

100 Introduction

What Is a Nonprofit Organization?

100.1 Nonprofit organizations range in size from small local entities to large international organizations. They encompass almost every activity imaginable—health and welfare, religion, education, research, social activities, and professional activities. But what exactly is a nonprofit organization?

100.2 In FASB ASC 958-10-20, the Financial Accounting Standards Board (FASB) defines nonprofit organizations by contrasting them to for-profit entities. Specifically, it defines a *not-for-profit entity* as an entity that possesses the following characteristics not typically found in business enterprises:

- a. They receive contributions of significant resources from resource providers who do not expect a commensurate or proportionate monetary return.

- b. They operate for purposes other than to make a profit.

- c. There is an absence of ownership interests like those of business enterprises.

100.3 In some cases, it may be difficult to determine whether an entity is a nonprofit organization since nonprofit organizations may have the preceding characteristics in varying degrees. (For example, an organization may receive significant revenue from exchange transactions rather than contributions but still meet the nonprofit definition.) In other cases, it is fairly obvious that an entity does not have the characteristics of a nonprofit organization. For example, nonprofit organizations do not include investor-owned enterprises and entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members, or participants, such as mutual insurance companies, credit unions, farm and rural electric cooperatives, and employee benefit plans.

100.4 To help clarify what a nonprofit organization is for GAAP purposes, FASB ASC 958-10-15-3 notes that nonprofit entities include the following:

- Cemetery organizations.

- Civic and community organizations.
- Colleges and universities.
- Elementary and secondary schools.
- Federated fund-raising organizations.
- Fraternal organizations.
- Health care entities.¹
- Labor unions.
- Libraries.
- Museums.
- Other cultural organizations.
- Performing arts organizations.
- Political parties.
- Political action committees.
- Private and community foundations.

- Professional associations.
- Public broadcasting stations.
- Religious organizations.
- Research and scientific organizations.
- Social and country clubs.
- Trade associations.
- Voluntary health and welfare organizations.
- Zoological and botanical societies.

100.5 IRS Definition

The Internal Revenue Service (IRS) defines a *tax-exempt organization* as an organization exempt from income taxes, primarily under Section 501 of the Internal Revenue Code (IRC). Section 501 includes specified types of exempt organizations, such as charitable, religious, and educational institutions; civic leagues; social clubs; etc. Most nonprofit organizations must apply for and receive recognition of tax-exempt status from the IRS. Churches, however, do not need to apply for tax-exempt status, but automatically qualify under IRC Section 501(c)(3).² Often, the only attribute shared by nonprofit organizations is their tax-exempt status.

Types of Nonprofit Organizations

100.6 IRS Classification

There are more than 25 categories of tax-exempt organizations classified under Section 501(c) of the Internal Revenue Code as well as additional types of organizations under other sections of the Code. Some of the major IRC Section 501(c) classifications include the following:

- *501(c)(3)*—Organizations that are religious, educational, charitable, scientific, or literary, or that test for public safety or foster national or international amateur sports competitions, or organizations for the prevention of cruelty to children or animals.
- *501(c)(4)*—Civic leagues, social welfare organizations, and local associations of employees, whose activities include promotion of community welfare along charitable, educational, or recreational lines.
- *501(c)(5)*—Labor, agriculture, and horticultural organizations, whose activities are educational or instructive, with the purpose of improving conditions of work or improving products and efficiency.
- *501(c)(6)*—Business leagues, chambers of commerce, real estate boards, etc., not organized for profit and whose activities are intended to improve business conditions of one or more lines of business.
- *501(c)(7)*—Social and recreation clubs, the purpose of whose activities are pleasure, recreation, and social.

100.7 FASB Classification

Although the IRC classifies exempt organizations by type of activity, SFAC No. 4, Paragraph 7, footnote 3, classifies nonprofit organizations in the following two categories by source of financial resources:

- *Type A*—A nonprofit organization whose financial resources are obtained entirely, or almost entirely, from revenues from the sale of goods and services. Type A organizations are essentially self-sustaining. Some private schools would be examples of Type A organizations.
- *Type B*—A nonprofit organization that obtains a significant amount of financial resources from sources other than the sale of goods and services. Type B organizations include most human service organizations (charities), churches, foundations, libraries, and other organizations whose major resources are private donations or public (governmental) support.

These general classifications are flexible. Many Type A nonprofit organizations need and receive public and private support, and many Type B organizations expand into sales of goods and services to supplement private and public support.

Voluntary Health and Welfare Entities

100.8 FASB ASC 958 Definition

FASB ASC 958, *Not-for-Profit Entities*, differentiates between voluntary health and welfare entities and other nonprofit entities. (For example, only voluntary health and welfare entities are required to present a statement of functional expenses as a basic financial statement.) Thus, it is important for the auditor to decide whether an entity is a voluntary health and welfare entity or another type of nonprofit organization. Sometimes the distinction may not be obvious, and the auditor will need to decide whether the organization meets the following definition of a *voluntary health and welfare entity* included in the FASB ASC Master Glossary:

A not-for-profit entity (NFP) that is formed for the purpose of performing voluntary services for various segments of society and that is tax-exempt (organized for the benefit of the public), supported by the public, and operated on a not-for-profit basis. Most voluntary health and welfare entities concentrate their efforts and expend their resources in an attempt to solve health and welfare problems of our society and, in many cases, those of specific individuals. As a group, voluntary health and welfare entities include those NFPs that derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes connected with health, welfare, or community services. For purposes of this definition, the general public excludes governmental entities when determining whether a NFP is a voluntary health and welfare entity.

100.9 **Nonauthoritative Guidance in the Black Book**

More guidance on the definition of a voluntary health and welfare organization is given in a book titled *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, Fourth Edition, 1998.³ The Black Book includes the same definition of a voluntary health and welfare organization that is discussed in paragraph 100.8. Pages 4-6 of the Black Book expand on the definition and note that voluntary contributions from the general public include direct gifts from board members, private foundations, or corporations, as well as allocations of contributions that federated fund-raising organizations or affiliated organizations receive from the general public. In addition, the Black Book states that membership in, or affiliation with, the National Health Council, Inc., the National Human Services Assembly, or the United Way of America is usually an indicator that an organization is a voluntary health and welfare organization. The objective of the Black Book is to attain uniform accounting and external financial reporting in compliance with generally accepted accounting principles by all voluntary health and welfare organizations. The Black Book *does not establish GAAP* but rather gives additional explanations of existing authoritative literature and illustrations particularly relevant to voluntary health and welfare organizations.

100.10 **Example Voluntary Health and Welfare Organizations**

Examples of voluntary health and welfare organizations include the following:

- Salvation Army.

- Red Cross.

- CARE.

- Goodwill Industries (local chapters—see paragraph 100.12).

- United Way.

- Boy Scouts.

- Girl Scouts.

- Boys & Girls Clubs.

- Girls Inc. (local chapters—see paragraph 100.12).

- Nonprofit organizations whose purpose is to find a cure for or help people who have diseases such as cancer, diabetes, heart disease, or muscular dystrophy.

100.11 Other Organizations Concentrating on Health, Welfare, or Community Services

Some nonprofit organizations that concentrate on health, welfare, or community services may obtain revenue primarily from client fees, governmental support, or other revenue sources rather than contributions from the general public. Since those organizations do not receive their support primarily from voluntary contributions from the general public, as defined in the FASB ASC Master Glossary, it is not clear whether they should be considered voluntary health and welfare organizations. The primary difference between voluntary health and welfare organizations and other nonprofit organizations is the requirement that voluntary health and welfare organizations include a statement of functional expenses as a basic financial statement. Therefore, if it is difficult to determine whether a particular organization is a voluntary health and welfare organization, the authors recommend including a statement of functional expenses as a basic financial statement. The Black Book, Chapter 1, page 6, (see paragraph 100.9) also states that such nonprofit organizations should follow the requirements for voluntary health and welfare organizations. The information required to prepare that statement should be readily available because FASB ASC 958-720-05-4 requires all nonprofit organizations to provide information about expenses reported by their functional classification. Accordingly, any allocation of expenses, such as salaries or occupancy, to various programs and supporting services, which would be reflected on a statement of functional expenses, would have already been done.

100.12 Classification of National Headquarters May Differ

The authors understand that the national headquarters of some voluntary health and welfare organizations are classified as other nonprofit organizations while their local chapters, affiliates, or member associations are classified as voluntary health and welfare organizations. Some examples are the national organizations of Goodwill Industries, Girls Inc., and the YMCA. Probably, the reason for this practice is that the national organizations do not provide

program services directly to the public as do local chapters but are service organizations to member associations (local chapters), providing them with marketing, communications, public relations, and management services, including national purchasing, training of staff, instructors, etc. Also, the national organizations typically receive a large portion of their revenue from dues charged to the local chapters. Typically, the local chapters are independent, and the financial statements of the national organization do not include the statements of the local chapters. However, some organizations' national headquarters that are directly involved in program services, such as the American Red Cross, include the local chapters in their financial statements.

Governmental Nonprofit Organizations

100.13 The AICPA Audit and Accounting Guide, *Not-for-Profit Entities* (Audit Guide), only applies to *nongovernmental* nonprofit entities. The Audit Guide provides the following guidance on the characteristics of a governmental entity. Basically, all public corporations and bodies corporate and politic are governmental organizations. However, other organizations are also considered governmental organizations if they have any of the following characteristics:

- Officers of the organization are elected by popular vote.

- A controlling majority of the organization's officers are appointed by elected officials. (The elected officials do not have to be from the same state or local government.)

- A government could unilaterally dissolve the organization and retain the organization's remaining net assets.

- The organization can levy taxes. (That includes being able to enact and enforce the levy.)

Also, other organizations are presumed to be governmental if they can directly issue tax-exempt debt (not through a state or municipal authority). However, the organization may rebut that presumption if none of the other governmental characteristics apply and compelling evidence exists that it should not be considered governmental.

100.14 The Effect of GASB Statement No. 34 on Governmental Nonprofit Organizations

Upon applying the definition of a governmental organization discussed in paragraph 100.13, some entities may determine that they are actually governmental nonprofit organizations. In that situation, GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, addresses accounting for those entities. See *PPC's Guide to Preparing Governmental Financial Statements*. Visit ppc.thomsonreuters.com or call (800) 431-9025 for ordering information.

Nonprofit Organizations Covered and Not Covered by This Guide

100.15 This *Guide* provides guidance particularly applicable to audits of nonprofit organizations covered by the Audit Guide. (Paragraph 100.4 lists the types of organizations covered by the Audit Guide.) Thus, hospitals, governmental colleges and universities, employee benefit plans, cooperatives, state and local governments (including special units

of government such as school districts and other special districts), and governmental nonprofit organizations are among the entities not covered by this *Guide*. The AICPA publishes the following audit and accounting guides on nonbusiness enterprises not covered by this *Guide*:

- *Depository and Lending Institutions*.

- *Employee Benefit Plans*.

- *Health Care Entities*.

- *State and Local Governments*.

These guides can be ordered by calling the AICPA Order Department at (888) 777-7077 or from www.cpa2biz.com. Also, *PPC's Guide to Audits of Local Governments*, *PPC's Guide to Single Audits*, *PPC's Guide to Audits of Employee Benefit Plans*, *PPC's Practice Aids for Audits of 403(b) Plans*, *PPC's Guide to Homeowners' Associations and Other Common Interest Realty Associations*, *PPC's Guide to HUD Audits*, *PPC's Guide to Health Care Consulting*, and *PPC's Guide to Audits of Financial Institutions* can be ordered by calling (800) 431-9025 or from ppc.thomsonreuters.com.

¹ Health care entities are not covered by the AICPA Audit and Accounting Guide, *Not-for-Profit Entities* (Audit Guide); instead they are covered by a separate AICPA Audit and Accounting Guide titled *Health Care Entities*. This *Guide* also does not provide guidance for health care entities. The remainder of the nonprofit entities included at FASB ASC 958-10-15-3 are covered by the Audit Guide. See the discussion at paragraph 100.15.

² *PPC's Guide to Religious Organizations* contains detailed guidance on tax exemption of religious organizations. The *Guide* can be ordered online at ppc.thomsonreuters.com or by calling (800) 431-9025.

³ The Black Book has limited availability but is on the National Health Council's *Publication Order Form*. It continues to provide relevant guidance.

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101 Similarities between Nonprofit Organizations and Business Enterprises

101.1 Although, as described in paragraph 100.2, nonprofit organizations have several characteristics and types of transactions that distinguish them from business enterprises, they nevertheless have many similarities to business enterprises. SFAC No. 4, Paragraph 14, indicates the following similarities:

- Both business enterprises and nonprofit organizations, such as schools, hospitals, orchestras, and others, may engage in similar activities.
- Both business enterprises and nonprofit organizations use resources, and both may charge a price or fee for the goods or services they provide. Such nonprofit organizations' operations may be measured by some of the same yardsticks of cost and service that apply to business enterprises.
- Both may seek resources by responding to competitive bidding situations (often known as *requests for proposals*, or RFPs).
- Both business enterprises and nonprofit organizations have similar operating problems such as obtaining and managing the labor, materials, and facilities required for the production of goods and services.
- Both types of enterprises use purchasing systems and incur obligations to vendors, creditors, and employees.
- Both types of enterprises may be subject to taxation, since nonprofit organizations are subject to federal and state taxes on income that is not substantially related to their tax-exempt purpose. (This is known as *unrelated business income* and is discussed in section 1003.)

- Both types of organizations are subject to federal, state, and local regulations. For instance, a nonprofit day care center must comply with local, state, or federal licensing requirements. Nonprofit organizations must comply with IRS regulatory and reporting requirements even if they do not pay any tax, and many nonprofit organizations that raise money from the general public or acquire government grants may be required to meet state charities registration and reporting requirements.

- Finally, over the long run, all for-profit and nonprofit organizations must receive enough financial resources to continue providing satisfactory levels of goods or services. Thus, the going concern concept applies to nonprofit organizations as well as to business enterprises.

These similarities in operating environments have obvious audit implications. For example, if a nonprofit organization has a material amount of service fee revenue, the auditor will need to address concerns similar to those for sales revenue of a business enterprise, such as completeness of billings and recording in the proper period. As another example, the auditor will need to specifically evaluate whether he or she has a substantial doubt about a nonprofit organization's ability to continue as a going concern just as he or she must in the audit of a business enterprise. The audit implications of such similarities have been reflected in the audit programs and other practice aids in this *Guide*.

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102 Differences between Nonprofit Organizations and Business Enterprises

102 Differences between Nonprofit Organizations and Business Enterprises

102.1 Paragraph 100.2 lists distinguishing characteristics of nonbusiness enterprises, including nonprofit organizations. Those characteristics relating to a nonprofit motive and the sources of resources generate more specific differences between nonprofit organizations and business enterprises. This section discusses the following differences that auditors ought to understand because these differences have implications for the audit of nonprofit organizations.

- Differences in organizational goals.
- Differences in sources and uses of resources.
- Different measurement of performance.
- Personnel and management differences.
- Differences in accounting and control matters.
- Different constraints on activities.

Differences in Organizational Goals

102.2 As the name implies, nonprofit organizations do not exist to create a profit. This does not mean that they can operate in the long run with expenses in excess of revenues; they must maintain positive net assets to continue as a

going concern. However, rather than a profit motive, nonprofit organizations have as a primary goal the achievement of educational, charitable, scientific, or similar objectives. In other words, nonprofit organizations exist to engage in specific activities or provide specific services, often to specified groups or in specified areas of need, that profit-oriented entities might shun. As a result, charitable, public interest, and social improvement considerations generally motivate the activities and operating policies of most nonprofit organizations and their staff members to a significantly greater extent than these considerations would affect businesses and business owners or employees.

102.3 Once the basic goal, known in tax parlance as the *exempt purpose*, is established, the organization generally will have less latitude than business enterprises in setting other goals. This is not only because the IRC exempt purpose classification serves as a boundary, but also because funding sources that support the organization's basic goal may specify the activities in which the organization can engage to achieve the broad goal or establish restrictions on the use of their resources that effectively limit activities and goal setting. The organization's own articles of incorporation may narrowly circumscribe the organization's goals in recognition of these realities.

Differences in Sources and Uses of Resources

102.4 The different ways in which nonprofit organizations receive some or all of their resources probably have the most significant impact on nonprofit organizations, including how they may use and account for their resources and, thus, the nature of audits. Generally, nonprofit organizations can obtain resources needed for operations in five ways. They can:

- a. receive grants from public or private sources;

- b. be paid for providing goods or services, either directly by the recipient or by a third party;

- c. receive support from their members (if they are a membership organization);

- d. solicit and receive contributions of funds and other resources from the general public; or

- e. receive revenue from investments.

The nature of these sources of resources results in greater restrictions on the expenditure of funds, uses of physical assets, and permissible activities of personnel of nonprofit organizations than is typical for business enterprises. This is because the use of governmental grants is tightly controlled by legislation and regulation and even private foundations, corporations, or individuals who provide resources often attach significant restrictions on their use. In addition, as discussed at paragraph 102.31, a growing number of states regulate fund-raising activities and require regular reports. In addition, some states also place restrictions on expenditures, mergers and combinations. Only when a nonprofit organization receives support from private sources or earns money with no restrictions on its use does the organization begin to approach the level of flexibility and discretion with respect to resource use that business enterprises enjoy. (Even then, certain IRS regulations limit how a nonprofit organization may use its

unrestricted funds and maintain its tax-exempt status.) The nature of each basic source of resources is discussed in the following paragraphs.

102.5 Grants

Grants are awards of money provided by government agencies, foundations, corporations, federated fund-raising agencies, such as the United Way, or individuals. Grants are usually sought by nonprofit organizations on a competitive basis by submitting proposals and budgets to funding sources, which then select the proposals to fund. Authorized representatives of nonprofit organizations usually must sign a grant award agreement (including a detailed budget) to receive grant funds. The grant award agreement then assumes the status of a contractual agreement between the recipient organization and the funding source. The grant agreement usually specifies the degree of flexibility the organization has to make unilateral financial and program changes and whether financial or program changes must have the approval (usually written and usually in advance) of the funding source. It also may identify certain goals or results to be achieved by the organization in carrying out the programs or activities funded by the grant. Some grants are considered exchange transactions, while others may be contributions. Grant funds that are contributions are categorized as either restricted (to be spent for specified programs, activities, or cost categories) or unrestricted (to be spent at the organization's discretion), with restricted or unrestricted status usually determined by the grant award agreement. Grant award agreements may specify or refer to audit requirements to be followed, and they are one source of information to be consulted by the auditor in determining the scope of the audit.

102.6 Payment for Providing Goods or Services

Nonprofit organizations can be paid for providing goods or services, and such payments usually take one of two forms. One form is fees from private individuals for goods or services they receive or will receive; for example, service fees billed directly to service recipients such as tuition billed to school students or sales revenue charged for the sale of publications. A second common form is reimbursement by third parties (such as insurance companies, governmental units, or others) for goods or services the organization provides to others. Third-party reimbursement is almost always limited to payment after the specified goods or services have been provided to eligible recipients and the nonprofit organization has filed required reports or reimbursement requests. Third-party reimbursement is usually carried out under a contract or written guidelines that may include audit requirements. In any event, contracts or guidelines under which nonprofit organizations receive payments from third parties for goods and services are an important source of information for the auditor in setting audit scope and as evidential matter about the accounting for the arrangement.

102.7 Payments for goods and services are usually considered unrestricted resources that the nonprofit organization can use as it chooses unless the organization has publicly stipulated that such payments will be used for one or more specific purposes or activities. In most cases, once third-party reimbursement has been made (assuming all contractual requirements are met), the organization is usually free to use the amounts however it chooses unless otherwise specified in a contract or agreement with the third party. Under the Internal Revenue Code, payments to a nonprofit organization for goods and services considered to be substantially related to the organization's exempt purpose (*related business income*) may be free from taxation. Conversely, payments for goods and services *not* considered to be substantially related to the organization's exempt purpose (*unrelated business income*) may be subject to taxation if certain other criteria are met. (See section 1003.)

102.8 Support from Members

Nonprofit organizations that define themselves in their incorporation papers or bylaws as membership organizations may receive support from their members, either in the form of membership dues or as contributions from members. Membership dues may include both a portion for an exchange transaction and a portion for a contribution. Any portion representing an exchange transaction is always considered to be unrestricted. Contributions from members are also usually treated as unrestricted funds unless the individual contributor stipulates that the contribution be used for one or more specific purposes or unless the organization informs its members that it is soliciting contributions from them for one or more specific purposes or activities.

102.9 Support from the General Public

Nonprofit organizations can also solicit contributions from the general public through direct mail, special events, delayed or planned giving, or other fund-raising methods. Contributions can be in the form of cash or securities (generally known as *cash contributions*) or in the form of materials, facilities, and services (known as *in-kind contributions*). Funds raised from the general public are generally considered to be unrestricted funds unless the individual donor stipulates that the contribution be used for one or more specific purposes or unless the organization publicly states that it is soliciting contributions for one or more specific purposes or activities.

102.10 Revenue from Investments

Nonprofit organizations may receive income from investments, including rents and royalties, dividends and interest, and proceeds from disposition of investments. In some cases, this revenue may be restricted by donors of the related investments. Nonprofit organizations that are considered private foundations for federal income tax purposes also are subject to excise taxes on their net investment income. See discussion at section 1002.

102.11 Multiple Methods or Sources of Funding

Many nonprofit organizations realize support and revenue through more than one of the methods mentioned in the preceding paragraphs or from more than one funding source. If various funding source audit guides or requirements are involved, multiple funding has implications for auditing the nonprofit organization. For example, the organization must be able to account for different program cost components that are funded by different funding sources to support amounts billed and recorded as revenue for reimbursable costs.

102.12 Differences between Resource Providers and Beneficiaries

In many nonprofit organizations (especially health and welfare organizations), the beneficiaries of the organization's activities are different from those who provide the resources for the organization's activities. Resource providers usually have some charitable, humanitarian, religious, public interest, or other nonmonetary motive and do not have a need for the services or can pay for the services themselves. The charitable beneficiaries have a need for which they cannot fully pay.

Different Measurement of Performance

102.13 No Single Performance Indicator

Business enterprises can usually readily evaluate overall performance by measuring profitability. Since most nonprofit organizations do not have a profit motivation, there is no single performance indicator comparable to a business enterprise's generally accepted benchmark of profit. Instead of measuring profit, the focus is on information

in the financial statements about the nature and relationship between resource inflows and outflows and information about service efforts and accomplishments.

102.14 More Complex Measurement

Measuring a nonprofit organization's performance and results can be more complex than for a business. Depending on the nature of its goals, a nonprofit organization may have to determine what to measure, what indicators to use, and how to gather data. In addition, different programs and activities within the same organization may require totally different measurement standards, indicators, and data. For example, a day care center's measurement standard of service efforts and accomplishment would be the number of children served, whereas performance of a weatherization program would be measured based on the number of eligible homes weatherized.

102.15 The different and more complex measurement for nonprofit organizations is reflected in features such as financial statement presentation of changes in classes of net assets, functional presentation of expenses, and disclosure of the nature of restrictions on net assets. Nonprofit accounting and financial statements are discussed in sections 105 and 106.

Personnel and Management Differences

102.16 The dependence of many nonprofit organizations on voluntary contributions and funding sources that impose restrictions on the use of their funds has implications for the management and personnel of the organizations, as discussed in the following paragraphs. The management and personnel factors in turn may affect accounting practices.

102.17 Volunteer Governing Boards

Many nonprofit organizations have volunteer governing boards whose members may serve for limited terms, possibly contributing to a lack of continuity in or understanding of accounting and recordkeeping requirements. Also, such governing board members may have less time available for auditors or less knowledge about matters that predated their terms on the board than one would find in upper management in a business enterprise. In addition, the fact that nonprofit organizations typically have a separate board charged with governance is different from many private businesses, where generally those charged with governance are part of management.

102.18 Restrictions on Recruitment, Hiring, and Compensation

Business enterprises can generally recruit and hire employees and set compensation within relatively broad legal limits, usually with a good deal of flexibility in filling specific positions. While nonprofit organizations' recruitment and hiring are also generally subject to the same broad legal limits (for example, equal employment opportunity laws and minimum wage requirements), some organizations may also find that funding source guidelines require them to hire people from specific geographic areas or meet other hiring criteria. In addition, flexibility in filling specific positions (particularly administrative) tends to be further restricted by funding source limitations on salaries.

102.19 Job Security and Turnover

Payroll is the major expense in many nonprofit organizations because they are service-oriented. Yet salary scales are often limited by budgetary requirements, personnel activities (except for volunteer work) are often limited to specific areas, and there is often an uncertain future because of the year-to-year nature of outside funding. Because of the uncertainty of continued support for the nonprofit organization from grants, bequests, etc., the control of

personnel and payroll costs of a nonprofit organization may differ from that of a business enterprise to the extent that nonprofit accounting and recordkeeping may focus on meeting the immediate needs of the current funding sources, possibly without an accompanying emphasis on basic, long-term requirements. In some organizations, year-to-year funding and limitations on compensation may contribute to increased turnover of personnel. Very high turnover can be disruptive of sound accounting and control environment practices and routines and can make it difficult for an auditor to obtain explanations and information about past activities.

102.20 Employee Training and Skills

Employee training and skills can also affect the effectiveness of internal control, particularly for smaller organizations. The service motivation of nonprofit organizations may affect internal priorities, with accounting and recordkeeping sometimes seen as less important than the organization's public service purposes. In some instances, limited resources may be available for financial management, leading to too few employees to permit an adequate segregation of duties. Also, lower pay scales may result in accounting and bookkeeping personnel whose education or experience in accounting may be limited. Similarly, rapid employee turnover can mean that replacements may not receive adequate training. These conditions can result in greater risk of misstatements in accounting records and financial statements. On the other hand, some accounting personnel in nonprofit organizations are so instilled with a belief in the mission of the entity that they continue working harder for less pay than if they found a job in the for-profit arena.

102.21 Volunteer Personnel

Some nonprofit organizations rely heavily on volunteers to help carry out the organization's mission, sometimes including volunteer financial management, bookkeeping, or accounting services. Volunteer staff members may lack training and be less amenable to direct control than paid employees, which can affect understanding of and compliance with program and accounting requirements.

Differences in Accounting and Control Matters

102.22 Previous paragraphs discuss the possible negative impact of certain personnel factors on nonprofit accounting practices. A strengthening factor, however, is that nonprofit organizations often are subject to more scrutiny by outside parties than are business enterprises of similar size. Funding sources, particularly governmental funding agencies, may require periodic reporting and audits, specify monitoring and compliance practices, and reserve the right to perform audits of programs they fund. Such external influences may heighten management's consciousness of and attitude toward the conduct of the organization's operations and may prompt management to establish specific controls that might not typically be found in a similarly sized small business enterprise. As discussed in the following paragraph, formal budgets serve as a significant control on the activities of nonprofit organizations. The auditor of a nonprofit organization usually needs to consider the budget and other matters such as the program fiscal year.

102.23 Importance of Budgetary Accounting

Most business enterprises have some form of budget and view it as a blueprint for action and a significant means of controlling activities and measuring results. Budgets serve these same purposes for nonprofit organizations. However, budgetary accounting is crucial to many nonprofit organizations because of the restricted nature of much of their resources. This means many nonprofit organizations must prepare and closely adhere to detailed budgets for specific programs or functions. Because of funding source constraints on revenue and expenditures, budgets in the

nonprofit sector are often a contractual agreement subject to limited flexibility. For many organizations, each budget is a plan for spending specific amounts of money in specific cost categories by line item to achieve specific goals within a set period of time. When a nonprofit organization wishes to modify a program budget, specific funding source guidelines and procedures may have to be followed, which often include gaining written permission from the funding source. Thus, in the audit, budgets and budget modifications may call for special attention. The audit programs in this *Guide* reflect the importance of budgets; they include steps directed to the proper approval of budgets and comparison of budgeted and actual amounts.

102.24 Determining Fiscal Year

Many nonprofit organizations have a unique problem in the determination of a fiscal year because of their complex regulatory environment. Differing regulatory bodies and funding sources may require financial reports for a fiscal year, calendar year, or a program year different from the fiscal year of the nonprofit organization. In some cases, the organization's fiscal year may be established to coincide with the fiscal year of the major funding source, but this is often impractical for those organizations that must report to various funding sources on various accounting periods. When auditing a nonprofit organization on an organizational fiscal year basis, it is common to encounter program funding for periods that differ from the organization's fiscal year. In such cases, the auditor will perform cutoffs for the periods involved if the organization maintains the records of the program on the program's fiscal year. For example, if a nonprofit organization's fiscal year end is September 30, 20X2, and it receives funding for one of its programs on a calendar year basis, the organization's annual financial statements will reflect three months of revenues and expenses applicable to one program year (October 1 to December 31, 20X1) and only nine months of revenues and expenses applicable to the other program year (January 1 to September 30, 20X2). That example assumes that the program funding results from an exchange transaction and not a contribution. Also, nonprofit organizations are more likely than for-profit entities to change fiscal years. This is often done to more closely match the organization's fiscal year to a major funding source's fiscal year. Changing fiscal years makes it more difficult to obtain meaningful comparative financial information.

102.25 Cash or In-kind Matches

To receive certain funds, nonprofit organizations often must provide matching resources—usually a percentage of a total program budget. Some funding sources require a cash match only, while others will accept either cash, in-kind contributions, or a combination of the two. The amount and nature of an organization's match is usually specified in the grant award agreement or the approved budget. Whether the match is in cash or in-kind, proper records need to be kept, and auditors need to be aware of organizational matching requirements.

102.26 Other Budget and Funding Source Requirements

Most nonprofit accounting has to accommodate fairly tight funding source controls on expenditures and budget flexibility. That is, the accounting records must be able to identify actual amounts expended for each budgeted expense category. In addition, different funding sources may require expenditures for basically the same sorts of items to be recorded under differing categories, further complicating accounting requirements, and, thus, the auditor's examination of the accounting records. The elaborate account coding systems often found in nonprofit organizations reflect these complicated requirements. An expenditure may need to be coded by natural expense category (travel, supplies, etc.), program, budget category, program year, etc.

Different Constraints on Activities

102.27 Business enterprises in the United States traditionally have had to deal with relatively few outside constraints in addition to those of the market (although government regulation and consumer pressure have grown in recent decades). Nonprofit organizations have been subject to a host of outside constraints for decades—requirements set by Congress, the IRS, funding sources, and state government—and such outside constraints continue to increase. Although both businesses and nonprofit organizations face numerous outside constraints, the nature of the constraints differs. Some requirements applicable to nonprofit organizations are discussed in the following paragraphs. They can directly affect the auditor's responsibilities.

102.28 Eligibility Requirements

Business enterprises are generally free to sell to or serve anyone seeking their goods or services. For nonprofit organizations, however, agreements with funding sources may specify the people or areas eligible to receive goods or services when the organization carries out specific programs or activities. In the case of specific eligibility requirements, such as income, age, geographic location, or others, nonprofit organizations are required to determine eligibility before expending funds or providing goods and services. When eligibility requirements are part of a contract or grant agreement with a funding source, revenue recorded based on services provided to ineligible recipients may be unearned because the eligibility conditions were not satisfied. The auditor may need to consider recording a liability or disclosing a contingent liability for possible disallowed costs or reimbursements, should the funding source disallow the amount. Funding sources may require the organization to maintain detailed documentation of recipient eligibility and may require the organization to have the auditor determine its compliance in this area.

102.29 IRS Requirements

Tax exemption is a privilege granted by Congress through the IRS. In return, nonprofit organizations are subject to a range of IRS requirements different from those for business enterprises. Primary among these are requirements that a nonprofit organization's income, expenditures, and activities be substantially related to its exempt purpose; that the organization pay taxes on income from activities not substantially related to its exempt purpose; that nonprofit organizations limit lobbying activities and avoid all partisan political activity; that none of the nonprofit organization's assets inure to the benefit of a private individual; that the organization be organized and operated to provide public, not private benefit; and that specific reports be filed to demonstrate compliance in these and other areas. Most tax-exempt organizations (other than churches) are required to file annual reports with the IRS. Those filing requirements are discussed beginning at paragraph 1001.39. Because of these requirements, nonprofit organizations frequently engage the auditor to prepare the applicable IRS and state reporting forms. Also, in auditing the financial statements, the auditor considers the need for accruals for any taxes the organization may incur on unrelated business income or other activities, as well as any contingent liabilities that would exist if the organization engaged in activities that jeopardized its tax-exempt status.

102.30 Funding Source Requirements

Previous paragraphs discuss the fact that funding sources often restrict the use of resources they provide nonprofit organizations. Many aspects of financial statements of nonprofit organizations are directed toward disclosure of such restrictions. Thus, in an audit performed in accordance with generally accepted auditing standards (GAAS), the auditor will pay a great deal of attention to determining the existence and nature of restrictions and their proper reflection in the statements. In addition, funding sources may impose audit requirements focusing on individual programs or grants that go beyond GAAS. The client may not be aware of such requirements, so to fully serve the client, the auditor may need to identify them and bring them to the client's attention. Chapter 14 of this *Guide* discusses compliance auditing when a nonprofit organization receives financial assistance from governments.

102.31 **State Fund-raising Requirements**

Fund-raising is often an integral part of a nonprofit organization's existence, and a growing number of states regulate fund-raising activities and require regular reports. Section 1005 discusses state filing requirements.

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Chapter 1 Background Information

103 Effect of Differences on the Audit

103 Effect of Differences on the Audit

103.1 Previous paragraphs indicate how differences between nonprofit organizations and business enterprises affect the audit of a nonprofit organization. The most important of those effects are summarized here.

- The auditor needs to be concerned with identifying restrictions imposed by funding sources (including eligibility requirements) and the organization's compliance with and disclosure of the restrictions.
- The organization's use of a volunteer governing board and personnel, and factors that adversely affect personnel turnover, training, and emphasis on accounting and control procedures, may increase the risk of misstatements in the financial statements and decrease the assistance and information the auditor can expect to obtain from client personnel.
- The auditor may need to give attention to the formal, approved budget and comparison of actual and budgeted amounts.
- The auditor may need to reconcile accounting records kept on the fiscal year or years of one or more programs to the organization's fiscal year.
- Charts of accounts and coding systems may be quite complex to accommodate the need to identify costs by object, program, budget category, function, etc. This not only may result in transactions that are more difficult to audit but may also result in greater risk of coding errors that may be significant to the financial statements.
- The auditor may need to address certain additional materiality considerations. (See further discussion in section 306.)

- Although the organization is tax-exempt, there will be some tax considerations; for example, liabilities for taxes on unrelated business income, or a contingent liability if the organization has engaged in activities that jeopardize its tax-exempt status.

- The auditor needs to be aware of any audit requirements imposed by funding sources that go beyond GAAS.

The chapters in this *Guide* discuss the effects of characteristics unique to nonprofit organizations on the planning of the audit in more detail. The audit programs and other practice aids in this *Guide* appropriately take into account the unique characteristics of nonprofit organizations.

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104 Authoritative Literature

104.1 Previous sections mention several authoritative documents pertaining to nonprofit organizations; that is, SFAC No. 4, FASB ASC 958, and the Audit Guide. This section discusses these and other authoritative accounting and auditing documents that establish standards or provide guidance for nonprofit organizations. The literature may be broadly classified as general or specific.

General Literature

104.2 Generally Accepted Accounting Principles

FASB Accounting Standards Codification (ASC) Topic 105, *Generally Accepted Accounting Principles*, establishes the FASB Accounting Standards Codification (FASB ASC) as the single source of authoritative, nongovernmental U.S. GAAP for nonpublic entities. Nonprofit organizations should follow the guidance in all topics of the Codification, unless specific provisions explicitly exempt nonprofit organizations or the subject matter precludes applicability (for example, FASB ASC 505-30, *Treasury Stock*).

104.3 Generally Accepted Auditing Standards

The AICPA's Statements on Auditing Standards (SAS) and Auditing Interpretations apply to audits of nonprofit organizations. The issuance of new SASs can have a profound impact on the conduct of an audit of a nonprofit organization. The AICPA's *Code of Professional Conduct* applies to all members of the AICPA.

104.4 In October 2011, the AICPA issued new clarified auditing standards that recodify and supersede most of the outstanding SASs effective for audits of periods ending on or after December 15, 2012. This *Guide* fully incorporates the clarified auditing standards (identified as "AU-C"). An in-depth discussion of the clarified auditing standards is provided beginning at paragraph 104.8.

Specific Accounting Literature

104.5 The following documents establish accounting standards or concepts specific to financial statements of nonprofit organizations.

- SFAC No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, establishes the objectives of general purpose external financial reporting by nonbusiness organizations. The preface to SFAC No. 4 explains that statements of financial accounting concepts do not establish generally accepted accounting principles

(GAAP). That is, they do not prescribe accounting procedures or disclosure practices for particular items or events. Instead, concepts statements set forth objectives and fundamentals that will be the basis for development of accounting standards. They may also provide some guidance in analyzing new or emerging accounting and reporting problems in the absence of applicable authoritative pronouncements.

- SFAC No. 6, *Elements of Financial Statements*, defines classes of items (elements) in financial statements that are directly related to measuring the performance and status of an entity; for example, assets, liabilities, net assets, revenues, expenses, gains, losses, etc. The Statement defines three classes of net assets for nonprofit organizations and changes in those classes during the period; that is, changes in permanently restricted, temporarily restricted, and unrestricted net assets. That net asset concept was adopted by FASB ASC 958.

- FASB ASC 958, *Not-for-Profit Entities*, contains the incremental guidance within the FASB ASC applicable specifically to nonprofit organizations. (See further discussion related to the FASB ASC at paragraph 104.2.)

104.6 The staff of the AICPA's Accounting Standards Team has issued 25 technical practice aids (TPAs) (TIS 6140.01-.25) specifically related to nonprofit organizations. TPAs provide guidance on accounting issues, but are nonauthoritative. When appropriate, the TPAs are discussed at the relevant points in this *Guide*. The TPAs are included in the AICPA's Technical Practice Aids service.

Specific Auditing Literature

104.7 The following AICPA pronouncements give auditing guidance specifically applicable to nonprofit organizations:

- AICPA Audit and Accounting Guide, *Not-for-Profit Entities* (Audit Guide), gives guidance on auditing and reporting on financial statements of nonprofit organizations. The Audit Guide has not been updated for the clarified auditing standards. See the discussion of current developments related to the Audit Guide beginning at paragraph 107.5.

- AU-C 935, *Compliance Audits*, addresses the application of generally accepted auditing standards to a compliance audit, such as a Single Audit.

- AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (referred to in this *Guide* as "GAS/A-133 AICPA Audit Guide"), provides guidance on the auditor's responsibilities when conducting financial statement audits performed under *Government Auditing Standards* (Part I) separately from the guidance for audits conducted under the Single Audit Act and OMB Circular A-133 (Part II). The 2012 edition of the GAS/A-133 AICPA Audit Guide is *not* fully updated for the clarified auditing standards. The AICPA currently expects to release the 2013 edition of the GAS/A-133 AICPA Audit Guide in early to mid-2013 that will fully incorporate the new standards.

- AICPA Auditing Interpretations 1-3 of Section 265 (AU-C 9265.01-.10) provide guidance related to communication of deficiencies in internal control over compliance related to Recovery Act awards that have been identified at an interim date prior to the completion of an OMB Circular A-133 compliance audit. Auditing Recovery Act awards are discussed in section 1403.

Generally Accepted Auditing Standards (GAAS)

104.8 Auditors of nonprofit organizations should conduct their engagements in accordance with GAAS developed by the American Institute of Certified Public Accountants (AICPA). The AICPA *Code of Professional Conduct* requires members to comply with SASs.

104.9 Defining Professional Responsibility

The auditor's degree of responsibility in complying with professional requirements is identified through two categories as follows (AU-C 200.25):

- *Unconditional Requirements.* *Unconditional requirements* are those that an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word *must* to indicate an unconditional requirement.
- *Presumptively Mandatory Requirements.* An auditor must comply with a *presumptively mandatory requirement* in all cases in which such a requirement is relevant except in rare circumstances when the auditor determines it necessary to depart from a relevant requirement. In that case, the auditor should perform alternative procedures to achieve the intent of the requirement (see AU-C 200.26). Auditing standards use the word *should* to indicate a presumptively mandatory requirement.

As discussed in paragraph 801.2, the auditor must document the justification for any necessary departure from a presumptively mandatory requirement of GAAS, along with how alternative procedures performed sufficiently achieve the intent of the requirement.

104.10 Use of the Terms *Must* and *Should*

Throughout this *Guide*, the authors use the terms *must* and *should* in accordance with AU-C 200.25. The authors also use the term *is required* interchangeably with *should*.

104.11 Clarified Auditing Standards

In response to growing concerns about the complexity of auditing standards and to converge U.S. GAAS with International Standards on Auditing (ISAs), the Auditing Standards Board recently completed a large-scale project (the Clarity Project) to revise all existing standards and to design a format under which all new standards will be issued. In October 2011, the AICPA issued:

- SAS No.122, *Statements on Auditing Standards: Clarification and Recodification*. This represents a completely new set of auditing standards revised in format, structure, style, and content from the previous standards. It superseded all existing SASs through SAS No. 121, except:

- SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries*. (Subsequently superseded by SAS No. 124.)

- SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*. (Subsequently superseded by SAS No. 126.)

- SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. (Currently being redrafted and will be superseded when the clarified version is issued.)^{4 5}

- SAS No. 87, *Restricting the Use of an Auditor's Report*. (Subsequently superseded by SAS No. 125.)

- SAS No. 117 on compliance audits and SAS Nos. 118-120 on supplementary information. These standards were previously issued and effective in clarified format.⁴

- SAS No. 123, *Omnibus Statement on Auditing Standards—2011*. This Standard amended SAS Nos. 117, 118, and 122 to address matters that arose after the clarified standards were finalized.

- SAS No. 124, *Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country*. This is the clarified and recodified version of SAS No. 51, *Reporting on Financial Statements Prepared for Use in Other Countries*.

All auditing interpretations corresponding to a SAS were considered in the development of the clarified standards and incorporated as necessary. Generally, the interpretations have been withdrawn, except for certain interpretations that were retained and revised to reflect the issuance of SAS No. 122.

104.12 **Effective Date**

With a few exceptions, all of the clarified standards are effective for audits of financial statements for periods ending on or after December 15, 2012. See the discussion of the implementation approach in this *Guide* beginning at paragraph 104.27.

104.13 Subsequently Issued Standards

Going forward, the ASB will continue to issue SASs to create, amend, or supersede the auditing standards as necessary. The following additional SASs have been issued and have the same effective date as the other clarified auditing standards.

- *SAS No. 125.* In December 2011, the ASB issued SAS No. 125, *Alert That Restricts the Use of the Auditor's Written Communication*. SAS No. 125 superseded SAS No. 87 (AU 532), *Restricting the Use of an Auditor's Report*, and amended, among other standards, AU-C 260, *The Auditor's Communication With Those Charged With Governance*, and AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

- *SAS No. 126.* In July 2012, the ASB issued SAS No. 126, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, which superseded SAS No. 59 of the same name. In issuing SAS No. 126, the ASB followed the format of the other clarified SASs, but did not converge with the ISAs, pending the FASB's anticipated development of accounting guidance addressing going concern. (At the time this *Guide* was completed, the FASB technical plan indicated that an exposure draft would be issued in the first half of 2013.) Accordingly, SAS No. 126 does not change or expand SAS No. 59 in any significant respect; however, it makes explicit the requirement for management representations related to going concern, which was implicit in previous standards.

- *SAS No. 127.* In January 2013, the ASB issued SAS No. 127, *Omnibus Statement on Auditing Standards—2013*. SAS No. 127 amended certain guidance on group audits contained in AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, as well as certain guidance in AU-C 800 relating to audits of special purpose framework financial statements.

104.14 Form and Structure of the Standards

The clarified standards were developed using formatting techniques, such as bulleted lists, that make them easier to read and understand. In addition, each clarified standard is divided into the following topics:

- **Introduction.** Includes matters such as the purpose and scope of the guidance, subject matter, effective date, and other introductory material.

- **Objectives.** Establishes objectives that allow the auditor to understand what he or she should achieve under the standards. The auditor uses the objectives to determine whether additional procedures are necessary for their achievement and to evaluate whether sufficient appropriate audit evidence has been obtained.

- **Definitions.** Provides key definitions that are relevant to the standard.

- **Requirements.** States the requirements that the auditor is to follow to achieve the objectives unless the standard is not relevant or the requirement is conditional and the condition does not exist.

- **Application and Other Explanatory Material.** Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the standard. The requirements section references the applicable application and explanatory material. Also, when appropriate, considerations relating to governments/entities that may be relevant for nonprofit organizations and smaller and less complex entities are included in this section.

104.15 A standard may also contain exhibits or appendices. Appendices to a standard are part of the application and other explanatory material. The purpose and intended use of an appendix is explained in the standard or in the title and introduction of the appendix. Exhibits to standards are interpretive publications. Interpretive publications are not auditing standards and do not contain requirements. Rather, they are recommendations on applying the standards in particular circumstances that are issued under the authority of the Auditing Standards Board. Auditors are required to consider applicable interpretive publications when planning and performing the audit.

104.16 **AU-C Section Organization**

Within the AICPA Professional Standards, the clarified standards use “AU-C” section numbers instead of “AU” section numbers. “AU-C” is being used temporarily to avoid confusion with references to existing “AU” sections. The “AU-C” identifier will remain effective through the end of 2013, by which time SAS No. 122 becomes fully effective for all engagements. At that time, the “AU-C” identifier will revert to “AU.” The organization of the AU-C sections (which aligns with the organization of the ISAs) is as follows:

- Preface.
- Glossary.
- AU-C Section 200-299: General Principles and Responsibilities.
- AU-C Section 300-499: Risk Assessment and Response to Assessed Risks.
- AU-C Section 500-599: Audit Evidence.

- AU-C Section 600-699: Using the Work of Others.

- AU-C Section 700-799: Audit Conclusions and Reporting.

- AU-C Section 800-899: Special Considerations.

- AU-C Section 900-999: Special Considerations in the United States.

- Exhibits and Appendixes.

104.17 An exhibit to SAS No. 122 contains a complete two-part cross-reference of AU-C and AU section numbers. One part of the cross-reference shows which existing AU sections are encompassed by each new AU-C section. The other part of the cross-reference shows, for each existing AU section, where the corresponding guidance can be found in the AU-C sections. Appendix 1B of *PPC's Guide to Audits of Nonpublic Companies*, "List of AU-C Sections Designated by SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, Cross Referenced to List of AU Sections," reproduces part of that Exhibit with the authors' revisions for subsequent issuance of new SASs.

104.18 **Preface**

AU-C Preface—*Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards*, contains the principles underlying an audit conducted in accordance with generally accepted auditing standards (the principles). These principles are not requirements and are not authoritative. They provide a framework that is helpful in understanding and explaining an audit and are organized to provide a structure for the codification of SASs. The structure addresses the purpose of an audit, responsibilities of the auditor, performance of the audit, and reporting.

104.19 **Overall Objectives and Requirements**

AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, contains the auditor's overall responsibilities in accordance with GAAS. The overall objectives of the auditor in conducting an audit of financial statements are as follows:

- Obtain reasonable assurance about whether the financial statements are free from material misstatement.

- Report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

104.20 The auditor must be independent of the entity when performing an engagement in accordance with GAAS unless (a) GAAS provides otherwise or (b) law or regulation requires accepting the engagement and reporting on the financial statements. In addition, the auditor should follow the requirements in Exhibit 1-1 to achieve the objectives in paragraph 104.19. These overall requirements are discussed throughout the *Guide* as appropriate.

Exhibit 1-1

Requirements for Overall Objectives and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards

Requirements	AU-C Reference
Be independent of the entity when performing an engagement in accordance with GAAS unless (1) GAAS provides otherwise or (2) law or regulation requires accepting the engagement and reporting on the financial statements (“must” statement). If not independent and neither (1) nor (2) apply, do not issue a report under GAAS.	AU-C 200.15
Follow relevant ethical requirements relating to financial statement audit engagements.	AU-C 200.16
Maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement of the financial statements may exist.	AU-C 200.17
Exercise professional judgment in planning and performing the audit.	AU-C 200.18
To obtain reasonable assurance, obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.	AU-C 200.19
Comply with all AU-C sections when the AU-C section is effective and the circumstances addressed by the AU-C section exist.	AU-C 200.20
Understand the entire text of an AU-C section, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.	AU-C 200.21
Do not represent compliance with GAAS in the auditor’s report unless the requirements of AU –C 220 and all other relevant AU-C sections have been followed.	AU-C 200.22
In planning and performing the audit, use the objectives stated in the individual AU-C sections to achieve the overall objectives of the auditor and to: <ul style="list-style-type: none"> • Determine whether any audit procedures in addition to those required by individual AU-C sections are necessary. • Evaluate whether sufficient appropriate audit evidence has been obtained. 	AU-C 200.23
Subject to AU-C 220.26, comply with each requirement of an AU-C section unless (1) the entire AU-C section is not relevant or (2) the requirement is not relevant because it is conditional and the condition does not exist.	AU-C 200.24
Identify the auditor’s degree of responsibility in complying with professional requirements according to the following categories: ^a <ul style="list-style-type: none"> • <i>Unconditional requirements.</i> Requirements an auditor must follow in all cases if the circumstances apply to the requirement. Auditing standards use the word “must” to indicate an unconditional requirement. • <i>Presumptively mandatory requirements.</i> Requirements an auditor must follow in all cases if the circumstances apply to the requirement, except in rare circumstances discussed in AU-C 220.26. Auditing standards use the word “should” to indicate a presumptively mandatory requirement. 	AU-C 200.25

Requirements	AU-C Reference
In rare situations, when the auditor determines it is necessary to depart from a relevant presumptively mandatory requirement, perform alternative audit procedures to achieve the intent of that requirement. It is expected that departure from a relevant presumptively mandatory requirement will only occur when the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the intent of the requirement.	AU-C 200.26
In planning and performing the audit, consider applicable interpretive publications.	AU-C 200.27
In applying the auditing guidance included in other auditing publications, use professional judgment and assess the relevance and appropriateness of such guidance.	AU-C 200.28
Evaluate whether not achieving an objective in a relevant AU-C section prevents achievement of the overall objectives of the engagement. If the overall objective of the engagement is not achieved, modify the opinion or withdraw from the engagement (when withdrawal is possible under applicable law or regulation). Document the failure to achieve an objective as a significant finding or issue in accordance with AU-C 230.	AU-C 200.29

Notes:

^a See discussion of the terms *must* and *should* at paragraph 104.9.

104.21 Interpretive Publications

Interpretive publications are not auditing standards, but rather recommendations on applying the SASs. Interpretive publications include Auditing Interpretations, exhibits to the SASs, AICPA Audit and Accounting Guides, and AICPA Auditing Statements of Position. Auditors should consider applicable interpretive publications. If the auditor does not apply an interpretive publication, the auditor should be prepared to explain how he or she complied with the underlying SAS provisions. The unconditional requirements and presumptively mandatory requirements are not intended to apply to interpretive guidance issued by the AICPA.

104.22 Other Auditing Publications

Other auditing publications have no authoritative status but may help auditors understand and apply the SASs. Other auditing publications include AICPA publications other than SASs and interpretive publications, articles in professional journals, continuing professional education programs, textbooks, guide books, audit programs and checklists, and auditing literature published by state CPA societies and other organizations (for example, PPC guides). If auditors apply the guidance in other auditing publications, they should satisfy themselves that the guidance is both appropriate and relevant. Appropriateness refers to whether the guidance is technically sound. Relevance refers to whether the guidance is applicable to the circumstances of a particular audit engagement. Indicators of appropriateness include the extent to which the publication is recognized as being helpful and the professional qualifications of its author or issuer. There is a presumption that other auditing publications reviewed by the AICPA Audit and Attest Standards staff (such as auditing practice releases and AICPA risk alerts) are appropriate.

104.23 The authors recommend that firms have a system in place to ensure staff members are informed about current authoritative literature. This *Guide* is updated for changes in professional literature and includes guidance about how those changes might affect nonprofit organization engagements. However, even when using the practice aids in this *Guide*, auditors are responsible for awareness and timely implementation of new pronouncements.

Quality Control

104.24 Statement on Quality Control Standards

Statement on Quality Control Standard No. 8, *A Firm's System of Quality Control*, establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. SQCS No. 8 comprehensively addresses the quality control (QC) processes over a firm's accounting and auditing practice. The standard places an unconditional obligation on the firm to establish a QC system designed to provide reasonable assurance that the firm complies with professional standards and legal and regulatory requirements, and that it issues reports that are appropriate in the circumstances. *PPC's Guide to Quality Control* provides guidance and practice aids to assist firms in developing, implementing, and maintaining a system of quality control.

104.25 Quality Control Auditing Standard

AU-C 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, provides requirements and application and other explanatory material to the auditor and engagement partner as they implement each element of quality control during the performance of an audit of financial statements. Thus, for every quality control element discussed in SQCS No. 8, AU-C 220 includes information that conveys how the firm ensures that the requirements of SQCS No. 8 are met in an audit engagement. The responsibility to ensure compliance with AU-C 220 is primarily placed on the audit engagement partner. However, certain requirements are also imposed on the engagement team and, if applicable, engagement quality control reviewer. In meeting the requirements of the quality control auditing standard, the engagement partner is permitted to delegate his or her responsibilities and to rely on the firm's quality control system.

104.26 The objective is for the auditor to implement quality control procedures at the engagement level that provide reasonable assurance that—

- The audit complies with professional standards and applicable legal and regulatory requirements.

- The auditor's report is appropriate in the circumstances.

104.27 The requirements that should be followed to achieve that objective are summarized in Exhibit 1-2.

Exhibit 1-2

Requirements for Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards

Requirements	AU-C Reference	Guide Reference— Practice Aid
Leadership Responsibilities for Quality on Audits		
The engagement partner should take responsibility for the overall quality on each assigned audit engagement. The performance of certain procedures may be delegated to other members of the engagement team and the engagement partner may rely on the firm's system of quality control.	AU-C 220.10	NPO-CX-14
Relevant Ethical Requirements		
The engagement partner and other members of the engagement team should remain alert for evidence of noncompliance with relevant ethical requirements by members of the engagement team.	AU-C 220.11	NPO-AP-1
If there is indication that members of the engagement team have not complied with relevant ethical requirements, the engagement partner, in consultation with others in the firm as appropriate, should determine that appropriate action has been taken.	AU-C 220.12	NPO-CX-14
<p>To form a conclusion on compliance with independence requirements that apply to the audit engagement, the engagement partner should—</p> <ul style="list-style-type: none"> • Obtain relevant information from the firm and, when applicable, network firms to identify and evaluate circumstances and relationships that create threats to independence. • Evaluate information that a breach of the firm's independence policies and procedures has occurred and determine whether the situation creates a threat to independence for the audit. • Take appropriate action to eliminate any identified threats or to reduce them to an acceptable level by applying safeguards. Report any inability to resolve the matter promptly to the firm so that it may take appropriate action. 	AU-C 220.13	NPO-CX-1.1
Acceptance and Continuance of Client Relationships and Audit Engagements		
The engagement partner should determine that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed and all conclusions reached are appropriate.	AU-C 220.14	NPO-CX-1.1
If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner should communicate that information promptly to the firm and take the necessary action.	AU-C 220.15	NPO-AP-1
Assignment of Engagement Teams		
The engagement partner should be satisfied that the audit engagement team (including any external specialists) has the appropriate competence and capabilities to (1) perform the audit	AU-C 220.16	NPO-AP-1 NPO-CX-1.1

Requirements	AU-C Reference	Guide Reference— Practice Aid
engagement as required by professional standards and applicable legal and regulatory requirements, and (2) enable the issuance of an auditor's report that is appropriate in the circumstances.		
Engagement Performance		
The engagement partner should take responsibility for the direction, supervision, and performance of the audit engagement. The engagement partner is charged with ensuring that (1) professional standards and applicable legal and regulatory requirements and the firm's policies and procedures are followed and (2) the auditor's report is appropriate in the circumstances.	AU-C 220.17	NPO-CX-14
The engagement partner should ensure that reviews are being performed in accordance with the firm's review policies and procedures.	AU-C 220.18	NPO-CX-14
Based on the review of audit documentation and discussion with the engagement team, on or before the date of the auditor's report, the engagement partner should be satisfied that sufficient appropriate audit evidence has been gathered to support the conclusions reached and the auditor's report to be issued.	AU-C 220.19	NPO-CX-14
The engagement partner should take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters.	AU-C 220.20	NPO-CX-14
<p>The engagement partner should be satisfied that—</p> <ul style="list-style-type: none"> • Members of the engagement team have followed consultation policies during the course of the engagement. • The nature and scope of the consultation is agreed upon with the party consulted and the conclusions resulting from such consultations are understood by the party consulted. • The conclusions resulting from such consultations have been implemented. 	AU-C 220.20	NPO-CX-14
<p>For those audit engagements, if any, for which the firm has determined that an engagement quality control review (EQCR) is required, the engagement partner should—</p> <ul style="list-style-type: none"> • Ascertain that an engagement quality control reviewer has been appointed. • Discuss significant findings or issues that arose during the audit engagement with the engagement quality control reviewer. • Ensure that the auditor's report is not released before the EQCR is completed. 	AU-C 220.21	NPO-CX-14
<p>The engagement quality control reviewer should perform an objective evaluation of the significant judgments made and the conclusions reached in formulating the auditor's report. This evaluation should involve—</p> <ul style="list-style-type: none"> • Discussing significant findings or issues with the engagement partner. 	AU-C 220.22	NPO-CX-14

Requirements	AU-C Reference	Guide Reference— Practice Aid
<ul style="list-style-type: none"> • Reading the financial statements and the proposed report. • Reviewing selected audit documentation relating to the significant judgments the engagement team made and the related conclusions it reached. • Evaluating the conclusions reached in formulating the report and considering whether the proposed report is appropriate. 		
When differences of opinion occur within the engagement team, with those consulted, or between the engagement partner and the engagement quality control reviewer, the engagement team should follow the firm's policies and procedures for resolving differences of opinion.	AU-C 220.23	NPO-CX-14
Monitoring		
The engagement partner should consider the results of the firm's monitoring process and whether deficiencies noted in that information may affect the audit engagement.	AU-C 220.24	NPO-CX-14
Documentation		
<p>The auditor should document:</p> <ul style="list-style-type: none"> • Issues identified with respect to compliance with relevant ethical requirements and how they were resolved. • Conclusions on compliance with independence requirements and any relevant discussions with the firm that support these conclusions. • Conclusions reached regarding the acceptance and continuance of client relationships and audit engagements. • The nature and scope of, and conclusions resulting from, consultations undertaken during the engagement. 	<p>AU-C 220.25</p> <p>AU-C 220.25</p> <p>AU-C 220.25</p> <p>AU-C 220.25</p>	<p>NPO-CX-1.1</p> <p>NPO-CX-1.1</p> <p>NPO-CX-1.1</p> <p>NPO-CX-14</p>
<p>The engagement quality control reviewer should document:</p> <ul style="list-style-type: none"> • That the procedures required by the firm's policies on engagement quality control review have been performed. • The date that the engagement quality control review was completed. • That the reviewer is not aware of any unresolved issues that would cause him or her to believe that the significant judgments made and the conclusions reached were not appropriate. 	AU-C 220.26	NPO-CX-14

Implementation of the Clarified Auditing Standards

104.28 Implementation in This Guide

With a few exceptions, all of the clarified standards are effective for audits of financial statements for periods ending on or after December 15, 2012. The majority of the requirements in the clarified standards are consistent with the requirements in the pre-clarified standards. Thus, the changes to the standards, although extensive, do not create many substantive changes in practice. The discussions throughout this *Guide*, references to authoritative literature, and practice aids have been fully updated for the clarified standards. The following paragraphs discuss where changes in practice are expected to occur as a result of the clarified standards.

104.29 Major Changes in Practice

Reporting requirements and considerations when performing an audit of group financial statements have changed significantly from previous standards. Chapter 13 provides guidance and reporting examples under the clarified audit reporting standards. *PPC's Guide to Auditor's Reports* provides extensive guidance and reporting examples under the clarified audit reporting standards. Guidance on performing group audits is provided in Chapter 2.

104.30 Other Changes in Practice

Implementation of the clarified auditing standards could also result in other changes in practice. The changes in practice may result from new requirements or from changes in requirements. In addition, depending on how auditors applied previous requirements, changes in practice may occur as a result of added emphasis in the clarified standards that makes requirements more explicit. The more significant of those changes are as follows:

- AU-C 210, *Terms of Engagement*, clarifies procedures for engagement acceptance and results in changes in the audit engagement letter. See section 203.
- AU-C 220, *Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*, specifies quality control requirements at the engagement level that were not included in previous auditing standards and includes specific documentation requirements. See paragraph 104.25.
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, contains a requirement to inspect correspondence with licensing or regulatory authorities. See sections 308 and 1116.
- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, makes explicit some requirements that were implicit in SAS No. 115. It also adds requirements to (a) communicate to management deficiencies other than significant deficiencies and material weaknesses that are important enough to warrant management's attention and (b) explain the potential effects of significant deficiencies and material weaknesses in the internal control communication. See section 1114.
- AU-C 300, *Planning an Audit*, contains an explicit requirement to document the audit strategy. See section 306.

- AU-C 320, *Materiality in Planning and Performing an Audit*, introduces the term *performance materiality*. See section 306.

- AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, requires inquiries of management about its awareness of fraud, noncompliance with laws or regulations, or uncorrected misstatements at the service organization that affect the user entity's financial statements. It also strengthens the requirements for using a service auditor's report and permits reference to the work of a service auditor in the auditor's report on the financial statements if necessary to explain a modification. See section 206.

- AU-C 450, *Evaluation of Misstatements Identified During the Audit*, revises some terminology used in evaluating misstatements and modifies the requirements for communicating and evaluating misstatements. See section 1112.

- AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, changes the requirement for when it is necessary to send a letter of inquiry to the client's lawyers, making it a risk-based decision. See section 1103.

- AU-C 505, *External Confirmations*, adds certain required procedures if management refuses to allow external confirmations. See Chapter 5.

- AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, clarifies that reviewing a predecessor's workpapers cannot be the only source of audit evidence about opening balances in an initial audit. The clarified standard also states that communication with the predecessor is not required if the most recent audited financial statements are more than *one year* before the beginning of the earliest period to be audited by the successor. The pre-clarified standard had a *two year* requirement. See section 205.

- AU-C 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures*, makes explicit the need to obtain an understanding of accounting estimates, including related controls, during risk assessment. The clarified standard also requires a retrospective review of estimates during risk assessment, provides specific procedures for estimates that give rise to significant risks, and includes specific documentation requirements. See section 1109.

- AU-C 550, *Related Parties*, makes explicit the need to obtain an understanding of related party relationships and transactions, including related controls, during risk assessment, adds a specific requirement to discuss related parties during the engagement team discussion, requires treating significant related party transactions outside the normal course of business as significant risks, and requires additional procedures (a) for significant

related party transactions outside the normal course of business and (b) if related parties not disclosed by management are identified. See section 1106.

- AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, expands certain requirements related to omitted procedures and subsequently discovered facts. See section 1119.

- AU-C 580, *Written Representations*, revises the wording of several required representations and results in changes in the management representation letter. See section 1104.

- AU-C 620, *Using the Work of an Auditor's Specialist*, includes internal specialists in a field other than accounting or auditing that are employed by the firm within the definition of an auditor's specialist. Previously, those specialists were considered members of the engagement team and were subject to less stringent requirements. See section 207.

- AU-C 700, *Forming an Opinion and Reporting on Financial Statements*, made significant changes related to auditor's reports. See chapter 13.

- AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks*, made significant changes related to OCBOA financial statements. See sections 1202 and 1303.

- AU-C 930, *Interim Financial Information*, requires the auditor to issue a written report when engaged to review interim financial information. See section 109.

Specific Ethics Literature

104.31 In addition to the generally applicable AICPA *Code of Professional Conduct*, several Ethics Interpretations or Rulings specifically address questions of independence with respect to nonprofit organizations. These documents are explained beginning at paragraph 202.34.

Specific Government Pronouncements

104.32 If a nonprofit organization receives federal awards, directly or indirectly, through a state or local government, specific government pronouncements may apply. Government documents are discussed at paragraph 1400.19. Section 1400 discusses authoritative literature related to compliance auditing for nonprofit organizations. See the discussion of *Government Auditing Standards* beginning at paragraph 108.3.

⁴ SAS No. 122 did not supersede these SASs, but it redesignated the previous AU sections as AU-C sections. The revised AU-C sections were also updated, if necessary, for conforming changes.

⁵ At the date this *Guide* was completed, the AICPA's Auditing Standards Board had approved the issuance of an exposure draft of a clarified SAS, *Using the Work of Internal Auditors*, that would supersede this standard.

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105 Accounting Standards for Nonprofit Organizations

History

105.1 The need for uniform and comparable accounting and financial reporting standards for nonprofit organizations has long been recognized. For example, a document entitled "Accounting Principles and Procedures of Philanthropic Organizations" was published in 1957, and the first edition of the Black Book (see paragraph 100.9) was published in 1964. Separate AICPA guides existed for hospitals and colleges and universities so that differences existed in the accounting standards for various types of nonprofit entities. In response to inconsistencies in certain accounting and financial reporting practices, in 1993, the FASB issued guidance related to accounting for contributions received and contributions made and financial statements of nonprofit organizations. The AICPA continued the trend toward consistent accounting and financial reporting practices for nonprofit organizations when it issued the Audit and Accounting Guide, *Not-for-Profit Entities*, in August 1996. The following paragraphs give a general overview of the objectives and features of accounting and financial reporting for nonprofit organizations. Chapter 9 discusses special accounting considerations in more detail.

Objectives of Nonprofit Accounting and Financial Reporting

105.2 As discussed in SFAC No. 4, the objectives of financial reporting for nonprofit organizations differ from those of business enterprises. The main objective of financial reporting for business enterprises is information about an enterprise's performance as measured by earnings. The objectives of financial reporting for nonprofit organizations articulated in SFAC No. 4 are to provide information to current and potential resource providers and others in assessing (a) the services a nonprofit organization provides and its ability to provide those services and (b) how management has discharged its stewardship responsibilities, as well as providing information about (c) the organization's economic resources, obligations, and net resources and (d) the effects of transactions, events, and circumstances that change those resources (that is, the organization's performance or service efforts and accomplishments). More specifically, nonprofit financial reporting objectives are to:

a. communicate the ways resources have been used to meet the organization's objectives and external requirements,

b. identify an organization's principal programs and their costs,

c. disclose the degree of control exercised by donors and funding sources over use of resources, and

d. help the user evaluate the organization's ability to carry out its fiscal objectives.

105.3 These objectives are further refined and expanded in FASB ASC 958. According to FASB ASC 958-205-05-3, “the primary purpose of financial statements is to provide relevant information to meet the common interests of donors, members, creditors, and others who provide resources to NFPs.” Similar to the objectives outlined in SFAC No. 4, FASB ASC 958-205-05-3 states that these external users desire to assess “(a) the services an NFP provides and its ability to continue to provide those services and (b) how managers discharge their stewardship responsibilities and other aspects of their performance.” More specifically, the purpose of nonprofit financial reporting is to provide information about:

a. the amount and nature of an organization's assets, liabilities, and net assets;

b. transactions and other events and circumstances that affect net assets;

c. the amount and kinds of inflows and outflows of economic resources during a period and the relationship between the inflows and outflows;

d. an organization's cash revenues, support, and expenses; its borrowing and repayment of borrowing; and other factors that may affect its liquidity; and

e. the service efforts of an organization.

105.4 Groups that are particularly interested in the financial information of a nonprofit organization include:

- Funding sources and contributors to the organization.

- Regulatory agencies.

- Governing boards (board of trustees or directors).

- Beneficiaries of the services rendered by the organization.
- Employees.
- Creditors and potential creditors.
- Constituent organizations; for example, a local chapter of a national organization.

Fund Accounting

105.5 Historically, fund accounting provided a mechanism for meeting differing needs of various users of nonprofit financial statements. For instance, contributors and funding sources are often interested in statements that account for the use of funds they provide, whether restricted or unrestricted. Regulatory agencies are often concerned with amounts spent for other than program purposes, including management, fund-raising, unrelated business income, lobbying, etc.; governing boards with the proper utilization of all funds; beneficiaries with the efficient use of program funds; and creditors and potential creditors with the unrestricted funds available for the continued operation of the organization. Fund accounting records resources whose use may be limited by donors, granting agencies, governing boards, or other individuals or entities or by law in separate funds. The funds segregate assets, liabilities, and fund balances into separate accounting entities based on specific activities, donor-imposed restrictions, or objectives.

105.6 GAAP Requirements for Presentation of Financial Statements by Fund

An organization's maintenance of its accounts by fund does not necessarily mean that its financial statements will be presented by fund. FASB ASC 958 does not prohibit or require the use of fund accounting. According to FASB ASC 958-205-45-3, "Reporting by fund groups is not a necessary part of external financial reporting; however, this Subtopic does not preclude providing disaggregated information by fund groups." It does require, however, providing information about three classes of net assets: (a) unrestricted, (b) temporarily restricted, and (c) permanently restricted. (Internal restrictions of net assets, such as board designations, may be disclosed; however, they are considered to be unrestricted.) Fund accounting may not accomplish the goal of informing the reader about donor restrictions, as required by FASB ASC 958-205. For example, some of the net assets of a fund established to account for property and equipment may be unrestricted, either because they were acquired with unrestricted support or because the donor restriction was satisfied when specific equipment was purchased, and some may be permanently restricted because of donor restrictions. So merely accounting for property and equipment in a separate fund does not satisfy the disclosure requirements of FASB ASC 958 about donor restrictions.

105.7 The authors suggest that nonprofit organizations currently using fund accounting consider whether it continues to provide useful information. Fund-accounting-based statements may still be required to compute debt covenant requirements, grantor funding source requirements, or other external reporting requirements. Some nonprofit organizations that wish to present financial information by fund provide that information in a supplementary schedule.

In addition, internal budgets may continue to be prepared on a fund accounting basis. The organizations that use fund accounting only in their annual financial statements may decide to discontinue its use. Financial statements that do not present results by funds can accommodate comparative presentations more easily than those using fund accounting. In addition, the GAAP requirements to provide information on unrestricted and restricted net assets and donor restrictions on assets can be met without using multiple columns. For many nonprofit organizations, the authors believe the financial statements most informative to their users will be those that do not use fund accounting and that present comparative results.

Basis of Accounting

105.8 The objective of an audit is to express an opinion about whether the financial statements are fairly presented in conformity with the applicable financial reporting framework that is used by the entity.⁶ The accrual basis of accounting is required for financial statements to be in conformity with GAAP. However, a nonprofit organization might present financial statements on a basis of accounting other than GAAP, including the cash or modified cash basis, income tax basis, or a basis of accounting prescribed by a regulatory agency. This *Guide* is primarily concerned with the audit of GAAP basis financial statements (although Chapter 13 does cover auditor's reports on financial statements on bases other than GAAP, and the discussion beginning at paragraph 1202.13 provides a brief overview of those financial statements). Guidance on preparing cash, modified cash, and income tax basis financial statements for nonprofit organizations is included in Chapter 8 of *PPC's Guide to Cash, Tax, and Other Bases of Accounting*, which can be ordered by calling (800) 431-9025 or from PPC's website at ppc.thomsonreuters.com.

⁶ The applicable financial reporting framework is the financial reporting framework that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation, as adopted by management, or those charged with governance, in the preparation and fair presentation of the financial statements. This *Guide* assumes that entities are following U.S. generally accepted accounting principles.

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Basic Financial Statements

106.1 As discussed in paragraph 105.6, FASB ASC 958 does not prohibit or require the use of fund accounting. However, the authors believe that when a nonprofit organization has adopted FASB ASC 958 it will find the financial statements to be more informative and more easily understood if its use of fund accounting is discontinued. As a result, the illustrative financial statements included in the appendixes to Chapter 12 do not reflect separate funds. The basic financial statements for all nonprofit organizations are as follows:

- *Statement of Financial Position.* The statement focuses on the organization as a whole and, therefore, reports total assets, liabilities, and net assets. Three classes of net assets are required to be reported: *permanently restricted net assets*, *temporarily restricted net assets*, and *unrestricted net assets*.
- *Statement of Activities.* Similar to the statement of financial position, this statement focuses on the organization as a whole and, therefore, reports the change in net assets for a period. It is required to report the change in permanently restricted net assets, temporarily restricted net assets, unrestricted net assets, and the total change in net assets. Revenues, expenses, gains, losses, and reclassifications are reported within these classes of net assets. Expenses must be reported by their functional classification either on the face of the statement or in notes to the financial statements.
- *Statement of Cash Flows.* This statement should be prepared following the requirements of FASB ASC 230, *Statement of Cash Flows*. In contrast to the statements of financial position and activities, the statement of cash flows reports cash flows in total rather than by the three classes of net assets.
- *Statement of Functional Expenses.* Voluntary health and welfare organizations must continue to present this statement in a matrix format. It should present, in reasonable detail, expenses by their functional and natural classifications (for example, salaries, occupancy, supplies, etc.). Although other nonprofit organizations are not required to present this statement, they are encouraged to do so.

Financial Statement Format

106.2 A variety of presentation formats may be used (for example, layered or columnar statements; comparative or only a summarized prior year total; etc.). FASB ASC 958 allows flexibility in formats that are appropriate for the individual circumstances as long as the statements are consistent with the accounting and reporting practices of FASB ASC 958.

106.3 For example, the statement of financial position can be prepared or arranged in different ways under FASB ASC 958 as long as information about liquidity, financial flexibility, and relationships between assets and liabilities is presented in the financial statements or in the notes to the financial statements. The statement can be classified between current and noncurrent assets and liabilities, sequenced according to the nearness of conversion to cash or use of cash, or prepared in other ways, with information about liquidity and financial flexibility included in the notes to the financial statements. The format for the statement of activities can also take many different forms. The statement can contain multiple columns for the different classes of net assets or can present a single column with information in different sections for the three classes of net assets. Additionally, the information can be presented in two separate statements, such as a statement of revenues, expenses, and other changes in unrestricted net assets and a statement of changes in net assets.

106.4 Chapter 12 discusses the considerations involved in preparing financial statements. In addition, the appendixes to Chapter 12 include illustrations of financial statements prepared under FASB ASC 958.

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Sarbanes-Oxley Act of 2002

107.1 The Sarbanes-Oxley Act of 2002 (the Act), among other items, established the Public Company Accounting Oversight Board (the PCAOB) under the supervision of the Securities and Exchange Commission (the SEC). The Act granted the PCAOB the authority to establish, or adopt auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports for auditors of public companies. The Act also authorized the SEC to recognize as *generally accepted* accounting principles established by a private entity that meet certain criteria. In April 2003, the SEC reaffirmed the status of the FASB as the designated private-sector standard setter and formally recognized the FASB standards as *generally accepted* under the Act. However, the SEC retained the authority, granted under the Act, to amend, modify, repeal, or reject any such standards.

107.2 Requirements for All Entities

It is important to note that there are two provisions of the Sarbanes-Oxley Act that apply to all corporate entities, including nonprofit organizations. First, it is illegal for any corporate entity to punish whistleblowers or retaliate against any employee who reports suspected cases of fraud or abuse. Second, it is a crime to alter, cover up, falsify, or destroy any document that may be relevant to an official investigation.

107.3 Impact on the Nonprofit Environment

Although the Sarbanes-Oxley Act did not target nonprofit organizations, the sector has not been free from scandal during this period. As a result, several states have proposed legislation for nonprofit governance. Some of those proposals or laws have pushed to subject nonprofit organizations to rules similar to those that public companies must follow as a result of the Sarbanes-Oxley Act.⁷

107.4 Two provisions of the Sarbanes-Oxley Act, which are discussed in paragraph 107.2, apply to all entities including nonprofit organizations. In addition, the Act impacts nonprofit organizations indirectly for the following reasons:

- Increased expectations by regulators (including state regulators) and donors for transparency of financial reporting and accountability of management.

- Increased professional skepticism by independent auditors that will probably lead to more in-depth questioning of management.
- Increased number of governance-related recommendations that independent auditors might include in the management letter, with the board desiring to see more of them addressed.
- Required disclosures in IRS Form 990 about (a) a conflict of interest policy, and (b) any transactions or financial relationships the organization has with its substantial contributors, officers, directors, trustees, and key employees. (Chapter 10 provides detailed information about Form 990.)
- Desire by board members to ensure that complex items are fully and fairly presented in the financial statements even when additional disclosure in those statements is not required.
- Desire by board members, especially ones who work for or audit publicly traded companies that are required to comply with the Sarbanes-Oxley Act, to ensure that the organization adopts certain provisions of the Act to improve internal control and minimize the risk of scandal.

Perhaps most importantly, the Act has, at its core, many practices that could become best practices for governance of nonprofit organizations. Auditors of nonprofit organizations ought to consider the trickle-down effect of the federal legislation on state legislation and continue to monitor developments in this area.

Current Developments in Nonprofit Accounting and Auditing Standards

107.5 AICPA Audit and Accounting Guide.

The AICPA Audit and Accounting Guide, *Not-for-Profit Entities* (Audit Guide), was initially issued in 1996 (formerly titled *Not-for-Profit Organizations*). The Audit Guide has not been revised or amended, other than for conforming changes, since its issuance. Various issues have arisen since the issuance of the Audit Guide including, but not limited to, issues not contemplated in the existing Audit Guide, issues arising as a result of the conforming change process, and issues arising in implementing the Audit Guide. Some of the accounting issues have led to diversity in practice. A nonprofit expert panel is currently in the process of completely overhauling the Audit Guide. The AICPA's Financial Reporting Executive Committee (FinREC) recently issued a working draft of the accounting content of a proposed new Audit Guide. The working draft did not include auditing considerations, analytical procedures, internal control considerations, or reporting. At the time this *Guide* was completed, the AICPA anticipated issuing a final, revised Audit Guide in 2013. The clarified auditing standards are anticipated to be incorporated with the 2013 final issuance. (See discussion of the clarified auditing standards beginning at paragraph 104.11.) Nonprofit organizations and their auditors need to be alert for further developments in this area. Future editions of this *Guide* will update the status of this project.

107.6 The auditing guidance included in the Audit Guide is considered guidance from an interpretive publication while the accounting guidance is considered nonauthoritative. (As discussed beginning at paragraph 104.2, the FASB Accounting Standards Codification is currently the single source of authoritative, nongovernmental U.S. GAAP for nonpublic entities.) However, the accounting guidance contained within the Audit Guide continues to provide guidance that should be considered if the FASB ASC does not specify the requirements for a transaction or event, or its accounting principles for similar transactions or events do not apply.

107.7 Accounting Standards Updates

As discussed beginning at paragraph 104.2, the FASB Accounting Standards Codification is the single source of authoritative, nongovernmental U.S. GAAP for nonpublic entities. The FASB periodically revises the Codification through the issuance of Accounting Standards Updates (ASUs), which generally include background information, basis for conclusions, and the amendments to the Codification. All Codification revisions are issued in this format. When appropriate, recently-issued ASUs are discussed at the relevant points in this *Guide*. Chapters 9 and 12 of the *Guide* address accounting and financial reporting considerations relevant to audits of nonprofit organizations. However, those chapters only provide a brief overview of accounting for and preparing financial statements of nonprofit organizations. Detailed guidance on those topics can be found in *PPC's Guide to Nonprofit GAAP* and *PPC's Guide to Preparing Nonprofit Financial Statements*. Those *Guides* can be ordered by calling (800) 431-9025 or from ppc.thomsonreuters.com.

107.8 The FASB Not-for-Profit Advisory Committee

In 2009, the FASB established the Not-for-Profit Advisory Committee (NAC) to support its efforts to address the accounting and reporting needs of nonprofit organizations and the users of their financial statements. In its advisory role, the NAC is to provide input and feedback to the FASB on existing GAAP, current and proposed FASB projects, and long-term issues. It will also assist the FASB in communicating and reaching out to the nonprofit sector and other interested parties.

107.9 As a result of recommendations from the NAC, the FASB currently has two projects specifically related to the needs of nonprofit organizations and the users of their financial statements on its technical agenda, as follows:

- *Not-for-Profit Financial Reporting: Financial Statements*. This is a standard-setting project, which means the objective is to look for improvements in the existing standards for financial statement presentation by nonprofit organizations. In this case, the areas under review relate to net asset classification requirements and the information about liquidity, financial performance, and cash flows provided in the financial statements. The FASB expects to begin deliberations on the project in the first quarter of 2013.
- *Not-for-Profit Financial Reporting: Other Financial Communications*. The objective of this research project is to study how nonprofit organizations use means other than their financial statements to communicate with donors, creditors, and others about their financial health and performance. When the FASB technical staff has completed its research, it will make a recommendation to the FASB about whether the project should move forward as a standard-setting project or as an educational project.

Both of these projects could result in significant new guidance that would need to be implemented by nonprofit organizations and understood by their auditors. Developments on these projects and the activities of the NAC can be

monitored on the FASB website at www.fasb.org. Future editions of this *Guide* will update the status of these projects.

107.10 Significant Proposed Accounting Standards

For several years, the FASB and the International Accounting Standards Board (IASB) have been working toward converging U.S. GAAP with International Financial Reporting Standards (IFRS). Those efforts are aimed at reducing the differences between U.S. GAAP and IFRS with the ultimate goal of having a single set of high-quality globally accepted accounting standards. The convergence efforts are expected to produce fairly substantial changes to present-day U.S. GAAP that will have wide-ranging implications for preparers, users, and auditors of financial statements. In particular, the current FASB projects on accounting for leases and revenue recognition could significantly affect nonprofit organizations. Additional information about those projects may be obtained from the FASB website at www.fasb.org. Future editions of this *Guide* will be updated for any final standards issued as a result of the projects that will affect audits of nonprofit organizations.

Other Governance and Accountability Standards

107.11 The Panel on the Nonprofit Sector Reports

The Independent Sector convened the Panel on the Nonprofit Sector—a collaboration among leaders of America's charitable organizations—to offer a comprehensive series of recommendations. The Panel on the Nonprofit Sector delivered “Strengthening Transparency, Governance, Accountability of Charitable Organizations.” (The report is available at www.nonprofitpanel.org.) The Panel later released a Supplemental Report with additional recommendations on strengthening accountability.

107.12 The Pension Protection Act of 2006 contained a series of charitable reforms, many of which reflect the recommendations of the Panel on the Nonprofit Sector. However, it is uncertain whether the recommendations of the Panel on the Nonprofit Sector will continue to influence Congressional legislation. Therefore, organizations and their auditors need to follow the process at www.independentsector.org so that they will be able to respond quickly and appropriately when, and if, changes are required. Because of the breadth of nonprofit expertise that went in to drafting the recommendations, nonprofit organizations may choose to consider the recommendations as best practices.

107.13 As the Panel has conducted its work, it has emphasized that a strong system of self-regulation and education is critical if the people making up the nonprofit community—boards, staff, volunteers, and donors—are to ensure that their organizations are adhering to the highest ethical standards. To assist in developing recommendations for strengthening self-regulation, the Panel created a special “Advisory Committee on Self-Regulation of the Charitable Sector.”

107.14 The Advisory Committee developed a set of principles of effective practice that all charitable organizations ought to aspire to follow. *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations* can be obtained at www.nonprofitpanel.org. The principles are arranged in the following four categories:

- *Legal Compliance and Public Disclosure*—Responsibilities and practices, such as implementing conflict of interest and whistleblower policies, that will assist charitable organizations in complying with their legal obligations and providing information to the public.

- *Effective Governance*—Policies and procedures a board of directors should implement to fulfill its oversight and governance responsibilities effectively.

- *Strong Financial Oversight*—Policies and procedures an organization should follow to ensure wise stewardship of charitable resources.

- *Responsible Fundraising*—Policies and procedures organizations that solicit funds from the public should follow to build donor support and confidence.

107.15 The Independent Sector released the *Principles Workbook: Steering Your Board Toward Good Governance and Ethical Practice* (the Workbook), a companion tool designed to help the nonprofit community meet its commitment to examine and improve their governance practices. The Independent Sector developed the Workbook in partnership with BoardSource, the national nonprofit organization concerned with increasing the effectiveness of nonprofit organizations by strengthening their boards of directors. The *Workbook* can be downloaded from the Independent Sector website at www.independentsector.org.

107.16 **Other**

Because of the Sarbanes-Oxley Act and the Senate Finance Committee actions, a number of oversight organizations have created or updated accountability and ethical standards for their members and others. Among them are:

- United Way (www.unitedway.org).
- Standards for Excellence Institute (www.standardsforexcellenceinstitute.org).
- Better Business Bureau Wise Giving Alliance (www.bbb.org/us/charity).
- Evangelical Council for Financial Accountability (www.ecfa.org).
- Combined Federal Campaign (www.charitychoices.com/cfc_stand.asp).

107.17 Organizations and their auditors need to be familiar with all applicable accountability and ethical standards.

Current Events Affecting Nonprofit Organizations

107.18 During 2009, at least three Ponzi schemes amounting to over \$1 billion each were uncovered. A number of smaller yet significant fraudulent schemes also came to light. The enormous, decades-long, Ponzi scheme perpetrated by Bernard Madoff quickly became the source of some very damaging economic and public relations trauma for some very prominent nonprofit organizations. Some relatively large and some smaller charities associated with well-known philanthropists were publicly embarrassed and also became financially distressed or ceased operations in the aftermath of the unraveling of the Madoff scheme. The depth of the financial and public relations fiasco that struck some public charities and private foundations was greater in magnitude than anything that had ever happened before in terms of the size of the fraud and its impact on charities.

107.19 Perhaps the consequences of the Ponzi frauds can be used by the nonprofit community as a lesson for the future. A number of organizations decided not to invest with Madoff when he refused to answer questions that the organizations had designed to screen potential investment advisors. Those organizations that had developed and followed clearly written procedures designed to review potential investment advisors did not invest with Madoff. Some tax-exempt organizations invested with Madoff through feeder funds that collected investors' money and seemingly just turned it over to Madoff. It is possible that those entities with a better screening process would have determined that the money they were investing was actually being given to Madoff.

107.20 These issues will continue to affect Madoff investors for a long time. First, depending on whether the investment was made directly with Madoff or with a feeder fund can affect whether or not any insurance reimbursement is possible. UBIT may have been paid on some investment returns, or excise taxes may have been paid by private foundations on assets that did not exist. Some organizations may be able to file refund claims for recovery of taxes paid. The trustee supervising the Madoff liquidation has publicly discussed trying to recapture gains that some long-term Madoff investors received from their investments with him. In some circumstances, investors actually received returns in excess of their actual total dollar investment. The trustee has indicated that he may try to recover any funds distributed to investors beyond those funds they actually invested.

107.21 Another major concern is whether or not those tax-exempt organizations invested in a prudent manner (i.e., properly diversified their investments, maintained well-written investment policies that clearly identified the procedures for engaging independent investment advisors, and delineated acceptable and unacceptable investment vehicles, target asset allocations, and acceptable risk for each type of investment or asset).

107.22 Private foundations and their managers are subject to various excise taxes, which could potentially be assessed. Auditors of the private foundations that invested with Madoff ought to be taking into account potential future excise taxes when performing their audits. If the investments were "jeopardizing investments," as defined by the IRS, substantial excise taxes could be due depending on the determination of how many actual individual investment transactions took place.

107.23 Some state attorneys general have indicated that they may take action against organizations and board members that failed to follow prudent investor guidelines. Another question for private foundations is whether or not their investments could be characterized as investments that jeopardize the exempt function of the organization. In addition, monies invested for pension purposes have obvious fiduciary responsibility implications for the individuals serving as trustees of those funds. Rev. Rul. 2009-9 explores a number of issues regarding such transactions, including the IRS position that investment losses from Madoff were theft losses and therefore considered ordinary losses.

107.24 The United States also had a plethora of serious financial issues affecting some significant health and educational related organizations during 2010. Erickson Retirement Communities was the target of *Washington Post* articles relating to the financing of retirement communities across the country with the proceeds of tax-exempt bond financing. Charges in the media included potential private inurement, conflicts of interest, UBI issues, and others. Other nonprofit organizations were found to have paid large amounts of money for luxury skyboxes at sport stadiums. Such negative publicity can have a long-term negative impact on the organization that becomes a news item in the local or national news.

107.25 In summary, practitioners need to be cognizant of how well the board is performing its fiduciary responsibility and overall monitoring of organizational activities. A careful reading of board minutes is especially important in nonprofit organizations of all sizes. Also, with the power of internet search engines available today, auditors have access to recent media stories related to client organizations, which may help determine whether a client organization is doing what it should be to fulfill its specified mission.

⁷ Nonprofit organizations may be subject not only to the laws of the states in which they were organized, but also those of states, counties, and cities in which they conduct business. The authors recommend that organizations consult with legal counsel regarding the applicability of each governmental entity's laws.

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Chapter 1 Background Information

108 Audit Requirements of Nonprofit Organizations

108 Audit Requirements of Nonprofit Organizations

Reasons for Audits of Nonprofit Organizations

108.1 Nonprofit organizations need audited financial statements or special purpose presentations for many of the same reasons as do business enterprises; for example, for submission to a bank to obtain a loan or to satisfy a requirement of a mortgage or other credit agreement. Also, a contract or an agreement with a private (nongovernmental) funding source might require audited statements or an audited special purpose presentation; for example, a presentation for a grant following specified accounting practices. In addition, audited statements are often needed for the following purposes unique to nonprofit organizations:

- *State Charities Registration.* Many states already have charitable registration requirements that include submission of an annual report with audited financial statements when the nonprofit organization's revenue exceeds a certain specified amount. In addition, other states are considering such a mandate or may in the future. See the discussion of state filing requirements in section 1005.
- *Requirement of National or Regional Organization or Association.* The central governing board of a national or regional organization that has affiliates or separate units in various parts of the country may require those affiliates to submit audited financial statements. This may be true whether or not the financial statements of the affiliate are required by GAAP to be combined or consolidated with the audited financial statements of the national organization.
- *Requirements of a Grantor or National Fund-raising Organization.* As previously mentioned, a funding source, including a private grantor or a federated fund-raising organization such as the United Way, may require audited financial statements as part of the agreement to make grants to the organization, solicit contributions on its behalf, or allocate to it a portion of the funds raised nationally, regionally, or locally.
- *Requirements of Governmental Agencies.* If a nonprofit organization receives financial assistance/awards from a state or local government or receives federal awards directly from a federal funding agency or indirectly

through another level of government, it may be subject to audit requirements. These requirements may extend beyond the requirements of GAAS and may be quite complex, as explained in the following paragraphs.

Requirements of GAAS Related to Compliance with Laws and Regulations

108.2 This *Guide* is primarily concerned with an audit made in accordance with GAAS. GAAS requires the audit to address compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts. (See AU-C 250.06.) Thus, in the audit of a nonprofit organization, substantial attention is paid to compliance with restrictions and requirements related to contributions, donations, gifts, and grants specified by the funding sources because such restrictions and requirements directly affect the recording and classification of the related support or revenue in the financial statements. This is true whether the funding source is governmental or nongovernmental. AU-C 935 gives guidance on applying this GAAS requirement when a nonprofit organization receives federal awards. Chapter 14 discusses compliance audit requirements.

Government Auditing Standards

108.3 In some cases, nonprofit organizations may be required to follow audit requirements that go beyond GAAS. A nonprofit organization may be required to have an audit following the requirements of the Government Accountability Office's (GAO) *Government Auditing Standards* (GAGAS or the Yellow Book). A Yellow Book audit can be required by law, regulation, agreement, contract, or policy. The most common Yellow Book audits are those required as part of a Single Audit performed under the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133. A Single Audit is required if the nonprofit organization expends more than a specified amount of federal awards. Another common way a nonprofit organization may be subject to Yellow Book requirements is due to provisions included in grant agreements or contracts regardless of the amount of federal awards expended, if any.

108.4 In December 2011, the GAO issued *Government Auditing Standards, 2011 Revision* (Yellow Book), which supersedes *Government Auditing Standards, July 2007 Revision*, effective for audits of financial statements covering periods ending on or after December 15, 2012. This *Guide* fully integrates the 2011 Yellow Book.

108.5 The Yellow Book includes standards for financial audits as well as attestation engagements and performance audits. The Yellow Book incorporates GAAS. Thus, performing a financial audit requires auditing the financial statements in accordance with GAAS, as well as following the additional general, field work, and reporting standards in *Government Auditing Standards*. This includes testing and reporting on compliance tests of laws, regulations, and provisions of contracts or grant agreements for which noncompliance would be material to the financial statements. An audit of financial statements in accordance with the Yellow Book may include additional reporting and documentation responsibilities.

108.6 Auditors should also be aware that the Yellow Book requires auditors meet certain continuing professional education requirements. The discussion beginning at paragraph 108.17 addresses Yellow Book continuing education requirements and related implementation guidance. The Yellow Book also requires that external peer reviews be completed at least once every three years and be provided to the party contracting for the audit. See paragraph 108.27 for a more detailed discussion of Yellow Book quality control requirements. The Yellow Book is available on the GAO's website at www.gao.gov/yellowbook. *PPC's Government Documents Library* includes the Yellow Book at Gov. Doc. 2.

108.7 The Yellow Book's Ethical Principles

The Yellow Book, in Chapter 1, discusses the fundamental ethical principles that are the foundation for all work performed under *Government Auditing Standards*. Chapter 3 builds on the principles and establishes requirements related to independence, professional judgment, competence, quality control and assurance, and peer reviews.

108.8 The Yellow Book emphasizes that the public expects auditors to follow ethical principles when performing work under *Government Auditing Standards*. According to Paragraph 1.12 of the Yellow Book:

Ethical principles apply in preserving auditor independence, taking on only work that the audit organization is competent to perform, performing high-quality work, and following the applicable standards cited in the auditors' report.

108.9 Although the Yellow Book's ethical principles are fundamental to all work performed under *Government Auditing Standards*, they are not written as specific requirements. Instead, they provide a framework that enables auditors to consider the facts and circumstances of each situation.

108.10 The Yellow Book emphasizes that performing audit work in accordance with ethical principles is both an individual and an organizational responsibility. The Yellow Book, Paragraph 1.14, provides the following ethical principles that guide the work of auditors and audit organizations conducting audits in accordance with *Government Auditing Standards*:

- The public interest

- Integrity

- Objectivity

- Proper use of government information, resources, and position

- Professional behavior

108.11 The Public Interest.

The Yellow Book, at Paragraph 1.15, defines *public interest* as “the collective well-being of the community of people and entities the auditors serve.” The auditor’s acceptance of responsibility to serve the public interest is considered to be critical to auditing in the government environment.

108.12 Integrity.

The Yellow Book, at Paragraph 1.17, indicates that *integrity* includes conducting work “with an attitude that is objective, fact-based, nonpartisan, and nonideological with regard to audited entities and users of the auditors' reports.” Integrity also includes being “honest, candid, and constructive.”

108.13 Objectivity.

The Yellow Book, at Paragraph 1.19, indicates that *objectivity* includes being independent in “mind and appearance . . . maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest.” Maintaining objectivity includes continually assessing relationships with audited entities and other stakeholders. (Independence is discussed in more detail beginning in paragraph 108.16 and in section 202.)

108.14 Proper Use of Government Information, Resources, and Positions.

The Yellow Book, at Paragraph 1.20, emphasizes that government information, resources, and positions are to be used for official purposes. They are not to be used for personal gain or contrary to the interests of the audited entity or the audit organization. The concept of proper use includes proper handling of sensitive or classified information or resources.

108.15 Professional Behavior.

The Yellow Book, at Paragraph 1.24, emphasizes that expectations for *professional behavior* include compliance with laws and regulations, avoidance of conduct that might discredit the auditor's work, and “putting forth an honest effort in performance of . . . duties and professional services in accordance with the relevant technical and professional standards.”

108.16 **Yellow Book Independence Requirements**

The independence requirements in the Yellow Book are significantly different from those in previous editions. The 2011 Yellow Book eliminated guidance on personal, external, and organizational impairments, and overarching principles for independence. However, the underlying concepts have been carried forward in a new conceptual framework for independence. The Yellow Book identifies specific nonaudit services that always impair independence and that auditors are prohibited from providing to audited entities. If a nonaudit service is not specifically prohibited, the auditor is required to assess its impact on independence using the conceptual framework. The independence requirements of the Yellow Book are discussed beginning at paragraph 202.70.

108.17 **Yellow Book Competence and Continuing Education Requirements**

The general standard related to competence in the Yellow Book requires that the staff assigned to perform the audit engagement must collectively possess adequate professional competence for the tasks required. This standard is generally consistent with the unconditional professional requirements in GAAS. The Yellow Book, at Paragraph 3.70, further states that an audit organization should have a process for recruitment, hiring, continuous development, assignment, and evaluation of staff to maintain a competent workforce. The Yellow Book continuing education requirements are included as part of the competence general standard.

108.18 According to Paragraph 3.76 of the Yellow Book, each auditor performing work under the Yellow Book, including planning, directing, performing field work, or reporting on an audit under the Yellow Book, should complete every two years, at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates. In addition, auditors who do any amount of planning, directing, or reporting on Yellow Book audits and auditors who are not involved in those activities but charge at least 20% of their time annually to Yellow Book audits should also obtain at least another 56 hours (for a total of 80 hours in every two-year period) of CPE that enhances their professional proficiency to perform audits. At

least 20 of the 80 hours should be completed in any one year of the two-year period. In other words, everyone working on a Yellow Book engagement should meet the 24-hour requirement. However, auditors who do not do any planning, directing, or reporting on a Yellow Book engagement, or who do not spend at least 20% of their time annually on Yellow Book engagements are not required to obtain an additional 56 hours of CPE to comply with the 80-hour requirement.

108.19 The Yellow Book, at Paragraph 3.77, states that determining what CPE subjects are appropriate to satisfy CPE requirements is a matter of professional judgment to be exercised by auditors in consultation with appropriate officials in their audit organization. In deciding appropriate CPE courses, auditors consider their experience, the responsibilities they have in a Yellow Book audit, and the operating environment of the audited entity.

108.20 The Yellow Book, at Paragraph 3.78, further states that individual auditors are primarily responsible for improving their own competencies and meeting CPE requirements. However, audit firms should establish quality control procedures to help ensure that auditors meet CPE requirements, including documentation of CPE completed.

108.21 CPE Topics and Implementation Guidance.

In April 2005, the GAO issued comprehensive guidance on CPE for auditors who perform Yellow Book engagements. Guidance on GAGAS Requirements for Continuing Professional Education (2005 Guidance) clarifies numerous CPE issues including measurement periods, 24-hour and 80-hour requirements, and CPE topics that meet the Yellow Book requirements. The concepts, but not the detailed guidance, of the 2005 Guidance have been incorporated into the Yellow Book. However, the 2005 Guidance is still applicable under the Yellow Book. Auditors may want to refer to it for identification of acceptable CPE topics. It is available on the GAO's website at www.gao.gov.

108.22 **Yellow Book Communication Requirements**

The Yellow Book states that auditors should make additional communications when performing Yellow Book audits. It also broadens the parties with whom auditors have to communicate and requires auditors to communicate specific information during the planning stage of a financial audit to reduce the risk that the needs or expectations of the parties involved may be misinterpreted. Yellow Book communication requirements are discussed more fully beginning at paragraph 203.11.

108.23 **Yellow Book Professional Judgment Requirements**

Government Auditing Standards establish an unconditional requirement that auditors must use professional judgment in planning, performing, and reporting on audits. Paragraph 3.61 of the Yellow Book states that professional judgment “includes exercising reasonable care and professional skepticism.” The concept of reasonable care requires auditors to act diligently in accordance with applicable professional standards ethical principles. Exercising professional skepticism entails a critical assessment of audit evidence while assuming that management is neither dishonest nor of unquestioned honesty.

108.24 The Yellow Book clearly states that professional judgment is both an organizational and individual responsibility. Paragraph 3.63 of the Yellow Book states:

Professional judgment represents the application of the collective knowledge, skills, and experiences of all the personnel involved with an audit, as well as the professional judgment of individual auditors. In addition to personnel directly involved in the audit, professional judgment may involve collaboration with other stakeholders, external specialists, and management in the audit organization.

108.25 Paragraph 3.64 of the Yellow Book indicates that applying professional judgment includes:

- Following the independence standards and related conceptual framework;
- Maintaining objectivity and credibility;
- Assigning competent staff to the audit engagement;
- Defining the scope of work;
- Evaluating, documenting, and reporting the results of the work; and
- Maintaining appropriate quality control over the audit.

108.26 **Yellow Book Reporting Requirements**

Government Auditing Standards contain several reporting requirements that exceed GAAS requirements. Additional reporting requirements include:

- Reporting on the auditor's compliance with *Government Auditing Standards*.
- Reporting on internal control and compliance with provisions of laws, regulations, contracts, and grant agreements.
- Reporting deficiencies in internal control, fraud, noncompliance, and abuse.
- Reporting views of responsible officials.
- Reporting confidential or sensitive information.
- Distributing reports.

These reporting requirements are discussed in Chapter 13.

108.27 Yellow Book Quality Control and Assurance Requirements

Government Auditing Standards state that a CPA firm conducting Yellow Book audits or attestation engagements must establish and maintain a quality control system that is designed to provide reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements. The firm has to undergo an external peer review at least once every three years by reviewers independent of the audit organization being reviewed. The external peer review requirement has to be met (i.e., peer review report issued) within three years after starting a firm's first Yellow Book audit (i.e., the start of field work).

108.28 The Yellow Book, beginning at Paragraph 3.85, provides a listing of policies and procedures that should be addressed in the CPA firm's quality control system. The firm's quality control policies and procedures have to be documented and communicated to its personnel. The firm's compliance with its quality control policies and procedures should be documented and retained long enough for those performing monitoring procedures and peer reviews to evaluate the extent of its compliance with its quality control policies and procedures. At least annually, the organization should analyze and summarize the results of its monitoring procedures, including identification of any systemic or repetitive issues needing improvement and recommendations for corrective action.

108.29 According to Paragraph 3.106 of the Yellow Book, auditors seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* should, if requested, provide the party contracting for the audit with the auditor's most recent peer review report and any subsequent peer review reports received during the period of the contract.

108.30 The Yellow Book, at Paragraph 3.105, states that external audit firms should make their most recent peer review report publicly available. This can be done for example, by posting the peer review report on publicly available internet site or to a publicly available site designed for transparency of peer review results. If these options are not available, the audit firm should use the same mechanism it uses to make other information public, and provide the peer review report to others upon request.

Single Audit Requirements

108.31 The Single Audit Act (the Act) and OMB Circular A-133 require nonprofit organizations expending \$500,000 or more in a year in federal awards to have either a single or program specific audit performed in accordance with OMB Circular A-133 and the Act.

108.32 If the nonprofit organization receives financial awards from a state or local government, including federal awards received indirectly through a state or local government, the state or local government may prescribe audit requirements specified in a regulatory agency's audit guide. Those requirements may range from only a GAAS audit to a Single Audit in accordance with OMB Circular A-133 or a modification of a GAAS or Single Audit. OMB Circular A-133 and the OMB Circular A-133 Compliance Supplement include requirements for a risk-based approach for determining major programs for testing, due dates for submission of audit reports, requirements for auditing costs charged to indirect cost pools, a requirement to submit a Data Collection Form to the Federal Audit Clearinghouse (the auditor prepares applicable sections and signs the form), and 14 types of compliance requirements. The AICPA Audit Guide, *Government Auditing Standards and Circular A-133 Audits* (GAS/A-133 AICPA Audit Guide), provides

guidance on the auditor's responsibilities when performing a Single Audit under OMB Circular A-133 and the Single Audit Act Amendments of 1996, including report examples.

108.33 Chapter 14 discusses OMB Circular A-133, the OMB Circular A-133 Compliance Supplement, and the GAS/A-133 AICPA Audit Guide. Chapter 14 provides guidance on considerations necessary when a nonprofit organization receives governmental financial awards. Reporting requirements are discussed in Chapter 13.

Resources for Auditors

108.34 In 2004, the AICPA launched the Governmental Audit Quality Center (the Center). The Center is a firm-based voluntary membership center designed to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. Governmental audits include Single Audits and Yellow Book-only audits of nonprofit organizations; thus, such audits are also covered by the Center.

108.35 To qualify for membership, firms must agree to meet the Center's membership requirements, which among other things include requirements related to training, quality control, and self-monitoring. Dues are based on the firm's number of CPAs as of the date of the firm's most recent fiscal year end. The Center's website includes a calculator to determine dues.

108.36 Additional details about the Center and membership requirements are available on the Governmental Audit Quality Center website at www.aicpa.org/gaqc.

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109 Reviews of Interim Financial Information

109 Reviews of Interim Financial Information

109.1 AU-C 930, *Interim Financial Information*, establishes standards and provides guidance on the procedures to be performed by an independent accountant engaged to review interim financial information.

Applicability

109.2 AU-C 930 is applicable when a nonpublic entity engages the accountant to perform a review of interim financial information and all of the following conditions are met:

- a. the entity's latest annual financial statements have been audited by the accountant or a predecessor;

- b. the accountant has been engaged to audit the entity's current year financial statements, or the accountant audited the entity's latest annual financial statements and expects to be engaged to audit the current year financial statements, or the engagement of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review;

- c. the client prepares its interim financial information in accordance with the same financial reporting framework (e.g., GAAP or an OCBOA) as that used to prepare the annual financial statements; and

- d. if the interim financial information is condensed information, all of the following conditions are met:
 - (1) The condensed interim financial information purports to conform with an appropriate financial reporting framework, which includes appropriate form and content of interim financial statements; for example, FASB ASC 270, *Interim Reporting*, may be an appropriate financial reporting framework for interim financial information.

(2) The condensed interim financial information includes a note that the financial information does not represent complete financial statements and should be read in conjunction with the entity's latest annual audited financial statements.

(3) The condensed interim financial information accompanies the latest audited annual financial statements or such audited annual financial statements are made readily available by the entity. Financial statements are considered readily available if a third-party user can obtain the financial statements without any further action by the entity (for example, financial statements on an entity's website may be considered readily available, but being available on request is not considered readily available).

The most likely circumstances when an audit firm will be applying AU-C 930 are when the firm has performed an annual audit and then performs the review or when the firm has been engaged to perform the audit, but performs the first review before the audit is completed.

109.3 Under AU-C 930, *interim financial information* represents financial information or statements prepared and presented in accordance with an applicable financial reporting framework (for example, GAAP) covering a period or periods less than a full year or for a 12-month period ending on a date other than the entity's fiscal year end. Interim financial information may be condensed or in the form of complete financial statements. (AU-C 930.06)

109.4 Overall Objectives and Approach

The overall objective of a review is to provide the accountant with a basis for reporting whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with the applicable financial reporting framework by performing limited procedures. The overall approach is influenced by the fact that the review is performed by an accountant who either has performed or will perform an audit of the annual financial statements. As a result, some of the steps in a review can be combined with similar steps for the annual audit, and various efficiencies can be achieved by performing some audit work in the course of performing the interim review.

109.5 The steps and procedures that are ordinarily appropriate for the review of interim financial information of a nonprofit organization are as follows:

- a. Assess engagement acceptance or continuance.
- b. Agree on the terms of engagement.
- c. Obtain or update an understanding of the organization and its internal control.

- d. Perform analytical procedures, inquiries, and other review procedures.

- e. Obtain a management representation letter.

- f. Evaluate the results of the review procedures performed.

- g. Communicate to management and those charged with governance.

- h. Issue the review report.

109.6 **Additional Information**

PPC's Guide to Audits of Nonpublic Companies contains further discussion of AU-C 930 and also includes a complete set of practice aids that can be used in a review of interim financial information.

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110 The PPC Audit Process

110 The PPC Audit Process

110.1 Generally accepted auditing standards require auditors to use information gathered about the entity and its environment (including internal control) to identify and assess the risks of material misstatement at both the overall financial statement and relevant assertion levels, and to determine the nature, timing, and extent of further audit procedures needed to respond to those risks. Further audit procedures are required to be performed to obtain audit evidence to support the auditor's opinion.

110.2 The authors have developed a practical approach to that audit process to address the requirements of authoritative literature and have designed practice aids to assist auditors in meeting those requirements. PPC's audit approach is designed to be flexible and adaptable, allowing auditors to better leverage their knowledge of the client to tailor their audit procedures. The audit approach has been divided into the following broad steps:

1 Perform procedures regarding acceptance/continuance of the client relationship, evaluate compliance with ethical requirements (including independence), and establish an understanding with the client in an engagement letter.

2 Develop a preliminary audit strategy, establish planning materiality, and perform risk assessment procedures to gather information about the entity and its environment that may be relevant in identifying risks of material misstatement of the financial statements.

3 Gather the information to understand and evaluate the design and implementation of the entity's internal control system.

4 Synthesize the information gathered, identify risks (both overall and specific risks) that could result in material misstatement of the financial statements, and finalize the overall audit strategy.

5 Assess the risks of material misstatement of the entity's financial statements.

6 Develop and perform appropriate responses (further audit procedures) to the risks of material misstatement of the financial statements considering the overall audit strategy and planning materiality.

7 Evaluate audit findings and evidence.

8 Prepare required reports and communications.

110.3 Although the requirements and guidance may suggest a sequential process, the audit is a continuous process of gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the client's financial statements. Therefore, the audit process is an iterative, nonlinear process, whereby the required procedures may be performed concurrently with other procedures. In addition, risks should be evaluated continuously throughout the audit.

Practice Aids

110.4 *PPC's Guide to Audits of Nonprofit Organizations* contains practice aids that guide the auditor through the entire audit process. The practice aids included in this *Guide* are discussed in the related text guidance. Chapter 12 provides guidance on drafting the financial statements. Chapter 13 contains a discussion on the auditor's report and provides several illustrative reports. Detailed guidance on reporting is covered in *PPC's Guide to Auditor's Reports*.

110.5 PPC practice aids at the NPO-CX section of this *Guide* assist auditors in complying with professional standards and achieving an efficient workflow. At NPO-CX-0.1, the authors have indicated which practice aids should be completed on each engagement to ensure compliance with professional standards. Additionally, the authors have indicated which practice aids, generally by themselves, do not fulfill a specific GAAS requirement, and which practice aids assist auditors in situations that do not occur on every audit.

110.6 The auditor may choose to document audit procedures in memo form rather than using a practice aid. To ensure that the memo documents the requirements of GAAS, the authors recommend that auditors read the practice aid for an indication of the matters to be considered and documented in the memo. As a general rule of thumb, the memo should address the subtitles in the practice aids, thereby indicating how all the major areas for consideration in the practice aid are addressed in the memo. Case Study 2 in *PPC's Guide to Audit Risk Assessment* (Appendix B) illustrates the PPC audit process using a combination of completed PPC practice aids and memos that replace certain practice aids.

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111 Organization of This Guide

111 Organization of This *Guide*

111.1 As previously noted, this *Guide* provides a step-by-step approach to providing audit services for nonprofit organizations. The following paragraphs discuss the organization of the *Guide* in more detail.

Chapter 2—Pre-engagement Activities

111.2 Chapter 2 explains the activities that take place (a) before a nonprofit organization engagement is accepted and (b) in the early planning stages of an engagement.

Chapter 3—Risk Assessment Procedures and Planning

111.3 Chapter 3's focus is on *general* planning decisions. General or preliminary planning can be distinguished from detailed planning of audit procedures—the subject of Chapter 4. Preliminary planning includes deciding on an overall strategy for the audit, obtaining an understanding of the entity and its environment, including its internal control, making an initial assessment of audit risk and materiality, and deciding on the overall timing of the engagement.

Chapter 4—Assessing Risks and Developing the Detailed Audit Plan

111.4 Chapter 4 focuses on (a) assessing the risks identified by the auditor throughout the process of performing the risk assessment procedures and (b) selecting responses that are appropriate to address those risks. The result of the auditor's risk assessment is the preparation of a detailed audit plan describing the nature, timing, and extent of further audit procedures.

Chapter 5—Substantive Procedures

111.5 Chapter 5 discusses substantive procedures, which consist of tests of details and substantive analytical procedures. Included in the chapter are discussions of substantive procedures that are required in every audit engagement and confirmation procedures.

Chapter 6—Testing Internal Control

111.6 This chapter discusses tests of controls, including circumstances when tests of controls should be performed and circumstances when testing would be unnecessary or inefficient. Chapter 6 discusses the nature of tests of controls, including inquiry and observation, inspection of documents, walkthroughs, review of reconciliations and similar bookkeeping routines, and reperformance of control activities.

Chapter 7—Audit Sampling in a Nonprofit Organization Audit Engagement

111.7 Chapter 7 explains how to decide the extent of audit tests. Decisions about extent include decisions about—

- Number of locations or components to be tested.
- Cutoff amounts for individually significant dollar items.
- Sample sizes.

Chapter 8—Audit Documentation

111.8 Chapter 8 focuses on the documentation necessary to comply with professional standards and on techniques and approaches to efficient workpaper organization and preparation.

Chapter 9—Special Accounting and Auditing Considerations for Nonprofit Organizations

111.9 This chapter provides guidance on various accounting and audit considerations that are often unique to nonprofit organizations and audit engagements.

Chapter 10—Tax Considerations in Audits of Nonprofit Organizations

111.10 This chapter provides extensive coverage of tax compliance and other tax considerations applicable to nonprofit organizations.

Chapter 11—Concluding the Audit

111.11 Chapter 11 discusses the general procedures that are necessary during the concluding phase of the audit. The general procedures discussed in this chapter are as follows:

- Procedures to search for commitments and contingencies, including obtaining lawyers' letters and other procedures relating to litigation, claims, or assessments.
- Obtaining written representations from management in a management representation letter.
- Procedures to search for subsequent events.
- Procedures to identify and evaluate the disclosure of related party relationships and transactions.

- Evaluation of whether there is a substantial doubt about the entity's ability to continue as a going concern.
- Procedures to identify and evaluate the disclosure of risks and uncertainties, including procedures for testing accounting estimates.
- Procedures to summarize and evaluate the overall results of audit tests, including the evaluation of uncorrected misstatements.
- Concluding on the form of opinion on the financial statements, and communicating that opinion and significant conclusions and other matters in written and oral reports.

Chapter 12—Financial Statements of Nonprofit Organizations

111.12 This chapter covers the unique aspects of financial statements of nonprofit organizations. Illustrative examples of financial statements and disclosures are provided in the appendixes to that chapter.

Chapter 13—Auditor's Reports

111.13 This chapter discusses the professional and regulatory standards for auditor's reports and provides several illustrative examples in its appendixes.

Chapter 14—Single Audits

111.14 This chapter discusses special considerations if the entity receives federal awards directly or indirectly through another agency.

Chapter 15—Compilation and Review Procedures

111.15 This chapter discusses the special considerations in a compilation or review of a nonprofit organization. Practice aids appropriate for these engagements are presented in the CR section.

Practice Aids

111.16 These sections of the *Guide* include all of the practice aids the auditor needs to efficiently conduct an audit in accordance with authoritative literature, including:

- Compilation and review checklists and practice aids (NPO-CR).
- Firm policies (NPO-FP).

- Confirmations and correspondence letters (NPO-CL).
- Checklists and practice aids (NPO-CX).
- Audit programs (NPO-AP, NPO-IA, NPO-AP-S).

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