exercise 4

- In a sample of 100 audited NFP financial statements, the author noted five NFPs that had related party disclosures. Those five disclosures related to the following:
 - The sale of property to a former executive director of the NFP
 - Members of a university's board and senior management being associated, either directly or through interlocking board memberships, with entities doing business with the university
 - An NFP paying entities related to board members for insurance premiums, investment advisory costs, advertising costs, construction costs, and vehicle leases
 - An NFP leasing facilities and obtaining retirement plan services from board members
 - An NFP receiving contributions from and providing services with related entities

Section 2

Fraud, It Couldn't Happen
Here, or Could It?



Section 2 – Fraud, It Couldn't Happen Here, or Could It?

- Our objective for this section is to understand how the issue of fraud can affect the audit of an NFP and common methods used to perpetrate fraud within NFPs



Is Fraud Really an Issue for NFPs?

- It would be nice to say that fraud does not occur in the NFP environment as many who work in this segment of society are individuals driven to serve the public. However, to say that fraud does not occur in NFPs would be naïve
- For example, in 11/24, the former CFO for the Detroit Riverfront Conservancy pleaded guilty to federal charges from a years-long scheme to embezzle **over \$40 million** from the Conservancy
 - Between 2013 and 2024, the CFO transferred approximately \$24.4 million from the Conservancy's bank accounts to an account he controlled
 - Between 2012 and 2024, the CFO used approximately \$14.9 million in Conservancy funds to pay a credit card of an entity he controlled
 - The CFO also used Conservancy funds to purchase cashier's checks from various financial institutions which he used for his own purposes



Is Fraud Really an Issue for NFPs?

- The former Conservancy CFO engaged in various practices to cover up and sustain this massive fraud scheme including
 - In some instances, the CFO falsified bank statements that he provided to the Conservancy's bookkeeper, altering or deleting unauthorized transfers on the statements to keep them off the Conservancy's books
 - The CFO took out a \$5 million line of credit on behalf of the Conservancy using forged documents to help cover up his substantial embezzlement
 - The CFO routinely transferred stolen Conservancy funds through elaborate chains of intermediate entities, all with the intent of concealing the source and nature of those funds



Is Fraud Really an Issue for NFPs?

- Long-term frauds, like the one perpetrated by the Conservancy's CFO, can be difficult to detect. For example,
 - The Conservancy had single audits in 2022, 2021, and 2018, which had clean opinions on both the financial statements and compliance
 - No findings were reported in the 2022, 2021, and 2018 single audits
 - One of the large charity rating agencies rated the Conservancy as a four-star charity (with a charity score of 95%) as late as 12/24. However, the rating agency had added a "proceed with caution" warning due to media reports on the matter
- Before leaving this example, we should note that AU-C section 240 discusses that due to the unpredictable way in which **management override of controls** could occur, it is a risk of material misstatement due to fraud and, thus, a **significant risk**



Exercise 5

How many board members do you think that the Detroit Riverfront Conservancy has and does the number of board members make any difference?



Solution to Exercise 5

- As of 12/24, the Conservancy had over 40 active board members listed on its website
- There is no magic number of board members, and it really is a “Goldilocks and the Three Bears” type of issue NFPs should consider
 - Too many board members can potentially result in a complicated structure and potentially water down oversight of management as individual members may assume their role is relatively small and it’s not their job
 - Too few board members can potentially stretch board members too thin and oversight of management can fall by the wayside
- **The course author’s thoughts:** If Apple and Amazon can be overseen by 8-12 board members, perhaps the typical NFP can be as well



Since We've Seen That Fraud Can Be an Issue for NFPs, What Are Some of the Auditor's Core Responsibilities Related to It?

- AU-C section 240 defines **fraud** as being an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements that are the subject of an audit
- AU-C section 240 states that the objectives of the auditor are to
 - Identify and assess the risks of material misstatement of the financial statements due to fraud;
 - Obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
 - Respond appropriately to fraud or suspected fraud identified during the audit



In Identifying and Assessing the Risks of Material Misstatement Due to Fraud...

- The auditor is evaluating whether one or more **fraud risk factors** are present
- The presence of fraud risk factors may not necessarily indicate the existence of fraud; however, they have often been present in circumstances in which frauds have occurred and, therefore, may indicate risks of material misstatement due to fraud
- **Fraud risk factors** are defined as events or conditions that indicate an **incentive** or pressure to perpetrate fraud, provide an **opportunity** to commit fraud, or indicate attitudes or **rationalizations** to justify a fraudulent action
 - Tip: Think **RIO** (**r**ationalizations, **i**ncentives, **o**pportunities)



Examples of Conditions Seen in NFPs That May Lead Some To **Rationalize** Committing Fraud

- Management and the board believing that program fulfillment is everything and controls are just something for the auditors
- Management and the board believing that program fulfillment is everything and ignoring other operational responsibilities (e.g., the submission of payroll taxes, the filing of IRS Forms 990 and 941, etc.)
- Personnel believing that they are under-compensated and thus entitled to misuse their position (e.g., taking the NFP's assets)
- Personnel believing that they are under-appreciated and owed something by the NFP



Examples of **Incentives** NFPs Have To Misreport Financial Statement Amounts

- Donors and grantors naturally prefer NFPs with **low** fundraising and management and general expenses and **high** program expenses
- Motivation to try to capitalize fundraising costs (i.e., instead of expensing them as incurred under FASB ASC 958-720-25-4) to spread those costs into future periods to make the NFP appear more proficient in fundraising
- Trying to portray the NFP as desperate to create an urgency amongst donors to contribute



Examples of Incentives NFPs Have To Misreport Financial Statement Amounts

- The receipt of conditional contributions contingent on the NFP's raising a certain level of matching gifts
- The receipt of conditional contributions contingent on the NFP's meeting certain performance objectives or cost-sharing amounts
- Motivation to report donor restrictions as having been met when they have not (e.g., to reduce a deficit in net assets without donor restrictions or reduce restricted amounts that the NFP is having difficulty satisfying)



Examples of Vulnerabilities in NFPs That Some May Seize as an **Opportunity** To Misappropriate Assets

- NFPs where a person or limited group has excessive power without compensatory controls
- Small NFPs where leadership is also heavily involved in side businesses
- Management and governing boards with limited financial and operational backgrounds
- Governing boards that do not provide meaningful oversight of management
- The absence of fraud reporting mechanisms



Examples of Vulnerabilities in NFPs That Some May Seize as an **Opportunity** To Misappropriate Assets

- A limited accounting department in terms of quality or quantity of personnel resulting in controls being ignored (e.g., the “we’ll get to those reconciliations someday” mindset) or severe segregation of duties issues (e.g., one person performs a process without the oversight of others and without anyone else ever performing it)
- The absence of background checks on personnel in operational and financial roles
- NFPs that are overly trusting of staff and volunteers and lacking in understanding of the importance of controls
- IT controls not taken seriously



Examples of Vulnerabilities in NFPs That Some May Seize as an **Opportunity** To Misappropriate Assets

- Volunteers with meaningful access to assets and limited controls
- Special events or fundraising activities involving large amounts of cash
- Grants under the control of a single individual or grants with limited oversight
- Missions involving the distribution of assets which are desirable by all (e.g., food, clothing, prepaid purchase cards, awards, etc.)
- Operations involving assets which can be taken without notice (e.g., the intake of contributed items at resale stores, non-capitalized collections at museums, etc.)



Is Revenue Recognition Really a Fraud Consideration in NFP Audits? Yes, Really!

- Paragraphs .26 and .27 of AU-C section 240 discuss that
 - When identifying and assessing the risks of material misstatement due to fraud, the auditor is required, based on a presumption that risks of fraud exist in revenue recognition, to evaluate which types of revenue, revenue transactions, or assertions give rise to such risks
 - If the auditor concludes that this presumption is not applicable, additional AU-C section 240 requirements apply
 - The auditor is required to treat those assessed risks of material misstatement due to fraud as **significant risks**



Is Revenue Recognition Really a Fraud Consideration in NFP Audits? Yes, Really!

- Under paragraph .22 of AU-C section 240, based on analytical procedures performed as part of risk assessment procedures, the auditor **is required** to evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatement **due to fraud**
- To the extent not already included, the analytical procedures, and evaluation thereof, **are required** to include procedures relating to revenue accounts
- Part of selecting effective analytical risk assessment procedures to identify unusual or unexpected relationships related to fraudulent revenue accounts involves brainstorming how those unusual or unexpected relationships may manifest themselves (**see following slides**)



Examples of Unusual or Unexpected Relationships and Analytical Procedures That Might Identify Them

- Unexpected and unexplainable changes in contribution revenue as compared to a prior period
 - A comparison of fundraising expense to contribution revenue over time
- Revenue does not change in the direction and/or magnitude that is expected based on changes in related expenses (e.g., a clinic's revenue and expenses move in surprisingly different directions) or level of services provided (e.g., a theatre's ticket sales seem out of line with the number of performance dates)
 - A budget to actual comparison of revenues and expenses
 - A trend analysis of revenues to related expenses or revenues to services provided



Examples of Unusual or Unexpected Relationships and Analytical Procedures That Might Identify Them

- A large amount of cost-reimbursement grant expenditures are recognized at the end of the grant period
 - A trend analysis of grant expenditures by month
- Unreasonable investment returns
 - Looking at investment returns as a percentage of investment assets



Examples of NFP Revenue Manipulation Methods Used in Fraudulent Financial Reporting

- Reporting contributions in the wrong net asset class or improperly reporting net asset reclassifications
- Improperly classifying conditional contributions as unconditional (or vice versa)
- Overstating or understating valuations of in-kind contributions
- Recognizing intentions to give (i.e., something short of a promise to give) as contributions (or vice versa)
- Classifying agency transactions as contributions (or vice versa)



Examples of NFP Revenue Manipulation Methods Used in Fraudulent Financial Reporting

- Improperly classifying grants (e.g., contributions versus exchange transactions, conditional versus unconditional)
- Reporting membership dues that are truly contributions as exchange transactions (or vice versa)
- Recognizing exchange transactions (e.g., dues, tuition, season tickets) over improper periods
- Improperly applying guidance related to contributed services, split-interest agreements, and collections



Before We Close Out This Section...

- In this section, we have discussed certain key aspects of the auditor's responsibilities related to fraud and issues related to fraud in NFPs
- To close out the section let's look at additional common types of fraud observed in NFPs...



Common Types of Fraud Observed in NFPs – Misappropriation of Benefits

- As part of their mission, many NFPs distribute benefits designed to assist others in society. These types of benefits can be misappropriated by methods such as
 - **The falsification of benefit application forms** – Sometimes employees receive the misappropriated benefits directly and sometimes they direct benefits to third parties in return for kickbacks
 - **The simple theft of certain benefits** – Some NFPs distribute benefits that can easily be taken and converted to personal use or resold for personal gain (e.g., food items, clothing, gift cards, etc.)



Common Types of Fraud Observed in NFPs – Payroll Frauds

- Payroll fraud can be committed by several methods, including
 - **Inflated wages** – Inflated wages within the payroll system can occur via: (1) adding fictitious hours to timesheets or the payroll system directly; (2) falsely adjusting the hourly or salaried rates; (3) reallocating amounts on timesheets to create overtime; and (4) creating other adjustments for items like bonuses or commissions
 - **Fictitious employees** – Fictitious employees can be added to the payroll system
 - **False expense reimbursements** – The payroll system can be used for false reimbursement of travel and other expenses. Expenses may be totally false, listed at inflated amounts, or charged multiple times



Common Types of Fraud Observed in NFPs – Credit Card Frauds

- Credit card fraud can occur by several methods, including
 - **The purchase of gift cards with credit cards** – A great number of credit card frauds involve employees purchasing gift cards with credit cards and then using the gift cards for personal use without an audit trail
 - **The purchase of personal items with credit cards** – Where weak controls and/or reviews are in place, employees can simply use credit cards for direct purchases of personal items. This is particularly true of items which may appear to have a business purpose (e.g., cell phones, laptops, etc.)



Common Types of Fraud Observed in NFPs – Travel and Expense Reimbursement Frauds

- Travel and expense reimbursement frauds often occur by employees
 - **Submitting expenses more than once** – Employees may submit the same expense on more than one reimbursement request by: (1) turning in the original receipt with one submission and a copy in a second submission; and (2) submitting the original receipt with one submission and a credit card statement reflecting the charge in a second submission
 - **Claiming false expenses** – Employees may request reimbursement for false expenses by: (1) generating false receipts; (2) saving receipts from personal expenses and subsequently claiming them as business related receipts; and (3) obtaining receipts from others
 - **Inflating expenses** – Employees may falsely inflate expenses on reimbursement requests by: (1) inflating mileage expenses; (2) adding tips to meal expense receipts that are higher than the actual amounts left; and (3) purchasing items to generate a receipt used to claim an item on the reimbursement request and then returning the item for credit



Common Types of Fraud Observed in NFPs – Procurement and Disbursement Frauds

- Examples of procurement and disbursement related frauds include
 - **Improper wire transfers** – If proper oversight and controls are not in place, those in the NFP with the authority to initiate wire transfers can use such authority to transfer funds to personal accounts or make personal payments on items like mortgages or autos
 - **Having the NFP pay for items never received/used** – This can include a wide array of items like: (1) having an NFP pay invoices related to an employee's side business; (2) paying fictitious vendors where an employee or his/her associate is actually receiving the payment; (3) employees purchasing items like IT equipment and immediately selling the items for personal profit upon receipt; and (4) vendors submitting false bids, false billings, double billings, etc.
 - **Improper use of credit cards** – As we discussed earlier, employees can use an NFP's credit cards to purchase personal items



Common Types of Fraud Observed in NFPs – Grant Frauds

- Grant related frauds can occur by several methods, including
 - **Employee misuse of grant funds** – It is not unusual for an individual or a very limited number of individuals to have substantive control over how a particular grant is expended. This may provide an employee with an increased ability to use grant funds inappropriately. For example, in a university setting, a professor may obtain a grant for research and then be responsible for spending the grant funds. It may be difficult for others within the university to know if the grant funds are being used appropriately or inappropriately
 - **Organization misuse of grant funds** – An NFP facing a shortfall in funding may be tempted to charge expenses inappropriately against a grant (e.g., misallocating indirect costs to a grant or simply categorizing direct costs in a fraudulent manner)



Common Types of Fraud Observed in NFPs – Inventory Frauds

- Inventory frauds are normally a larger issue for commercial entities than they are for NFPs. However, some NFPs do have operations that include inventories (e.g., gift shops or thrift store operations)
- NFPs with thrift store operations (which seem to be trending) may be especially prone to inventory frauds as employees may be able to remove items with relative ease and sell the items in another market for personal gain (e.g., garage sales, antique shops, or online sites)



Common Types of Fraud Observed in NFPs – Cash Receipts Frauds

- Many NFPs receive cash as part of their operations. Cash receipts can stem from many different activities. For example, church offering plate collections, receipts from bake sales and garage sales, fees for services provided, ticket sales for events, etc.
- Cash receipts may be collected by an NFP's employees or by volunteers
- An NFP's cash generating activities may be established operations with good controls or may be less established and less controlled
- Because cash receipts may come from many different activities and can be handled by a wide range of individuals, they are generally more susceptible to undetected theft than cash collected by a commercial entity

Section 3

Issues Related to Presenting Liquidity Information



Section 3 – Issues Related to Presenting Liquidity Information

- Our objective for this section is to perceive the key issues related to how NFPs present and disclose liquidity information



Effects of Restrictions, Designations, and Other Limitations on Liquidity

- **FASB ASC 958-210-45-8** requires that NFPs **provide information about liquidity** by any of the following
 - Sequencing assets according to their nearness of conversion to cash **and** sequencing liabilities according to the nearness of their maturity and resulting use of cash (i.e., presenting a **nonclassified statement of financial position**)
 - Classifying assets and liabilities as current and noncurrent (i.e., presenting a **classified statement of financial position**)
 - Disclosing in the notes any additional relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets
- **Note.** FASB ASC 954 requires NFP business-oriented health care entities to present a classified statement



Effects of Restrictions, Designations, and Other Limitations on Liquidity

- A complication in the real-world application of the guidance in the prior slide is that NFPs often receive donor-restricted contributions and the effect those restrictions **may or may not** have on presenting the related assets on the statement of financial position
- The general guidance in this area is found in **FASB ASC 958-210-45-6**, which is summarized on the following slide



Donor Restrictions and Asset Classifications

Assets may be restricted by donors. Normally, however, restrictions apply to net assets, not to specific assets. Assets need not be disaggregated on the basis of the presence of donor-imposed restrictions on their use (e.g., cash available for current use and without donor restrictions need not be reported separately from cash received with donor-imposed restrictions **that is also available for current use**). However, cash or other assets received with a donor-imposed restriction **that limits their use to long-term purposes** should not be classified with cash or other assets that are without donor restrictions and are available for current use. If the nature of the restriction or designation (i.e., amount and purpose) is not clear from the description on the face of the statement of financial position, the kind of asset whose use is limited either by a donor-imposed restriction or by governing board designations should be described in the notes to the financial statements.



Donor Restrictions and Asset Classifications

- Two key takeaways from the prior slide are that...
 - **Assets may be restricted by donors** (e.g., a donor restricts the use of contributed land in perpetuity for use as open green space)
 - Cash or other assets received with a donor-imposed restriction **that limits their use to long-term purposes** (e.g., assets resulting from a capital campaign for the purchase of a building) should not be classified with cash or other assets that are without donor restrictions and are available for current use
- Because the above limit the **use of the assets to long-term purposes**, it means that they generally are unavailable to meet current operating obligations (i.e., they have an impact on liquidity)



In Applying the Guidance in Both FASB ASC 958-210-45-8 and 958-210-45-6...

- If the NFP presents a **nonclassified statement of financial position**, assets held for meeting donor restrictions that limit use to long-term purposes should be
 - Separately displayed on the face of the statement of financial position in a position of longer-term relative liquidity as compared to similar assets available for current operating purposes (i.e., using a description that identifies the nature of the asset, such as cash or contributions receivable, but displayed lower), **or**
 - Displayed on the face of the statement of financial position using a separate line item (e.g., “assets whose use has been limited or restricted”) in a position of relative liquidity consistent with its noncurrent purpose
- If the NFP presents a **classified statement of financial position**, assets held for meeting donor restrictions that limit use to long-term purposes should be classified as noncurrent (e.g., a separate line item, such as “assets whose use has been limited or restricted”)



Exercise 6

Paws and Claws Animal Shelter (PCAS) has a June 30 year end. At year end, PCAS receives a \$50,000 cash gift from Terri Er that is restricted for veterinary services provided to shelter animals. PCAS recorded this amount as contribution revenue in net assets with donor restrictions. Each year, PCAS spends over \$500,000 on veterinary services. **Is PCAS required to classify these resources apart from operating cash in its June 30 statement of financial position?**



Solution to Exercise 6

No. As we saw earlier, cash received with donor-imposed restrictions that is available for current use **need not be reported separately** from cash that did not arise from donor restricted gifts that is also available for current use. In this case, the contributed resources are available for current use, as they will clearly be used in the coming year for veterinary services that are part of PCAS's regular ongoing programs. Thus, the \$50,000 cash received is not required to be reported separate from operating cash (as liquidity-wise it generally would be available to creditors). **Note.** PCAS certainly could separately report the cash if it desired to



If You Find a Potential Restricted Asset That's Tough To Think Through, Consider the FASB ASC 958-210 Definition of **Liquidity**

An asset's or liability's nearness to cash. Donor-imposed restrictions may influence the liquidity or cash flow patterns of certain assets. For example, a donor stipulation that donated cash be used to acquire land and buildings limits an entity's ability to take effective actions to respond to unexpected opportunities or needs, such as emergency disaster relief. On the other hand, some donor-imposed restrictions have little or no influence on cash flow patterns or an entity's financial flexibility. For example, a gift of cash with a donor stipulation that it be used for emergency-relief efforts has a negligible impact on an entity if emergency relief is one of its major ongoing programs



What if an NFP's Governing Board **Designates Specific Assets** for Long-Term Purposes?

- The governing boards of some NFPs may designate resources to be held for long-term purposes (e.g., debt-service reserves, quasi-endowment, or the future acquisition of property and equipment)
- While the guidance in this area is less clear, the general consensus is that if the governing board **identifies specific assets** to be invested or held pursuant to the designation of net assets **for noncurrent purposes**, those assets should be sequenced with other assets that will be consumed in a similar term (in a **nonclassified statement of financial position**) or reported outside the current assets section (in a **classified statement of financial position**)



FASB ASC 958-210 Requires NFPs To Present Additional Disclosures About the **Liquidity** and **Availability** of Financial Assets

- As if the presentation of liquidity information on the face of the statement of financial position was not complicated enough, FASB ASC 958-210 requires additional disclosures about the **liquidity** and **availability** of financial assets
- These unique NFP disclosures include those shown on the following slide



FASB ASC 958-210 Contains Two Related Areas of Disclosure Regarding **Liquidity** and **Availability**

Liquidity	NFPs are required to provide qualitative information in the notes to financial statements that is useful in assessing an entity's liquidity and that communicates how an NFP manages its liquid resources available to meet cash needs for general expenditures within one year of the date of the statement of financial position.
Availability	NFPs are required to provide quantitative information either on the face of the statement of financial position or in the notes , and additional qualitative information in the notes as necessary, that communicates the availability of an NFP's financial assets at the date of the statement of financial position to meet cash needs for general expenditures within one year of the date of the statement of financial position. (Note. The availability of a financial asset may be affected by: its nature; external limits imposed by donors, laws, and contracts with others; and internal limits imposed by governing board decisions.)



The Additional Disclosure Providing Qualitative Information About **Liquidity** Might Look Like...

NFP E is primarily funded by contributions from donors that contain restrictions. Those restrictions require that resources be used in a certain manner or in a future period. Therefore, NFP E must maintain adequate resources to meet those responsibilities to its donors and certain financial assets may not be available for general expenditure within one year. As part of its liquidity management, NFP E has a policy to structure its financial assets to be available as general expenditures, liabilities, and other obligations become due. NFP E also invests its cash in excess of its daily needs in short-term investments. The Board of Trustees occasionally designates amounts to its liquidity reserve and its quasi-endowment fund (used primarily for long-term investing) that could be utilized in the event of an unanticipated liquidity need. NFP E could also draw upon a \$100,000 available line of credit (as discussed in Note 10).



The Additional Disclosure Providing Quantitative and Qualitative Information About **Availability** Might Look Like...

The below reflects NFP E's financial assets as of the statement of financial position date, reduced by amounts that are not available for general use due to contractual or donor-imposed restrictions within one year of the statement of financial position date. Amounts that are not available also include board designated amounts that could be utilized if the Board of Trustees approved the use. However, amounts already appropriated from either the donor-restricted endowment or quasi-endowment for general expenditure within one year of the statement of financial position date have not been subtracted as unavailable.

Financial assets, at year-end	\$900,000
Less those unavailable for general expenditures within one year, due to:	
Contractual or donor-imposed restrictions:	
Restricted by donor with time or purpose restrictions	(400,000)
Subject to appropriation and satisfaction of donor restrictions	(200,000)
Board designations:	
Quasi-endowment fund, primarily for long-term investing	(175,000)
Amounts set aside for liquidity reserve	(25,000)
Financial assets available to meet cash needs for general expenditures within one year	<u>\$100,000</u>



Exercise 7

In the last exercise we saw that Paws and Claws Animal Shelter (PCAS) has a June 30 year end. At year end, PCAS receives a \$50,000 cash gift from Terri Er that is restricted for veterinary services provided to shelter animals. PCAS recorded this amount as contribution revenue in net assets with donor restrictions. Each year, PCAS spends over \$500,000 on veterinary services. **How should PCAS consider this gift when calculating the amount of “financial assets available to meet cash needs for general expenditures within one year” for its June 30 availability of resources disclosure?**



Solution to Exercise 7

Since the \$50,000 is available to meet cash needs for general expenditures within one year (as veterinary services could certainly be considered a general expenditure) it would not have to be subtracted in calculating financial assets available to meet cash needs for general expenditures within one year. In this scenario, PCAS would want to disclose this in its qualitative disclosure related to availability. **Note.** Alternatively, PCAS could choose to take the position that all financial assets associated with donor-restricted gifts are unavailable for general expenditures



Exercise 8

On June 30, PCAS had \$750,000 in cash and investments that the PCAS Board had previously designated as a quasi-endowment fund for long-term investing. At the subsequent July 15 board meeting, the PCAS Board voted to undesignate \$150,000 from the quasi-endowment for use in general operations. **Would the Board's subsequent undesignation be considered when calculating the amount of "financial assets available to meet cash needs for general expenditures within one year" for its June 30 availability of resources disclosure?**



Solution to Exercise 8

In the author's view, no. The availability of resources disclosure is made as of the date of the statement of financial position. On June 30, the \$150,000 was still internally designated by the PCAS Board and not available for general expenditures. PCAS could add in its qualitative disclosure related to availability that the \$150,000 was released from internal designation subsequent to the statement of financial position date



Auditing the Effects of Restrictions, Designations, and Other Limitations on Liquidity

- Examples of audit procedures to consider include inquiring of management/others and reviewing documentation relating to donor restrictions, board designations, and other limitations and determining whether their effects on liquidity are properly presented. In particular, look for
 - Cash, contributions receivable, and other assets restricted by donors for use in long-term purposes (e.g., investment in land, buildings, and equipment)
 - Cash and cash equivalents of donor-restricted endowment funds held temporarily until suitable long-term investments are identified
 - Specific assets designated by the governing board for long-term purposes
 - The composition of current assets and current liabilities if the NFP prepares a classified statement of financial position

Section 4

Is This a Promise To Give or Something Else?



Section 4 – Is This a Promise To Give or Something Else?

- Our objectives for this section are to understand
 - The importance of distinguishing promises to give from intentions to give; and
 - Common audit procedures employed to test an NFP's recording of promises to give



Do We Have a Promise To Give or an Intention To Give?

- FASB ASC 958-605 defines **promises to give** as being “A written or oral agreement to contribute cash or other assets to another entity. A promise carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. A promise to give may be either conditional or unconditional.”
- FASB ASC 958-605-25-8 also specifies that for a promise to give to be recognized, there must be sufficient evidence in the form of verifiable documentation that a promise was made and received
 - As we'll discuss in Section 6, confirming contributions receivable may provide additional evidence about the existence of promises to give



Sometimes, NFPs May Receive Communications That Are Borderline Promises To Give

- FASB ASC 958-605-25-9 tells us that a communication that does not indicate clearly whether it is a promise **is considered an unconditional promise to give if it indicates an unconditional intention** to give that is legally enforceable (legal enforceability refers to the availability of legal remedies, not the intent to use them)
- However, FASB ASC 958-605-25-10 tells us that solicitations for donations that clearly include wording such as “information to be used for budget purposes only” or that clearly and explicitly allow resource providers to rescind their indications that they will give are **intentions to give rather than promises to give and shall not be reported as contributions**



An Example of How NFPs May Receive Communications That Are Borderline Promises To Give Related to Wills

- If an individual tells an NFP that it has been included in the individual's will, that is merely an intention to give and not a promise to give (as individuals can modify their wills during their lifetimes)
- If an individual **promises to give** a specific amount of cash or specific assets and the date of death is used as a payment date for the promise, the NFP can make the case that it has received a promise to give
 - There would still be several issues to think through including the collectibility and measurement of the contribution
 - At the end of the day, the NFP may arrive at a fair value estimate of zero depending on the facts and circumstances



Exercise 9

Willie Go gives The Requiem Symphony (TRS) a paid-up cash value life insurance policy in which TRS was given ownership of the policy and named as the sole beneficiary. The policy will pay \$500,000 upon the death of Willie. **Is this an intention to give, a promise to give \$500,000 in cash upon the death of Willie, or something else altogether?**



Solution to Exercise 9

Something else altogether. In this case, TRS has received a noncash gift of an insurance contract. TRS would recognize the financial asset at its fair value on the date of the gift (e.g., the cash surrender value of the policy)



Examples of Audit Procedures To Test an NFP's Recording of Promises To Give Include...

- Considering the internal controls over the receipt of contributions
- Selecting items from data maintained by the development department, determining whether a contribution should have been recognized and, if so, vouching the item to recognized contributions in the accounting records
- Comparing the detail of contributions receivable in the accounting records with data maintained by the development department and investigating reconciling items
- Reviewing board minutes for discussions of material contributions and inquiry of NFP personnel



Examples of Audit Procedures To Test an NFP's Recording of Promises To Give Include...

- Performing analytical procedures such as comparing contribution revenue to:
 - Fundraising expense;
 - Number of donors to get an average per donor;
 - Prior year amounts; and
 - Budgeted amounts
- Reviewing contribution receipt books/logs/registers to see if items were properly recorded or if there are missing items or unexplained gaps in sequencing



Examples of Audit Procedures To Test an NFP's Recording of Promises To Give Include...

- Examining contributions recorded before and after the NFP's year end to determine whether the NFP had proper cutoff
- Evaluating how the NFP has measured unconditional promises to give including
 - Considering the NFP's controls over how it: (1) values unconditional promises to give at initial recognition; (2) periodically reviews the valuation of contributions receivable; (3) estimates, identifies, and writes off uncollectible promises to give
 - Reviewing and testing the methods and assumptions used to measure unconditional promises to give
 - Reviewing unconditional promises to give for collectability (e.g., looking at: the NFP's previous collection experience and collection policies; the donors' reputations; and the aging of the promises), and, if appropriate, changes in fair value of the underlying assets

Section 5

Conditional Versus Unconditional Promises to Give



Section 5 – Conditional Versus Unconditional Promises To Give

- Our objectives for this section are to understand
 - The importance of distinguishing conditional promises to give from unconditional promises to give; and
 - Common audit procedures utilized to test an NFP's determination that contributions are conditional or unconditional



Distinguishing Conditional From Unconditional Contributions

- The determination of whether a contribution is conditional or unconditional is crucial as it drives the **timing** of the revenue recognized
- **Unconditional contributions** are **recognized immediately** and classified as either net assets with or without donor restrictions
- **Conditional contributions** received are **accounted for as a liability** (e.g., if amounts are received upfront) **or are unrecognized initially**, that is, until the barriers to entitlement are overcome, at which point the transaction is recognized as unconditional and classified as either net assets with or without donor restrictions



FASB ASC 958-605 Contains Several Important Definitions Related to Conditional Contributions

- A **conditional contribution** is a contribution that contains a donor-imposed condition
- A **conditional promise to give** is a promise to give that is subject to a donor-imposed condition
- A **donor-imposed condition** is a donor stipulation (donors include other types of contributors, including makers of certain grants) **that represents a barrier that must be overcome before the recipient is entitled to the assets transferred or promised**. Failure to overcome the barrier gives the contributor a **right of return** of the assets it has transferred **or** gives the promisor a **right of release** from its obligation to transfer its assets



A Conditional Contribution Has Both a Barrier and a Right of Return/Release



An NFP will determine whether a contribution is conditional on the basis of whether an agreement includes a **barrier that must be overcome and either a right of return of assets transferred or a right of release of a promisor's obligation to transfer assets**. The presence of **both** a barrier **and** a right of return or a right of release indicates that an NFP is not entitled to the transferred assets or a future transfer of assets until it has overcome the barrier(s) in the agreement (i.e., until the barrier is overcome the contribution would be deemed to be conditional in nature).



Assessing Whether an Agreement Contains a Barrier

- A barrier often places specific requirements on an NFP about the use of the transferred assets to be entitled to those assets
 - FASB ASC 958-605 provides several indicators to be used in assessing whether an agreement contains a barrier
 - Depending on the facts and circumstances, some indicators may be more significant than others, and no single indicator is determinative
- FASB ASC 958-605-25-5E states that in cases of ambiguous donor stipulations, a contribution containing stipulations that are not clearly unconditional shall be presumed to be a conditional contribution



In Assessing Whether an Agreement Contains a Barrier, NFPs Will Consider Indicators, Including...

▲	The inclusion of a measurable performance-related barrier (e.g., a requirement indicating that an NFP's entitlement to transferred assets is contingent upon the achievement of a certain level of service, an identified number of units of output, or a specific outcome) or other measurable barrier (e.g., a stipulation that an NFP is entitled to the assets only upon the occurrence of an identified event such as meeting a matching requirement);
▲	The extent to which a stipulation limits discretion by the NFP on the conduct of an activity more specifically than the general activity being conducted or the time frame in which the contribution must be used (e.g., limited discretion could include a requirement to follow specific guidelines about qualifying allowable expenses, a requirement to hire specific individuals as part of the workforce conducting the activity, or a specific protocol that must be followed); and
▲	Whether a stipulation is related to the purpose of the agreement (this indicator generally excludes administrative tasks and trivial stipulations).



Exercise 10

Bison Unbound (BU) has a September 30th fiscal year end. In June 20X1, Pioneer Pete makes a conditional promise to give BU \$750,000 to purchase additional land **if** BU raises \$750,000 or more in matching contributions by calendar year end. At September 30, 20X1, BU had raised \$600,000. By November 30, 20X1, BU had raised the entire \$750,000 in matching contributions. **When would BU recognize the conditional promise to give as revenue?**



Solution to Exercise 10

The \$750,000 contribution from Pioneer Pete would be recognized on November 30, 20X1 (i.e., the date the barrier to entitlement of the conditional promise to give had been met). We should also note that under FASB ASC 958-310-50-4, in its September 30, 20X1 notes, BU would disclose that it had received a \$750,000 conditional promise to give conditioned on BU raising \$750,000 in matching contributions for the land purchase by December 31, 20X1



Exercise 11

Dinner Is Served Here (DISH) receives a grant from the Slab Foundation to assist those in need in the community. Under the agreement, the Slab Foundation promises to make quarterly payments of \$50,000 for a year. While not containing any concrete barriers per se, the grant contains a clause stating that “the Slab Foundation may terminate any or all payments if, in its sole discretion, it determines that DISH fails to make satisfactory progress toward assisting those in need.” **Does this clause constitute a barrier?**



Solution to Exercise 11

In the author’s view, no. It is not unusual for grants to include satisfactory progress clauses giving the grantor the right to decide to cancel the agreement if the project takes a direction that the grantor dislikes. Barriers should be objectively determinable by both parties, in terms of the specific condition that must be satisfied and the point when satisfaction occurs. This clause would appear to meet neither characteristic (as a decision by the Slab Foundation to cancel would be based solely on subjective considerations). Since no other barriers are present, DISH would likely recognize the grant as an unconditional contribution



Examples of Audit Procedures To Test an NFP's Determination That Contributions Are Conditional or Unconditional Include...

- Considering the NFP's controls over how it recognizes and distinguishes unconditional contributions from conditional contributions
 - The internal control system also needs to ensure that revenues arising from conditional contributions are recognized when the barriers to entitlement have been overcome (i.e., when they become unconditional)
- When performing analytical procedures related to revenues, watching for unusual trends/relationships and potential indications that conditional contributions are incorrectly being reported as revenue
- When confirmations are utilized, reviewing confirmation responses for indications of conditions



Examples of Audit Procedures To Test an NFP's Determination That Contributions Are Conditional or Unconditional Include...

- Examining documentation supporting recognition of contributions (including grant agreements that have been determined to be contributions), noting information such as the absence of conditions
- Inquiring of NFP management and development personnel about the existence of conditional contributions. Also, reviewing board minutes for discussions of conditional contributions

Section 6

Restricted Versus Unrestricted Contributions



Section 6 – Restricted Versus Unrestricted Contributions

- Our objectives for this section are to understand
 - The importance of distinguishing restricted versus unrestricted contributions; and
 - Common audit procedures utilized to test an NFP's contributions with donor-imposed restrictions



Donor-Imposed Restrictions on Contributions

- The FASB ASC defines a **donor-imposed restriction** as being a donor stipulation (donors include other types of contributors, including makers of certain grants) that specifies a use for a contributed asset that is more specific than broad limits resulting from the following:
 - The nature of the NFP
 - The environment in which it operates
 - The purposes specified in its articles of incorporation or bylaws or comparable documents for an unincorporated association



Donor-Imposed Restrictions on Contributions

- The FASB ASC **donor-imposed restriction** definition also states that
 - Some donors impose restrictions that are temporary in nature (e.g., stipulating that resources be used after a specified date, for particular programs or services, or to acquire buildings or equipment)
 - Other donors impose restrictions that are perpetual in nature (e.g., stipulating that resources be maintained in perpetuity)
 - Laws may extend those limits to investment returns from those resources and to other enhancements (diminishments) of those resources. Thus, those laws extend donor-imposed restrictions
- It is important to note that the determination of whether a contribution is donor restricted or unrestricted **does not affect when the revenue is recognized but where it is recognized** (i.e., either in net assets with or without donor restrictions)



Donor-Imposed Restrictions May Occur Explicitly or Implicitly

- Donor restrictions may occur **explicitly** (e.g., a donor stipulation in a written or oral communication accompanying the contribution) or **implicitly** (e.g., the circumstances surrounding the receipt of a contribution)
- Examples of donor-imposed restrictions
 - A letter (or oral statement) from a donor, accompanying a contribution, states that the contribution should be used for Program A
 - Contributions are made to a capital campaign whose stated objective is to raise funds for a new facility
 - Contributions are made in response to a fundraising appeal with the stated objective of raising funds for Program B



NFPs Have Fiduciary Responsibilities To Follow Donor-Imposed Restrictions

- When an NFP accepts donor-restricted contributions, it also accepts the responsibility to follow those restrictions
 - NFPs that fail to do so run the potential threat of litigation or loss of resources
- It is essential that an NFP track restrictions on net assets and when those restrictions have been satisfied and reclassified
 - For example, in order to properly track, report, and disclose net assets with donor restrictions, an NFP needs to be able to produce a listing of the amounts and purposes for which its net assets are restricted



NFPs Have Fiduciary Responsibilities To Follow Donor-Imposed Restrictions

- There are various tools that NFPs use to track restrictions on net assets depending on the size and sophistication of the NFP including
 - G/L coding
 - Subsidiary ledgers
 - Project accounting systems
 - Fund accounting
 - Spreadsheets
- Regardless of the tool used, an NFP needs to maintain documentation about the activities and other purposes for which the restricted net assets can be used
 - Such documentation should include any restrictions on periods in which the gifts can be spent, restrictions on specific assets, limitations on investing, or other restrictions that limit the use of the resources



What About the Receipt of Unconditional Promises to Give With Payments Due in Future Periods?

- **Receipts of unconditional promises to give with payments due in future periods are reported as donor-restricted support (unless explicit donor stipulations or circumstances surrounding the receipt of a promise make clear that the donor intended it to be used to support activities of the current period)**
- Let's look at a couple of examples...



What About the Receipt of Unconditional Promises to Give With Payments Due in Future Periods?

- Sadie Morebucks promises to give \$10,000 a year for four years to be used to fund scholarships for finance majors; it is reasonable to assume that Sadie wanted \$10,000 in scholarships to be granted in each of the four years. The promise to give would be reported as donor-restricted support since there is both a purpose restriction (scholarships) and four time restrictions (one for \$10,000 expiring when the first payment is due, another for \$10,000 expiring when the second payment is due, etc.)
 - **In this case, the NFP is implying time restrictions that expire in the periods that the payments of the unconditional promise to give are due**



What About the Receipt of Unconditional Promises to Give With Payments Due in Future Periods?

- Blake Batter promises to give \$10,000 to sponsor the Annual Dessert Dinner being held in the current fiscal year to assist the NFP in its current year activities. Blake specifies that the payment will occur early in the next fiscal year. Because Blake's explicit stipulation specified an event of the current year, no time restriction is implied by the NFP, and since the purpose restriction is met by holding the Dessert Dinner in the current year, the net assets are no longer donor-restricted at the end of the year
 - **In this case, the NFP is not implying a time restriction that expires the next fiscal year as another time period (i.e., the current period) is inherent in the donor's purpose restriction**



Exercise 12

We saw in the example of Sadie Morebucks that the donor promised to give \$10,000 a year for four years to be used to fund scholarships for finance majors. Thus, the NFP implied four (annual) time restrictions. **If the NFP awarded \$40,000 in scholarships in the first year, could the NFP say all the restrictions were met in that initial year?**



Solution to Exercise 12

No. Based on Sadie's promise to give, it is reasonable to assume that she intended \$10,000 in scholarships to be granted in each of the four years. So, **in the absence of clarifying donor stipulations from Sadie**, it would be inappropriate for the NFP to look backwards each year and conclude that the purpose restriction had been met by \$40,000 in scholarships granted in the year of the promise



Exercise 13

They Will Come Food Pantry embarks on a capital campaign to build a new storehouse/distribution center. Don Oar contributes \$25,000 to the capital campaign. **Based on the limited facts provided, is the restriction released when the NFP makes construction-related expenditures or when the building is completed?**



Solution to Exercise 13

When the building is completed. FASB ASC 958-205-45-12 states that “unless donor stipulations limit the use of the assets for a period of time or for a particular purpose, donor restrictions on long-lived assets, if any, or cash to acquire or construct long-lived assets are considered to have expired when the assets are placed in service.” **So most capital campaigns would be expected to fall under that general rule.** In rare situations, a donor’s gift instrument might be worded in such a specific manner that the NFP would consider whether the purpose restriction is satisfied when construction expenditures are made. For example, if the gift agreement was worded in a way where it says it is to be used toward construction costs (i.e., not necessarily towards the completion of the item), the NFP may have some leeway there to release amounts as they are being spent



Exercise 14

It's a Hoot Owl Refuge embarks on a three-year capital campaign to build a new facility. To help the project take flight, Ed Wig unconditionally promises \$50,000 restricted for the new facility. Ed Wig said the promise will be payable in Year 3 when the building is expected to be completed. It's a Hoot is able to complete construction and open the facility by end of Year 2. **Are the restrictions met when the assets are placed in service or when the receivable is due?**



Solution to Exercise 14

In general, when two or more restrictions exist, the effect of the expiration of those restrictions is recognized in the period in which the last remaining restriction has expired. **However**, FASB ASC 958-205-45-10A states that in determining when the last of two or more donor-imposed restrictions that are temporary in nature has expired, explicit donor stipulations generally carry more weight than implied restrictions. Here we have a purpose restriction (to build a new facility) and an implied time restriction (since the promise is payable in Year 3). Absent an explicit stipulation to the contrary, it would be reasonable to conclude It's a Hoot fulfilled the donor restriction on the promised gift. The restriction for the construction of the new facility expires when the building is placed in service (FASB ASC 958-205-45-12). A reclassification of net assets would be reported to reflect the decrease in net assets with donor restrictions and the increase in net assets without donor restrictions in Year 2



Examples of Audit Procedures To Test an NFP's Contributions With Donor-Imposed Restrictions Include...

- Considering the NFP's controls over how it recognizes, records, and monitors restrictions
 - NFPs may utilize different general ledger accounts or subsidiary ledgers to track restricted contributions (and for purpose restrictions the related expenses)
- Reviewing and considering the major fundraising appeals that the NFP made during the year. For example,
 - If the NFP conducted a capital campaign during the year the auditor would want to see whether the NFP properly restricted the contributions received in response to the campaign
 - If the NFP allows and encourages donors to restrict donations to specific programs in its fundraising appeals (i.e., the auditor would want to see whether the NFP properly reported restricted amounts)
- When confirmations are utilized, reviewing confirmation responses for indications of restrictions



Examples of Audit Procedures To Test an NFP's Contributions With Donor-Imposed Restrictions Include...

- When performing analytical procedures look for unusual trends in the net asset classifications. For example, if net assets with donor restrictions are increasing each year is that because
 - The NFP is simply receiving more and more restricted contributions;
 - The NFP is having problems in meeting restrictions; or
 - The NFP is not properly reclassifying amounts as restrictions are satisfied?
- Reviewing agreements and documentation related to contributions for indications of restrictions
- Inquiring of NFP management and development personnel about the existence of restricted contributions. Also, reviewing board minutes for discussions of restricted contributions



To Confirm or Not To Confirm

- One of the example audit procedures that we just observed discussed reviewing confirmation responses for indications of restrictions
- AU-C section 330 generally requires the auditor to use external confirmation procedures for **accounts receivable**. For purposes of AU-C section 330, **accounts receivable** are defined as
 - An entity's claims against customers that have arisen from the sale of goods or services in the normal course of business; and
 - A financial institution's loans
- **Contributions receivable** do **not** meet the AU-C section 330 definition of accounts receivable and thus they are **not** required to be confirmed. However, auditors may still elect to use confirmations to obtain audit evidence regarding contributions receivable



Pros to Confirming

- Confirmations generally provide effective evidence regarding the **existence** of contributions receivable
- Confirmations also provide evidence related to
 - The existence or absence of restrictions;
 - The existence or absence of conditions; and
 - The periods over which the promises to give become due



Cons to Confirming

- Confirmations of contributions receivable do not always have as high of a response rate as compared to confirmations of accounts receivable in the commercial sector
 - Confirmation of grants from government agencies is often ineffective
- Some NFPs are sensitive about sending confirmations as they believe it may offend donors



Before We Leave the Topic of Donor-Imposed Restrictions, Let's Discuss Auditing Net Assets and Changes Therein

- Since NFPs have a mission-focused operating purpose and an absence of business-entity ownership interests, they measure equity and changes in equity differently than for-profits
 - Instead of traditional for-profit equity accounts, the statement of financial position reports **net assets without donor restrictions**, **net assets with donor restrictions**, and **total net assets**
 - Instead of traditional for-profit net income, the statement of activities reports the changes in the two net asset classifications (including **reclassifications** between the classes) and total net assets
 - NFPs also have unique disclosure requirements related to the nature and amounts of different types of donor-imposed restrictions and board designations of net assets without donor restrictions



Since Net Assets Are a Residual (i.e., Equity) Balance and Closely Tied to Donor-Imposed Restrictions, They Can be Unique To Test

- As we discussed earlier, an NFP has a fiduciary responsibility to follow donor-imposed restrictions (including the tracking and monitoring of restrictions)
- Ideally, the NFP should be able to prepare a detailed roll-forward of net assets, segregated into the proper net asset classes, reflecting the following column headings
 - Net asset balances at the beginning of the period;
 - Net asset additions during the period;
 - Net asset reclassifications during the period;
 - Net asset reductions during the period; and
 - Net asset balances at the end of the period



Examples of Audit Procedures To Test an NFP's Reporting of Net Assets Include...

- Considering the NFP's controls over how it monitors restrictions and reclassifies net assets once restrictions have been fulfilled
- Determining compliance with restrictions (e.g., testing expenditures to determine that restricted net assets are used for their restricted purposes). Then, determining that appropriate reclassifications have been reported in the statement of activities
- When performing analytical procedures, looking for unusual trends in the net asset classifications
- Reviewing board minutes for discussions related to donor restrictions and board designations



Examples of Audit Procedures To Test an NFP's Reporting of Net Assets Include...

- Inquiring of NFP management and development personnel about compliance with donor restrictions. Also, making sure the NFP has a clear understanding of the difference between donor-imposed restrictions and internal designations
- Where GAAP allows options related to net asset presentation (e.g., FASB ASC 958-605-45 allows NFPs to report donor-restricted contributions whose restrictions are met in the same reporting period as support within net assets without donor restrictions) understanding the NFP's election and its compliance with the election it has chosen
- Obtaining and testing the disclosures related to net assets with donor restrictions and board-designated net assets without donor restrictions



Exercise 15

When an auditor considers an NFP's adherence with donor restrictions and reclassifications of net assets, **are there some restrictions that the auditor may be more concerned with than others or are all restrictions the same from an audit perspective?**



Solution to Exercise 15

Auditors will incorporate concepts such as materiality and the nature of the restrictions involved in considering an NFP's adherence with donor restrictions and reclassifications of net assets. For example, if an NFP reported the reclassification of \$250,000 related to a gift restricted for the expansion of a building, the auditor would want to look at expenditures to see whether expenditures satisfying the restriction actually occurred. However, if the NFP reported the reclassification of \$25,000 related to a gift restricted to support program X, and the NFP normally spends in excess of \$1,000,000 on program X, the auditor's testing of functional expenses may provide substantial support for the NFP's reclassification

Section 7

Additional Issues Related to Contributions



Section 7 – Additional Issues Related to Contributions

- Our objectives for this section are to understand issues related to:
 - Agency transactions;
 - Contributed services; and
 - Contributed collection items



Staying Mindful of Agency Transactions

- Some NFPs may be parties to agency transactions which FASB ASC 958-720 defines as a type of exchange transaction in which the reporting entity acts as an agent, trustee, or intermediary for another party that may be a donor or donee
- FASB ASC 958-605-15-6 states that the guidance in FASB ASC 958-605 **related to contributions received does not apply** to transfers of assets in which the reporting entity acts as an agent, trustee, or intermediary, rather than as a donor or donee
- **Instead**, these transactions are addressed in the sections of FASB ASC 958-605 which address transfers of assets to a NFP or charitable trust that raises or holds contributions for others



Examples of Audit Procedures To Test an NFP's Identification of Agency Transactions Include...

- Review communications with donors and solicitation materials to see if a donor is specifying the beneficiary. FASB ASC 958-605-55-78 discusses that a donor may specify the beneficiary by
 - Name;
 - Stating that **all** entities that meet a set of donor-defined criteria are beneficiaries; or
 - Actions surrounding the transfer that make clear the identity of the beneficiary
- Review communications with donors and solicitation materials for the presence or absence of variance power (see FASB ASC 958-605-25-25)
- For transactions deemed to be agency transactions, determine whether the presentation is in alignment with FASB ASC 958-605



Contributions of Services

Checklist for recognizing contributed services

Contributions of services are recognized in the financial statements if the services received meet one or more of the following criteria:

- ☐ They create or enhance nonfinancial assets.
- ☐ They require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation. Services requiring specialized skills are provided by accountants, architects, carpenters, doctors, electricians, lawyers, nurses, plumbers, teachers, and other professionals and craftsmen.
- ☐ The services are provided by personnel of an affiliate that directly benefits the recipient NFP and the affiliate does not charge the recipient NFP. (**Note.** This is from ASU No. 2013-06.)



Examples of Audit Procedures To Test an NFP's Recording of Contributed Services Include...

- Obtaining an understanding of the NFP's controls and policies regarding
 - The types of contributed services that will be recognized in the f/s
 - The basis for valuing contributed services
 - The procedures for overseeing volunteers and recording the quantity and nature of the services provided
- Reviewing the documentation supporting recognition of contributed services for completeness and reasonableness of amounts recognized (e.g., documentation including the donors' names, positions, descriptions of services, hours worked, valuation, and programs benefited)



Examples of Audit Procedures To Test an NFP's Recording of Contributed Services Include...

- Inquiring of NFP management and development personnel about whether unrecorded volunteer services are occurring that should be recorded
- Reviewing the reasonableness of the NFP's support for contributed services that are not recognized but disclosed



Contributed Collection Items

- Contributions of works of art, historical treasures, and similar items that are not part of a collection are recognized as assets and as revenue or gains
- An NFP need not recognize contributions of works of art, historical treasures, and similar assets if the donated items are added to collections that meet all three of the criteria in the definition of a collection in FASB ASC 958
- Contributed collection items are recognized as revenues or gains if collections are capitalized and are not recognized as revenues or gains if collections are not capitalized



Examples of Audit Procedures To Test an NFP's Recording of Contributed Collection Items Include...

- Obtaining an understanding of the NFP's controls and policies over
 - The proper accession of contributed collection items
 - The proper valuation of capitalized contributed collection items
 - Compliance with donor restrictions
- Examining documentation supporting contributed collection items and potential related restrictions
- Reviewing board minutes for discussions of contributed collection items and authorized accessions of those items
- Reviewing the support and methodologies for the fair value determination of capitalized contributed collection items



Examples of Audit Procedures Related to Collections Beyond the Contribution Cycle Include...

- Obtaining an understanding of the controls and policies including
 - Controls ensuring that purchased collection items are authorized, contributed collection items are appropriately accessioned, and deaccessions are authorized
 - The proper valuation of collection items
 - Procedures for securing collections and periodically physically inspecting them
 - If applicable, determining that noncapitalized assets are collections
 - Monitoring compliance with restrictions
- Examining documentation supporting accessions and deaccessions of collection items
- Reviewing the support for current period purchases



Examples of Audit Procedures Related to Collections Beyond the Contribution Cycle Include...

- Reviewing board minutes for discussions of authorizations of major accessions and deaccessions
- Inquiring of curatorial personnel regarding deaccessioned collection items
- Testing the NFP's maintenance and control over collections
 - Reviewing the NFP's procedures for controlling collections and physically inspecting them
 - Considering whether to observe the physical inspection
 - Reviewing actions taken by management to investigate discrepancies disclosed by the physical inspection and to adjust the records



Examples of Audit Procedures Related to Collections Beyond the Contribution Cycle Include...

- For restricted collection items, reviewing collection item transactions for propriety of use and disposition
- Reviewing the proper presentation, valuation, and disclosure of collections, including considering the need for using a specialist
- Determining whether proceeds of sales of collection items are used for the acquisitions of new collection items, the direct care of existing collections, or both

Section 8

Special Issues Related to the Statement of Activities



Section 8 – Special Issues Related to the Statement of Activities

- Our objectives for this section are to understand several special issues related to the statement of activities including:
 - NFPs including a measure of operations;
 - Gross or net presentation of sales of gifts in kind;
 - Presentation of special events; and
 - Contributed items sold at fundraising events



Changes in Net Assets

- NFPs have operating purposes other than to provide goods or services at a profit, and resource providers do not focus primarily on profit as an indicator of an NFP's performance. Therefore, the combination of revenues, expenses, gains, and losses often is referred to as a change in net assets
- The statement of activities will report the change in net assets for each of the two net asset categories (i.e., without and with donor restrictions) and the change in total net assets



Possibly Including a Measure of Operations



Financial statement flexibility

Classifying revenues, expenses, gains, and losses within classes of net assets does not prevent incorporating additional classifications within a statement of activities. For example, within a class or classes of changes in net assets, an NFP may classify items as: (1) operating and nonoperating; (2) expendable and nonexpendable; (3) recurring and nonrecurring; and (4) in other ways.



A Few Key Requirements Related to Including a Measure of Operations



Since terms such as operating income, operating profit, operating surplus, operating deficit, and results of operations are used with different meanings, if an intermediate measure of operations (e.g., excess or deficit of operating revenues over expenses) is reported, it is required to be in a financial statement that, at a minimum, reports the change in net assets without donor restrictions for the period.



If an NFP's use of the term **operations** is not apparent from the details provided on the face of the statement, a note to the financial statements is required to describe the nature of the reported measure of operations or the items excluded from operations.



Examples of Audit Procedures Relating to NFPs Presenting an Operating Measure in the Statement of Activities Include...

- Determining whether the presentation of revenue and expense transactions is properly classified as operating or nonoperating within the NFP's definition of its operating measure
- Determining that nonoperating expenses are also included in the functional expense allocations
- Considering whether the note disclosures regarding the operating measure are complete and accurate



Gross or Net Presentation of Sales of Gifts in Kind

- Sales of contributed inventory or other gifts in kind should be reported **gross** if the sales are part of an entity's **ongoing major or central** operations and activities [i.e., the sales are reported separately from (and therefore in addition to) the initial recording of the contribution of that inventory or other gifts in kind, with a corresponding cost of sales]
 - e.g., items contributed to an NFP and subsequently sold in its thrift shops
- For sales of contributed inventory or other gifts in kind that result from **incidental or peripheral** transactions, either **gross** or **net** reporting is permitted
 - e.g., an NFP that does not have a vehicle donation program receives a contributed Honda Civic with 200,000 miles on it from a donor and sells it
- As we will discuss later, **special rules apply to contributed items to be sold at fundraising events** (FASB ASC 958-605-25-20)



How Do We Know if Something Is Ongoing Major or Central or Incidental or Peripheral?

- FASB ASC 958-220-45-18 is a key source of guidance in this area
- Events are **ongoing major and central** activities if they are normally part of an NFP's strategy and it normally carries on such activities **or** if the event's gross revenues or expenses are significant in relation to the NFP's annual budget
 - e.g., the Paint by Number Art Museum has a gift shop with significant activity
- Events are **incidental or peripheral** if they are not an integral part of an NFP's usual activities **or** if their gross revenues or expenses are not significant in relation to the NFP's annual budget
 - e.g., 100th Baptist Church occasionally produces and sells a cookbook that is an insignificant activity



Special Events

- FASB ASC 958-220-45-19 discusses **gross** versus **net** reporting for special events (e.g., golf tournaments, dinners, dances, etc.). Much of this guidance builds upon the concepts discussed in the prior slide
- For special events that are **ongoing major** activities, an NFP will report the **gross** revenues and expenses of those activities
 - FASB ASC 958-220-55-11 provides three possible methods of displaying an ongoing major special event
 - FASB ASC 958-220-55-12 discusses that if the activity is not a qualifying joint activity that all costs of the activity, other than the direct donor benefits, are reported as fundraising
- For special events that are **incidental or peripheral** transactions, an NFP may report **net** amounts
 - Costs netted against receipts are limited to direct costs



Exercise 16

NFP X is planning to hold an “I Love Tennis” outdoor tennis tournament at a Wisconsin country club. The tournament is to be held on February 14, 20X1 and NFP X has a calendar year-end. In fall 20X0, NFP X begins selling tickets to the tournament at \$150 per player. The direct donor benefits of the event (i.e., the fair value of being able to play at the club and the lunch provided) are \$50 per player. NFP X is unsure what it will do if the event is snowed out, but believes that the event will be significant in relation to its annual budget. At year-end, NFP X had sold 100 tickets to the event and incurred \$2,000 in promoting the event.

How should NFP X report the \$15,000 in ticket sales and \$2,000 in promotional costs at December 31, 20X0?



Solution to Exercise 16

Of the \$15,000 in ticket sales received by year-end, \$10,000 related to contributions and \$5,000 related to exchange transactions (i.e., the fair value of the direct donor benefits). NFP X would consider the \$10,000 to be a conditional contribution (as it appears conditioned on the event occurring and there is no indication that donors have explicitly waived the condition) and therefore would be reported as a refundable advance. The \$5,000 exchange transaction piece would be deferred revenue. The \$2,000 in promotional costs would be reflected in fundraising expense at year-end (see FASB ASC 958-720-25-4)



Special Rules Apply to Contributed Items To Be Sold at Fundraising Events

- FASB ASC 958-605-25-20 provides special rules for the treatment of contributed items to be sold at fundraising events (e.g., tickets, gift certificates, works of art, and merchandise)
- These types of gifts are reported as contributions and measured at fair value when originally received by an NFP (e.g., an asset and contribution revenue)
- When the item is sold at the fundraising event, the contribution revenue that was recognized when the gift was originally received is adjusted up or down based on the result of the sale
 - Said another way, the NFP links the two transactions (i.e., the original receipt of the gift and the gift's disposition at the event) together



Examples of Audit Procedures Related to Special Events Include...

- Determine that the NFP has properly bifurcated transactions that have both exchange and contribution elements
- Evaluate special event revenue for timing and revenue recognition issues
- Evaluate the NFP's determination of gross versus net presentation

Section 9

Functional Expenses



Section 9 – Functional Expenses

- Our objectives for this section are to understand:
 - Key concepts related to functional expenses; and
 - Common audit procedures utilized to test an NFP's functional expense allocation



Functional Expenses

- FASB ASC 958-720-45-2 requires that a statement of activities or the notes provide information about expenses reported by their functional expense classification, such as major classes of **program services** and **supporting activities**
- The number of functional reporting classifications for **program services** varies according to the nature of the NFP and the services it renders (i.e., NFPs have latitude in defining their major programs)
 - A large university may have programs for student instruction, research, and patient care, among others
 - A health and welfare entity may have programs for health or family services, research, disaster relief, and public education, among others
- **Supporting activities** are all activities other than program services. For example,
 - Management and general;
 - Fundraising; and perhaps
 - Membership development



Activities That Make Up Program Services and Supporting Activities

Program Services	Supporting Activities		
	Management and General	Fundraising	Membership Development
Activities that result in goods and services being distributed to beneficiaries, members, or customers that fulfill the purposes or mission for which the NFP exists.	Activities that are not directly identifiable with one or more program, fundraising, or membership development activities.	Activities undertaken to induce potential donors to contribute money, securities, services, materials, facilities, other assets, or time.	Include soliciting for prospective members and membership dues, membership relations, and similar activities.

Note. If there are no significant benefits or duties connected with membership, the substance of membership development activities may, in fact, be fundraising, and reported as such



Getting From Natural Expenses to Functional Expenses Involves...

- Getting from natural expenses to functional expenses involves
 - Where natural expenses can be specifically identified with a program or supporting service assigning those expenses directly to that function; and
 - Where natural expenses cannot be specifically identified with a program or supporting service reasonably allocating the natural expenses among the applicable functions
- Special rules (found in FASB ASC 958-720) apply for reporting the costs of activities that are part of the fundraising function and also have elements of one or more other functions (i.e., joint activities)
- FASB ASC 958-720 requires NFPs to provide a description of the methods used to allocate costs among program and support functions



What Are NFPs Doing?

- Natural to functional expense allocations vary from one NFP to another. There are several reasonable allocation approaches that may make sense, **and** NFPs will have different allocation methodologies depending on the expenses in question
- In 100 audited NFP financial statements the author reviewed for another course, the author noted the following: (1) in many cases it was difficult to determine the specific allocation methodologies utilized as the footnotes were written very broadly; (2) approximately 60% of NFPs specifically discussed using time and effort studies as a basis for allocating costs; (3) approximately 50% of NFPs specifically discussed using square footage as a basis for allocating costs; and (4) approximately 15% of NFPs specifically discussed using headcount as a basis for allocating costs
- The author also noted that: (1) a few NFPs mentioned allocating interest expense based on the functional categories that benefited from the proceeds of a debt issuance; and (2) a few NFPs mentioned allocating information technology costs based on the number of machines



Examples of Audit Procedures To Test an NFP's Functional Expense Allocation Include...

- Obtaining an understanding of the functional expense allocation methodology and the controls over it
- Reviewing the NFP's methodology for allocating payroll and related costs to the functional classifications
- Verifying the reasonableness and consistent application of the allocation methodology
- If meaningful changes have occurred at the NFP (e.g., new construction is completed, new debt is issued, a significant program is added/deleted) verifying that the NFP has updated its allocation methodology
- Testing the NFP's allocation of costs to the various functional categories (e.g., selecting a sample and determining if the expenses have been properly allocated)



Examples of Audit Procedures To Test an NFP's Functional Expense Allocation Include...

- Performing an analytical review of functional classifications by comparing current period expenses in total and by functional classification with expectations (which could be based on prior-period expenses, budget, or other factors)
- Verifying that the NFP's presentation of program services and supporting activities expenses is proper, consistent, and includes the appropriate costs
- Verifying the proper reporting of fundraising expenses has occurred (e.g., fundraising costs have been expensed as incurred, joint activities have been analyzed and reported following FASB ASC 958-720, etc.)



Exercise 17

Save the Sunsets lacks the background and staffing to conduct a fundraising campaign, so it enters into a transaction with Fundraising NFP X. Fundraising NFP X solicits contributions on behalf of Save the Sunsets for a fee of 20% of the contributions raised. Fundraising NFP X raises \$500,000 from donors and remits \$400,000 to Save the Sunsets after retaining its fee of \$100,000. **Should Save the Sunsets report contribution revenue of \$500,000 or \$400,000?**



Solution to Exercise 17

Save the Sunsets should report \$500,000 of contribution revenue and \$100,000 of fundraising expense. In this transaction, Fundraising NFP X is the recipient entity (agent) and Save the Sunsets is the specified beneficiary. This is basically a gross versus net reporting concept and generally we should go gross unless GAAP allows us to go net. **Note.** More thoughts related to this specific example can be found in the AICPA Technical Questions and Answers 6140.21 and 6140.22

Section 10

Yellow Book Audits of NFPs



Section 10 – Yellow Book Audits of NFPs

- Our objective for this section is to discuss when NFPs are required to have Yellow Book audits and key aspects of what those audits entail

(Note. We will focus our discussion on Yellow Book financial statement audits as those engagements are the most common application of the Yellow Book to NFPs)



When Are NFPs Required To Have a Yellow Book Audit?

- Unlike the single audit requirements, the Yellow Book itself does not specify which entities must have Yellow Book audits. Rather, it is something external to the Yellow Book that requires its application. NFPs may be required to have a Yellow Book audit due to laws, regulations, contracts, grant agreements, and policies
- Some examples of laws, regulations, and other authoritative sources that require the use of the Yellow Book include
 - The Single Audit Act Amendments of 1996 and the Uniform Guidance for Federal Awards
 - State and local laws and regulations
 - Grant agreements or contracts
 - Federal audit guidelines pertaining to program requirements



What Is a Yellow Book Financial Statement Audit?

- The primary purpose of a Yellow Book financial statement audit is to provide an opinion about whether an entity's financial statements are presented fairly, in all material respects, in conformity with an applicable financial reporting framework
 - Auditors are certainly accustomed to doing this in a GAAS audit and the Yellow Book incorporates the GAAS requirements by reference (i.e., in a Yellow Book audit we do everything GAAS requires us to do **plus** what the Yellow Book adds)
- Reporting on a Yellow Book financial statement audit **also** includes **reporting on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and grant agreements that have a material effect on the financial statements**
 - While the auditor will be reporting on internal control over financial reporting and compliance they will not be opining on those matters



A Few Key Points About Yellow Book Audits

- The Yellow Book adds **nine additional areas of performance requirements** to GAAS. For example,
 - The Yellow Book extends the AICPA requirements in AU-C section 250 (concerning consideration of noncompliance with laws and regulations) to also include consideration of noncompliance with provisions of contracts and grant agreements
 - The Yellow Book describes a finding as being: (1) a deficiency in internal control; (2) noncompliance with provisions of laws, regulations, contracts, or grant agreements; or (3) instances of fraud
 - The Yellow Book describes findings as consisting of four elements that the audit will develop: **criteria, condition, cause, and effect/potential effect**



A Few Key Points About Yellow Book Audits

- The Yellow Book adds **seven additional areas of reporting requirements** to GAAS. For example,
 - Auditors are required to **report on internal control and compliance with provisions of laws, regulations, contracts, or grant agreements** regardless of whether they identify internal control deficiencies or instances of noncompliance
 - The Yellow Book requires auditors to **report** as findings: (1) any **significant deficiencies** or **material weaknesses**; (2) **material noncompliance**; and (3) **material fraud**
 - For each finding, the auditor will report the **four elements of a finding** plus **recommendations for corrective action** and the **views of responsible officials**



A Few Key Points About Yellow Book Audits

- The Yellow Book contains a robust set of requirements related to auditor **independence**. While principles-based, the Yellow Book independence requirements are also very specific in certain areas
 - For example, the Yellow Book specifies that preparing financial statements in their entirety from a client-provided trial balance or underlying accounting records creates significant threats to auditors' independence, and auditors are required to document the threats and safeguards applied to eliminate and reduce threats to an acceptable level in accordance with the Yellow Book conceptual framework or decline to provide the services
 - When performing nonaudit services for an NFP, auditors are required to document consideration of management's ability to effectively oversee nonaudit services to be provided [i.e., the presence of suitable skill, knowledge, or experience (SKE)]



Exercise 18

NFP X is required to have a Yellow Book audit and has also asked the auditor to prepare the financial statements. The auditor believes NFP X has someone with SKE to oversee the nonaudit service. **What should the auditor do?**



Solution to Exercise 18

- The auditor should be fine to prepare the financial statements and perform the audit. The auditor would
 - Document the understanding with the client regarding the nonaudit service;
 - Document the client's SKE;
 - Document the significant risk of preparing the financial statements; and
 - Document the safeguard applied to reduce the self-review threat to an acceptable level (e.g., not including individuals who prepared the financial statements as audit team members; **or**, if the audit team prepared the financial statements, having an auditor who was not a member of the audit team review the work performed)



Exercise 19

NFP Y is required to have a Yellow Book audit and has also asked the auditor to prepare the financial statements. In the prior year, the auditor found that [1] many audit adjustments were needed for accruals and journal entries that were not recorded; [2] numerous significant deficiencies and material weaknesses were reported related to the accounting system, which do not appear to have been addressed; and [3] the finance director (who was responsible for overseeing the nonaudit services provided) performed an extremely hasty review of the financial statements (e.g., a disclosure checklist provided by the auditor was largely uncompleted/erroneously completed) and had no questions or comments. **What should the auditor do?**



Solution to Exercise 19

- In this situation, before considering anything else, the auditor would have to question whether the finance director really has SKE or is simply unwilling to exercise the SKE he/she has
 - SKE must be present for the auditor to perform the nonaudit service and the audit
- If the auditor cannot get comfortable that the client has someone with SKE who will oversee the nonaudit service, either
 - The auditor would need to decline to perform the audit; **or**
 - NFP Y would need to engage someone else to prepare the financial statements for the auditor to audit



Exercise 20

NFP Z is required to have a Yellow Book audit and has also asked the auditor to assist with preparing some account reconciliations and financial statement line items. **What should the auditor do?**



Solution to Exercise 20

- The auditor would apply all the normal Yellow Book independence requirements that we have mentioned (e.g., documenting the understanding to perform the service, documenting the presence of SKE at NFP Z, etc.)
- The Yellow Book discusses that when providing other services related to preparing accounting records and financial statements (i.e., services short of preparing the financial statements in their entirety) the auditor will evaluate the significance of the threats created and **document the evaluation**
 - If the auditor determines a significant threat exists, the auditor will document the safeguard applied



A Few Key Points About Yellow Book Audits

- The Yellow Book contains both a **24-hour CPE requirement** and a **56-hour CPE requirement** which are obtained over a two-year period
- With very limited exceptions,
 - the **24-hour CPE requirement** applies to **all auditors doing Yellow Book work**
 - the **56-hour CPE requirement** is **added** for
 - those involved in planning, directing, or reporting; **or**
 - staff which charge at least 20 percent of their time annually to Yellow Book engagements
- Examples of topics which qualify towards the 24-hour CPE requirement would be NFP accounting and reporting, governmental accounting and reporting, the Yellow Book, single auditing, HUD, GAAS, fraud in NFPs and governments
- Courses which qualify towards the 56-hour CPE requirement are much broader but exclude certain topics like individual taxation

Section 11

Single Audits of NFPs



Section 11 – Single Audits of NFPs

- Our objective for this section is to discuss when NFPs are required to have single audits and key aspects of what those audits entail



When Are NFPs Required To Have a Single Audit?

- NFPs may be required to have a single audit. A single audit is an audit performed under the requirements of the Uniform Guidance for Federal Awards
 - In limited circumstances, entities required to have a single audit may have a program-specific audit (which is essentially a single audit of one program)
- In 2025, a change in the single audit threshold occurred
 - For auditee fiscal years beginning prior to 10/1/24, NFPs that expended \$750,000 or more in a year in federal awards were required to have a single audit
 - For auditee fiscal years beginning on or after 10/1/24 (i.e., 9/30/25 year ends), NFPs that expend \$1,000,000 or more in a year in federal awards are required to have a single audit
- Single audits add a level of requirements and responsibilities to those found in GAAS and the Yellow Book



What Is a Single Audit?

- A single audit essentially takes a Yellow Book financial statement audit and **adds a compliance audit component**. The compliance audit component includes the auditor determining the major programs (following strict rules in the Uniform Guidance for Federal Awards) and
 - Testing and reporting on the NFP's internal controls over compliance for each major program [this does not involve opining on controls but does involve effectiveness testing of controls (with very limited exceptions)]
 - Testing and opining on the NFP's compliance with the direct and material compliance requirements for each major program
- As can be inferred from the above, the term **single audit** can be a bit of a misnomer as it really entails two audits (i.e., a financial statement audit plus a compliance audit)
 - The use of the word **single** refers to a single once-a-year audit of the entity's federal awards instead of having multiple audits of its various federal awards each year



In a Single Audit, the NFP Is Responsible for...

- Identifying, in its accounts, all federal awards received and expended and the federal programs under which they were received. Federal program and award identification will include, as applicable, the
 - Assistance Listing title and number;
 - Award number and year;
 - Name of the federal agency; and
 - Name of the pass-through entity and the identifying award number assigned by the pass-through entity
- Establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with federal statutes, regulations, and the terms and conditions of federal awards that could have a material effect on each of its federal programs



In a Single Audit, the NFP Is Responsible for...

- Complying with federal statutes, regulations, and the terms and conditions of federal awards related to each of its federal programs
- Preparing the financial statements and the Schedule of Expenditures of Federal Awards (SEFA)
- Ensuring that the single audit is properly performed and submitted when due
- Following up and taking corrective action on audit findings, including preparing a summary schedule of prior audit findings and a corrective action plan



In a Single Audit, the Auditor Is Responsible for...

- **Performing a Yellow Book audit of the entity's financial statements and reporting on the SEFA.** This includes
 - Providing a GAAS and Yellow Book audit opinion on the financial statements;
 - Providing an AU-C section 725 "in relation to" opinion on the SEFA; and
 - The Yellow Book reporting (but not opining) on internal control and compliance at the financial statement level
- **Performing a compliance audit of federal awards.** This includes
 - Determining major programs
 - Performing additional procedures and reporting (but not opining) on internal controls over compliance at the major program level
 - Providing an opinion on compliance for each major program
 - Preparing a Schedule of Findings and Questioned Costs



In a Single Audit, the Auditor Is Responsible for...

- **Following up on prior audit findings.** This includes
 - Performing procedures to assess the reasonableness of the Summary Schedule of Prior Audit Findings prepared by the auditee; and
 - Reporting, as a current year audit finding, when the auditor concludes that the Summary Schedule of Prior Audit Findings materially misrepresents the status of any prior audit finding
- **Assisting in the audit submission process including the data collection form**

Thank you!
