

Audits 101

A primer for nonprofits

The word “audit” can strike fear into the heart of any person or nonprofit, particularly in today’s post-Sarbanes-Oxley compliance environment. But the audit process is essential for nonprofits of all stripes because the information you and your management team, your board of directors, and your finance committee receive during the planning and financial reporting phases serves to clarify and enhance your understanding of the organization’s overall health.

So if you don’t know the difference between an internal audit, external audit and an audit committee, it may be time to enroll in Nonprofit Audits 101.

Know the language

Let’s begin with the basics by briefly defining the two types of audits and explaining the job of an audit committee:

Internal audit. This type of audit is a function of your board’s fiduciary responsibility to the organization. What makes it an “internal” audit is that it’s performed by an “insider,” such as a staff member, not someone who’s independent and without any ties to your organization. The audit examines whether your policies and processes related to financial matters meet your standards and those of outside agencies.

An internal audit may look at how your nonprofit’s accounting and financial policies line up with Generally Accepted Accounting Principles (GAAP) and applicable state and federal laws. It also may review the accuracy of financial information and how efficiently your organization handles money matters.

Another aspect of the internal audit may be to examine your organization’s internal controls efficiency and compliance — for example, requiring two signatures on checks over a certain amount and having an inventory-tracking process.

External audit. A person outside of your nonprofit who is independent of the board and staff conducts this type of audit. An external audit is a completely separate function from an internal audit.

In an external audit, a CPA reviews your organization’s financial statements and issues an opinion on whether those statements offer a fair picture of your finances and whether they adhere to GAAP. Financial statements an auditor may review include your balance sheet, income statement and statement of cash flows.

Be sure to choose your auditor wisely. An external audit needs to be completed by someone who is independent of your nonprofit. That means not turning to a board member's spouse who happens to be a CPA. Choose a CPA with no ties to your organization.

A 2004 survey by BoardSource indicated that 85% of responding nonprofits hire an outside auditor to conduct an external audit once a year. Your state charity regulator may even require an outside audit.

Audit committee. This is a group of financially knowledgeable people who provide oversight of your organization's financial reporting and internal controls. Board members, as well as other volunteers, may serve on the audit committee. Depending on the size and complexity of the nonprofit, an audit committee generally has three to five members. Some states, however, mandate who can serve on an audit committee.

An important role of audit committee members is to maintain open communication with internal and external auditors to discuss audit processes and results, and to resolve any issues that are identified. The keys to a successful audit committee are its independence and its ability to bring financial expertise specifically related to not-for-profits to the table.

Be prepared

What's true for the Boy Scouts also is true for nonprofits undergoing an internal or external audit: Being prepared makes all the difference.

An external auditor will want to see detailed documentation related to your organization's operations, such as:

- Bank correspondence, including statements, reconciliations, deposit slips and canceled checks,
- Accounts receivable and payable,
- Fixed assets, such as property and equipment,
- Leases and other contracts,
- Loans and mortgages,
- The current year's budget,
- Payroll records, including Forms 941, W-2 and W-3,
- Grants and contributions, including restrictions on their use,
- Your accounting system,
- Donated services and materials,
- Special events and benefits,
- Inventory, including sales records, and
- Minutes from board meetings.

The auditor will review your records and ask questions. In some cases, you'll need to make copies of documents; in others, you'll just need to provide access. Talk with your auditor for a detailed list of what he or she will need to review.

The auditor also will want to question board or staff members about your internal controls. Among the issues likely to be reviewed are how money and other resources are received and spent, what you do to comply with applicable laws, and how financial transactions are recorded.

Ideally, you'll prepare all year for an external audit by maintaining a file of appropriate paperwork and talking with your auditor as questions arise about how to deal with certain situations, such as launching a program to sell items to raise funds or accepting a large grant. This ongoing approach can make the annual audit smoother and faster.

Make the grade

Internal and external audits can take some effort to complete. However, internal audits provide increased assurance that your nonprofit is operating with integrity and within recognized guidelines. External audits provide an independent review of your financial statements and adherence to GAAP. Both are important elements of good governance.