



SURVIVING AN AUDIT

Dear Colleague,

On behalf of the National Minority AIDS Council (NMAC), thank you for picking up this manual and taking a step toward increasing your capacity in this struggle. As we enter the third decade of HIV/AIDS, it is more important than ever to develop our skills and knowledge to better serve our communities and our constituents.

NMAC, established in 1987 as the premier national organization dedicated to developing leadership within communities of color to address the challenge of HIV/AIDS, works to proactively produce and provide skills-building tools for our community. One such tool is the manual that you hold in your hands.

The Technical Assistance, Training and Treatment Division's mission to build the capacity and strength of community-based organizations, community planning groups for HIV prevention and health departments throughout the United States and its territories is supported through a multifaceted approach. This approach includes individualized capacity-building assistance, written information (manuals, publications and information provided through NMAC's website and broadcast e-mail messages) and interactive learning experiences (trainings). All components are integral to providing a comprehensive capacity-building assistance experience, as opposed to offering isolated instances or random episodes of assistance.

After undergoing a revision of existing curricula and publications and an expansion of our current catalog of subject areas to include more organization infrastructure topics, NMAC is proud to present you with this new manual, *Surviving an Audit*. One of 15 topic areas in which we provide capacity-building assistance, this manual will provide you with detailed information, resources and the knowledge to enhance your capacity to provide much-needed services in your community.

Our hope is that this revised manual will give you the skills and knowledge to increase your capacity and serve your community at a greater level than ever before. Please feel free to contact us if you would like further information on what other services we can provide to you and your community.

Yours in the struggle,

A handwritten signature in black ink, appearing to read 'Paul Akio Kawata'. The signature is stylized and somewhat abstract, with a large, sweeping initial 'P' and 'A'.

Paul Akio Kawata
Executive Director

- Preface5
- Introduction7
- UNIT 1:**
- The Audit9**
- Introduction11
- I. What is an Audit?11
- II. Types of Audits12
- UNIT 2:**
- Regulatory Background for Financial Issues**
- Impacting Federal Grant Recipients15**
- I. Office of Management and Budget Circulars17
- UNIT 3:**
- Common Financial Management Issues21**
- Introduction23
- I. Issues with Internal Controls23
- II. Issues with Financial Reporting24
- III. Issues with Staffing the Financial Management Function24
- IV. Issues with Information Technology24
- UNIT 4:**
- Addressing Financial Management Issues25**
- I. Addressing Internal Control Issues27
- II. Addressing Financial Reporting Issues29
- III. Taxes29
- IV. Compliance Requirements30
- V. Accounting and Bookkeeping31
- VI. Preparation for the Financial Statement Audit32
- VII. Accounting Staff Issues34
- VIII. Information Technology Issues35
- UNIT 5:**
- Legal Issues and Grant Management37**
- Appendix A: Glossary43**
- Appendix B: Frequently Asked Questions45**
- Appendix C: Bibliography47**

Preface

Organizational Effectiveness

Successful community-based organizations (CBOs) can attribute their success to employing 15 key components that support organizational effectiveness. See the model below.

Ongoing learning and training in each of these areas will allow your organization to meet the needs of your constituents.

For information regarding training in any of these areas, contact the National Minority AIDS Council's Technical Assistance, Training and Treatment Division by telephone at (202) 234-5120 or by e-mail at ta_info@nmac.org.

ORGANIZATIONAL EFFECTIVENESS MODEL



Introduction

Purpose

To provide board members and staff of minority community-based organizations (CBOs) with the financial and legal skills they need to handle receipt of federal funding. This manual will address the most common legal and financial challenges CBOs face and offer practical solutions.

Learning Objectives

By the end of this unit, learners will be able to:

- ✓ Identify common financial management issues that federally funded minority CBOs encounter when managing grants.
- ✓ Successfully address common management issues.
- ✓ Understand legal responsibilities and how to minimize risk.

Pre-training Assessment

Test your knowledge on nonprofit audits with this quiz. Review the answers on page 41 before, and again after, completing the manual.

Pre-training Assessment

Please determine whether the following statements are True or False.

1. **True** **False** Preparation of financial statements is the responsibility of the auditor.
2. **True** **False** "Audits" are only undertaken to examine financial statements.
3. **True** **False** A private, nonprofit organization receiving federal funds is not impacted by federal standards governing cost principles and fiscal management policies.
4. **True** **False** Sound internal controls cannot prevent all instances of waste, fraud and abuse.
5. **True** **False** Accounting policies and procedures do not have to be written as long as the staff is aware of them.
6. **True** **False** Tax-exempt organizations must file tax returns.
7. **True** **False** Only an organization's management has legal and regulatory responsibility for fiscal management of grants.
8. **True** **False** Organizations have follow-up responsibilities on financial statement and/or compliance audit findings.

Check answers on page 41, after reading the manual thoroughly.

UNIT 1:

The Audit

Purpose:

To identify the various types of audits.

Learning Objectives:

By the end of this unit, learners will be able to:

- ✓ State the purpose of and describe a financial statement audit.
- ✓ State the purpose of and describe a compliance audit.
- ✓ State the purpose of and describe an operational audit.

Introduction

Community Based Organizations (CBOs) often obtain a major portion of their funding from grants, which enable them to provide more services under flexible conditions.

Being entrusted with such resources means organizations must be accountable for resource use. Acceptance of grants, particularly federal grants, means compliance with rules and regulations that affect the recordation, classification and reporting of accounting data.

A CBO's board of directors and management are responsible for utilizing resources efficiently, effectively and economically to achieve the organization's stated goals and objectives in a way that complies with any rules set by their funders. The audit is the main tool for ensuring an organization's accountability and monitoring its resource use.

What is an Audit?

"An audit is a methodological review and objective examination of an item, including the verification of specific information as determined by the auditor or as established as general practice.

"Generally, the purpose of an audit is to express an opinion on or reach a conclusion about what was audited. In financial accounting, it is usually the financial statements of an enterprise that are the subject of an audit."¹

In other words, an audit is a systematic examination by a competent and independent person who obtains and objectively evaluates evidence so as to form an opinion and issue a report.

AUDIT

A review and objective examination of a program or practice. Generally, the purpose of an audit is to express an opinion on or reach a conclusion about the subject reviewed. In financial accounting, it is usually the financial statements of the entity that are the subject of an audit.

1. Larry P. Bailey, *Miller GAAS Guide* (Orlando: Harcourt Brace & Company, 2001), p. 103.

Types of Audits

There are three types of audits typically undertaken by/on behalf of CBOs: 1) financial statement audits, 2) compliance audits, and 3) operational audits. Each type has its own objectives and purpose.

FINANCIAL STATEMENTS

Statements that reflect the collection, tabulation and final summarization of accounting data. Financial statements for a nonprofit organization should include statements of financial position, activities and cash flow.

Financial Statement Audit

The financial audit is what usually comes to mind when the term “audit” is mentioned. Financial audits assess whether the organization is accurately representing its financial position, results of operations and cash flow in conformity with generally accepted accounting principles.

An entity’s financial statements reflect the collection, tabulation and summarization of accounting data. The financial statements of a nonprofit organization should include three key statements at a minimum:

- ✓ **Statement of financial position:** Reports the net assets of the organization, focusing on the assets and liabilities in each of three classes — permanently restricted net assets, temporarily restricted net assets and unrestricted net assets.
- ✓ **Statement of activities:** Classifies revenues, expenses, gains and losses within the three classes of net assets. Typically these reports classify finances by function, such as program.
- ✓ **Statement of cash flows:** A detailed accounting of all cash spent and brought in.

Some key points should be noted about a financial statement audit:

- ✓ The auditor is independent of the organization.
- ✓ The auditor bases the opinion on a sample of financial data rather than on every item that makes up the financial statement.
- ✓ Auditors offer reasonable assurance about whether the financial statements are free of material misstatement. They can not guarantee with 100% certainty that the financial statements are accurate.
- ✓ The opinions expressed are on the financial statements as whole and not on individual items within the statements.

Observation

Financial statements are the responsibility of the entire organization. Management has the responsibility to maintain accounting records and prepare the financial statements. The auditor’s product is the report summarizing findings.

Compliance Audit

For federally funded CBOs, the compliance audit is designed to determine whether the financial assistance has been spent in accordance with applicable laws, regulations and grant criteria. Typically a compliance audit is performed in accordance with procedures set by the user of the report.

Operational Audit

The operational audit examines all or part of an organization for the purpose of measuring the effectiveness and efficiency of its performance in relation to management's objectives or budgets. Effectiveness refers to success in achieving stated goals and objectives; efficiency refers to how well available resources are used to achieve stated goals and objectives. Operational audits can examine and evaluate a business activity, such as property, plant and equipment management procedures, or determine whether a particular program is achieving its objectives.

Some key points about an operational audit:

- ✓ Operational audits require subjective judgment because the criteria for effectiveness and efficiency are not always clearly established. Auditors should draw upon their knowledge, familiarity with similar practices and past experiences to develop evaluation standards.
- ✓ The audit report frequently reports identified problems or deficiencies and includes suggested improvements.

UNIT 2:

Regulatory Background for Financial Issues Impacting Federal Grant Recipients

Purpose:

To highlight the regulatory and other standards that impact CBOs receiving federal funding awards.

Learning Objectives:

By the end of this unit, learners will be able to identify those standards that affect the operations of CBOs receiving federal funding awards, including standards issued by:

- ✓ The Office of Management and Budget (OMB)
- ✓ The General Accounting Office (GAO)
- ✓ The American Institute of Certified Public Accountants (AICPA)

CBOs receiving federal funds are impacted by three sets of regulatory standards: 1) the Office of Management and Budget's (OMB) circulars; 2) the General Accounting Office's (GAO) Generally Accepted Government Auditing Standards (GAGAS); and 3) the standards of the American Institute of Certified Public Accountants (AICPA).

I. Office of Management and Budget Circulars

OMB circulars are issued as instructions or information to federal agencies. Compliance with the provisions of these circulars is often cited in grant award documents. Complete copies can be accessed electronically at <http://www.whitehouse.gov/omb/circulars.html>. Particular highlights of each are summarized below.

A. OMB Circular A-110: Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations

CBO management should become thoroughly familiar with the requirements of this circular as it contains accounting and reporting requirements that grant recipients must follow.

It is divided into four subparts:

- ✓ **Subpart A — General:** States the purpose of the circular and defines selected terms.
- ✓ **Subpart B — Pre-award Requirements:** Offers instructions and other guidelines needed to apply for federal awards.
- ✓ **Subpart C — Post-award Requirements:** Sets forth the standards for an organization's financial management, cost sharing and matching requirements, accounting for program income, performing audits and determining the allowability of costs. This section contains the essence of the circular's impact on an organization's day-to-day administration of federal awards, and should be used as a checklist for sound financial management.

GENERALLY ACCEPTED GOVERNMENT AUDITING STANDARDS (GAGAS)

Auditing standards issued by the General Accounting Office that must be followed by auditors of federal programs when required by law, regulation, agreement or contract.

OMB CIRCULARS

Documents issued by the Office of Management and Budget (OMB) as instructions or information to federal agencies. Three circulars in particular provide required guidance to nonprofit organizations regarding their financial management operations as federal award recipients. They are:

- Circular A-110, Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations
- Circular A-122, Cost Principles for Non-Profit Organizations
- Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations

Four particular standard sets are included. The **financial and program management standards** apply to financial management and reporting, cost accounting and program management. The **procurement standards** cover obtaining goods and services with federal funds. The **reports and records requirements** set minimum standards for an organization to evaluate the financial and programmatic results of the program. The **termination and enforcement requirements** describe the reasons a recipient organization's grant may be revoked and how a federal agency can go about revoking this award.

- ✓ **Subpart D — After-the-Award Requirements:** Contains federal award closeout, disallowance and adjustment procedures.

B. OMB Circular A–122: Cost Principles for Non-Profit Organizations.

This circular standardizes cost determination principles for grants, contracts and other agreements with nonprofit organizations. It sets out what's allowable in terms of costs. Certain operational costs may not be chargeable to a federal award and must be tabulated and tracked separately.

The circular consists of three attachments.

- ✓ **Attachment A — General Principles:** This attachment provides guidance on general cost principles, guidance on reasonable costs, and guidance on allocable costs.
- ✓ **Attachment B — Allowable Costs:** There are 56 individual costs listed. These principles apply whether a cost is treated as direct or indirect. It should be noted that the failure to mention a particular cost item is not to imply that it is unallowable; rather, allowability is based on how similar or related cost items are treated.
- ✓ **Attachment C — Not-For-Profits Not Subject to the Circular:** Lists organizations not subject to the requirements of the circular.

C. OMB Circular A–133: Audits of States, Local Governments, and Non-Profit Organizations

This circular sets uniform standards for federal agencies to audit non-federal agencies receiving federal funds.

Circular A–133 requires federal agencies to audit all nonprofit organizations that receive more than \$300,000 per year in federal awards. While organizations that receive less than \$300,000 per year in federal awards are exempt from the federal audit requirement that year, they must make records available for review by federal agencies, pass-through entities or the US General Accounting Office.

This circular can provide important information to help organizations prepare for audits, as it lays out a model audit and details each test that needs to be conducted to comply with the standard.

General Accounting Office Standards

The General Accounting Office (GAO) is a nonpartisan agency of the federal government that performs the audit function for Congress. Recognizing the need for auditing standards for federal auditors, it issued the *Government Auditing Standards*, commonly referred to as the “Yellow Book.” These standards, to be followed by auditors when required by law, regulation, agreement or contract, are often referred to as generally accepted government auditing standards (GAGAS).

Auditors performing a GAO-standard audit will issue three reports: an opinion on the organization’s financial statements, a report on compliance with applicable laws and regulations, and a report on the organization’s internal control structure.

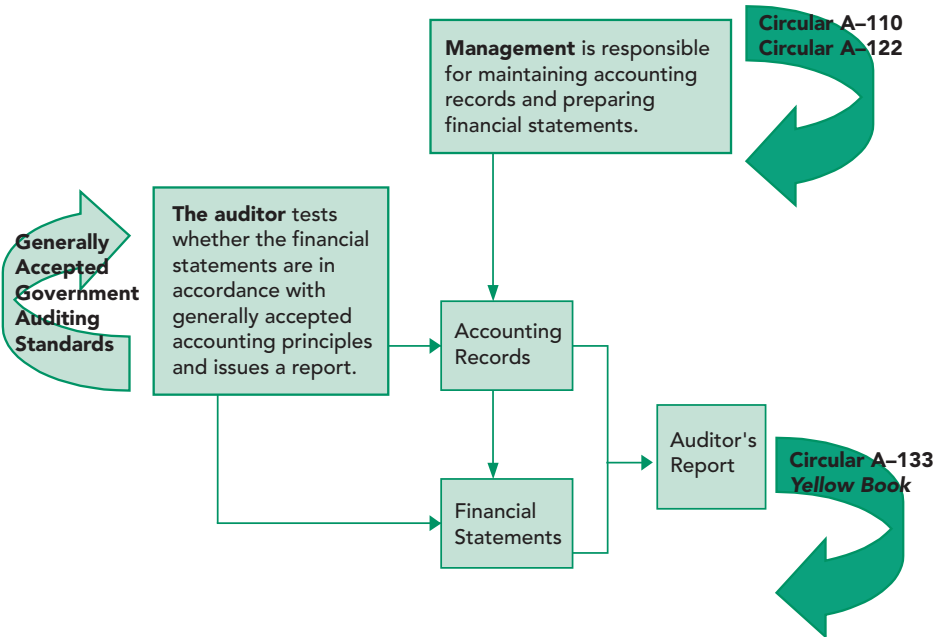
American Institute of Certified Public Accountants

The American Institute of Certified Public Accountants (AICPA), a national professional accounting organization, also has developed audit standards.

The AICPA’s *Statements on Auditing Standards* (SAs) provide detailed guidance on planning, conducting and reporting on financial statements and are considered the most authoritative references auditors can use to resolve problems encountered during an audit. The AICPA standards have been incorporated into the GAO standards described above.

Below is an overview of the financial statement audit process and the standards impacting the process.

THE FINANCIAL STATEMENT AUDIT PROCESS



UNIT 3:

Common Financial Management Issues

Purpose:

To identify common financial management issues that federally funded CBOs encounter when managing grants.

Learning Objective:

By the end of this unit, learners will be able to:

- ✓ Identify four problem areas that can adversely impact a CBO's financial management operation.

Introduction

Far too often, organizations minimize financial management issues which have the potential to threaten a program, or, if serious enough, the organization's very existence.

The National Minority AIDS Council's consultations with CBOs in 2002 identified a number of financial management issues in four major areas:

- ✓ Internal controls
- ✓ Financial reporting
- ✓ Staffing the financial management function
- ✓ Information technology

The identified problems and issues are briefly presented in this section, with solutions presented in Unit 4.

I. Issues with Internal Controls

Internal control is the way an organization can check that it is operating effectively and efficiently, reliably reporting its finances and complying with all applicable laws and regulations.

Observation

Internal control is a process or means to an end, and not the end itself. The process is effected by individuals, policy manuals, documents and forms.

Below are specific internal control issues CBOs commonly face, according to NMAC's 2002 study:

- ✓ Policies and procedures for accounting processes are poorly written, not implemented or not followed.
- ✓ Budgeting and cash flow management is inadequately prepared or not followed.
- ✓ Board oversight of the organization's finances is improper or ineffective.

INTERNAL CONTROLS

The process established by an organization's board of directors, management and other personnel that is designed to provide reasonable assurance that the organization will efficiently and effectively achieve its objectives, reliably report finances, and comply with applicable laws and regulations.

II. Issues with Financial Reporting

COMPLIANCE REQUIREMENTS

The laws, rules, regulations and award terms that regulate an organization's activities as a federal grant recipient.

Financial reporting issues identified by NMAC's 2002 study included:

- ✓ Lack of a formal system for capturing costs and cost-allocation plans.
- ✓ Lack of familiarity with filing requirements.
- ✓ Lack of familiarity with compliance requirements.
- ✓ Inadequate bookkeeping practices.
- ✓ Inadequate preparation for audits.

III. Issues with Staffing the Financial Management Function

An adequately trained financial management/accounting staff has a direct and material effect on the organization's ability to summarize financial results, maintain financial stability and operate efficiently. Issues identified in this area included:

- ✓ The financial management/accounting staff was poorly trained and/or lacked expertise in the accounting and compliance processes.
- ✓ Organization management did not fully understand their duties and did not control responsibility applicable to financial reporting and compliance requirements.
- ✓ Organization management did not take appropriate follow-up action for identified problems and weaknesses in internal controls (including matters communicated by auditors).

IV. Issues with Information Technology

An effective information technology system (computer hardware and software) facilitates the timely and effective recording of accounting transactions and the production of accounting reports. Typical problems with information technology in the NMAC study included:

- ✓ Accounting staff relied on manual accounting systems.
- ✓ Accounting staff not maximizing the capabilities of existing systems.

UNIT 4:

Addressing Financial Management Issues

Purpose:

To learn how to successfully address common financial management issues.

Learning Objectives:

By the end of this unit, learners will be able to:

- ✓ Address the four areas in which problems can adversely impact a CBO's financial management operation.
- ✓ Conduct an assessment of their CBO's internal control environment.
- ✓ Develop a checklist in preparation for the annual financial statement audit.

The early identification and correction of financial management issues will minimize, if not eliminate, their impact on the organization's operations. This unit highlights some of the salient issues and provides some ways to address them.

I. Addressing Internal Control Issues

An internal control structure may vary from organization to organization, depending on size, complexity of operations and other characteristics. However, the basic components of internal control, and the critical importance of this type of audit, are the same, as highlighted below:

- ✓ **Control environment:** The tone, attitude and method of operations of the organization's board and management. It reflects the ethics and values of those that create and implement the policies and procedures and greatly affects adherence to policies and procedures.
- ✓ **Risk assessment:** The organization's identification, analysis and management of risks in the preparation of financial statements.
- ✓ **Control activities:** The policies and procedures that help ensure that management's directives are carried out.
- ✓ **Monitoring:** The process used to assess the quality of the internal control's performance over time.

Auditors test to make sure internal controls effectively safeguard the organization's assets, produce reliable financial statements and help the organization comply with applicable laws and regulations.

CONTROL ENVIRONMENT

The overall attitude and actions of the organization's board of directors and management regarding the effectiveness of specific controls. It is the tone that influences the control consciousness of the organization's staff.

Observation

Internal control can only do so much to protect against problems and produce sound accounting data. The inherent limitations that can be caused by human error or collusion must be recognized.

In the following sections, we will address the issues with specific components of internal control identified in the NMAC study.

The Control Environment

This first component of internal control — environment — assesses the tone for the organization and serves as a foundation of all the other components of internal control.

Use the following checklist to assess your organization’s internal control.

	Yes	No	N/A
A. What is the ethical tone of your organization?			
1. Have you developed, communicated and implemented ethical standards?	_____	_____	_____
2. Is there a positive tone at the top and throughout the organization regarding a positive control environment?	_____	_____	_____
3. Does management have a concern about weaknesses in the system of internal controls? Are they willing to correct them?	_____	_____	_____
B. Is your board of directors (and/or appropriate board committee) actively involved in the financial oversight and reporting process?			
1. Does your board request/receive/review/act on periodic financial reports?	_____	_____	_____
2. Do your financial reports compare budget to actual draw-downs and expenditures?	_____	_____	_____
C. Do you have written policies and procedures to provide a written statement to guide operations, implement new actions, or define and implement required regulatory actions?	_____	_____	_____
D. Have you implemented policies regarding the segregation of duties?	_____	_____	_____
E. Have you developed formal job descriptions?	_____	_____	_____
F. Do you have a conflict of interest policy or code of ethics/conduct in place?	_____	_____	_____
G. Are your objectives clearly written, communicated, and monitored in terms of budget, financial and operating goals?	_____	_____	_____
H. Do you have planning and reporting systems in place?	_____	_____	_____

II. Addressing Financial Reporting Issues

An organization's accounting system — its methods to identify, assemble, analyze, classify, record and report transactions and to maintain accountability for the related assets and liabilities — are critical to accurate financial reporting and grant award compliance. To be sure you are properly accounting and reporting finances, your organization should:

- ✓ Ensure that your accounting system has the capability to capture and report costs by program.
- ✓ Develop and implement a formal cost allocation plan. The purpose of the cost allocation plan is to assign costs to a cost objective (grant, program, etc.) on the basis of relative benefits or by some other equitable relationship.
- ✓ Develop a chart of accounts that will allow for the identification and reporting of costs by program.
- ✓ Operating policies and procedures must be thought of in terms of cost allocation.

III. Taxes

The failure to file required tax documentation can put your organization at risk of financial and legal penalties in addition to incurring back taxes and interest. Management and accounting personnel must be thoroughly aware of their tax filing responsibilities. **Taxes must be paid when due.**

As a charitable organization, your nonprofit may be classified by the Internal Revenue Service as a tax-exempt or 501(c)(3) organization. As a tax-exempt organization, you are not liable for any federal income tax and, depending on your location, may be exempt from state income taxes, property taxes and/or sales taxes. But be careful. Note that an exemption from one type of tax does not mean an exemption from all taxes, and that even when an organization is exempt from taxes, they do need to fill out relevant paperwork such as Form 990s. Consult your accountant or state agency for specifics and answers to any questions.

The chart on the next page summarizes some federal tax treatments for nonprofit organizations.

Type of Tax	Treatment
Income Tax	The 501(c)(3) organization files Form 990 or 990 EZ and pays income tax only on net profit from unrelated activities; employees pay income tax on salaries received.
Payroll Taxes	The organization files quarterly Form 941s and annual W2s/W3s. FUTA (Federal Unemployment Tax Assessment), filed using Form 940, is not paid.
Sales Tax	Depending upon the state, some organization sales can be exempt from sales tax.
Property Tax	The use of a property determines its exemption.

IV. Compliance Requirements

Federal compliance requirements regulate a nonprofit organization's activities, define costs and their allowability, state financial reporting requirements, and detail procedures for correcting concerns identified during audits.

Per OMB Circular A-133, an independent auditor must assess each nonprofit's compliance with the following specific standards:

- ✓ **Activities Allowed or Disallowed:** The specific requirements for activities allowed or disallowed are unique to each federal program and should be specified in the grant agreement.
- ✓ **Allowable Costs/Cost Principles:** CBOs must follow guidelines set out in OMB Circular A-122 on cost principles.
- ✓ **Cash Management:** CBOs must comply with timelines set by awarding agencies for using funds awarded.
- ✓ **Davis-Bacon Act:** All laborers and mechanics working on projects financed by federal assistance must be paid wages not less than those established for the locality by the US Secretary of Labor.
- ✓ **Eligibility:** Each federal funding agency sets individual standards on what type of programs and organizations may receive its funding. Auditors must ensure any awarded program continues to meet these standards.
- ✓ **Equipment and Real Property Management:** Nonprofit organizations must follow the provisions of OMB Circular A-110 in the procurement, recordation and maintenance of equipment.

- ✓ **Matching, Level of Effort, Earmarking:** Nonprofit organizations must meet its individual federal funder's requirements for matching (or cost-sharing), level of effort (specific levels of service that must be performed) and earmarking (the minimum and/or maximum amount of the organization's funds that must be used for a specific purpose).
- ✓ **Period of Availability of Federal Funds:** Nonprofit organizations can charge to the award only those costs resulting from obligations incurred during the funding period and any authorized pre-award costs.
- ✓ **Procurement:** Organizations must use procurement procedures that conform to applicable federal law, regulations and standards set forth in OMB Circular A-110.
- ✓ **Suspension and Debarment:** For all funded activities, organizations are prohibited from contracting with or making sub-awards to parties that are suspended or debarred or whose principles are suspended or debarred.
- ✓ **Program Income:** Costs related to gross income directly generated by the federally funded project during the grant period may be deducted from revenue brought in to determine program income.
- ✓ **Real Property Acquisition and Relocation Assistance:** These compliance requirements relate to the equitable treatment of persons displaced by federally assisted programs from their homes, businesses or farms.
- ✓ **Reporting:** The compliance requirements for reporting fall into three areas: 1) financial reporting addresses the requirement to report program outlays and program revenues, 2) performance reporting requires the organization to submit performance reports at least annually, and 3) special reporting addresses other reporting requirements for activities such as allocation of program funding.
- ✓ **Sub-recipient Monitoring:** Organizations must describe how they monitor any sub-recipients to which they pass federal program funds.
- ✓ **Special Tests and Provisions:** Each federal program may choose to mandate other unique tests or provisions of its own.

[See Unit 5 — Legal Issues for more discussion on compliance requirements.]

V. Accounting and Bookkeeping

Financial accounting rests on a framework of rules for identifying, recording, classifying and interpreting internal and external events typically recorded in the organization's "books." Generally, your "books" should consist of the following record-keeping systems:

- ✓ **Journal:** Where transactions are initially recorded. The "general journal" lists transactions as debits and credits to relevant accounts. "Special journals" summarize transactions that share a particular characteristic, such as a payroll journal, a cash payments journal or a purchases journal.

ACCOUNTING "BOOKS"

The ledgers that hold an organization's recorded and classified financial transactions.

- ✓ **Ledger:** A book containing the accounts. The general ledger is a collection of all asset, liability, net asset, revenue and support and expense accounts; a subsidiary ledger contains a group of specific accounts.
- ✓ **Trial balance:** Lists all open accounts in the general ledger and their balances and may be prepared at any time. The trial balance taken immediately after all adjustments have been posted is called an adjusted trial balance. A trial balance taken immediately after closing entries have been posted is called a post-closing trial balance.

Financial information should be analyzed and reconciled prior to being entered into the financial system or else accounts run the risk of being misstated or insupportable.

VI. Preparation for the Financial Statement Audit

Inadequate preparation can adversely impact the audit process. The auditor acts on the premise that the organization is “ready” for the audit. To prepare, organizations should close all books, prepare up-to-date trial balances and collect all requested documents. Use the following checklist on the next page to help you prepare.

Observation

Inadequate preparation can result in financial records being misstated **or in audit reports that report poor conditions and material weaknesses.**

Preparation Checklist for Financial Statement Audit for the Year Ended _____

Corporate Documents:

- ✓ Articles of incorporation and by-laws
- ✓ Organization chart
- ✓ Personnel policies and other operating procedures manuals

Financial Reports:

- ✓ Trial balance at _____
- ✓ Operating plans/budgets for the year ended _____

Cash:

- ✓ List of all bank accounts and authorized check signers, including new and closed accounts
- ✓ Bank statements for all accounts at _____ (prior year) and at _____ (current year)
- ✓ Account statements for cash equivalents (investments) at _____ (prior year) and at _____ (current year)
- ✓ Bank reconciliation at _____

Accounts Receivable, Prepaid Expenses and Other Assets:

- ✓ Summary of all accounts receivable by source (if applicable) at _____
- ✓ Schedule of prepaid expenses
- ✓ Supporting schedules or documentation for all other assets (security deposits, employee advances, etc.)

Property and Equipment:

- ✓ Detailed listings of property, equipment and leasehold improvements
- ✓ Schedule of capital asset purchases made during the year ended _____ including supporting invoices for each acquisition
- ✓ Schedules of disposals and retirements for the year ended _____
- ✓ New lease agreements (operating and capital)

Liabilities:

- ✓ Detailed listing of accounts payable at _____
- ✓ Summary of all notes payable and copies of agreements, if applicable

Revenue:

- ✓ Copies of contracts and agreements with all funding agencies
- ✓ Schedules of interest income, dividend income and miscellaneous revenue
- ✓ Cash receipts journal for the year ended _____ and for two months subsequent to _____ (year end)

Expenses:

- ✓ Supporting invoices and canceled checks for a sample of disbursements — to be determined based on the range of check numbers issued
- ✓ Copies of payroll related tax forms (941s, state unemployment, W2s, W3s, etc.)
- ✓ Insurance policies and related canceled checks for premium payments
- ✓ Cash disbursements journal for the year ending _____ and for two months subsequent to _____ (year end)

Other:

- ✓ All minutes of meetings of the board of directors (including committee meetings)
- ✓ List of current members of the board of directors
- ✓ Pension plan information
- ✓ New loan agreements
- ✓ Name and address of attorney
- ✓ Consultant agreements
- ✓ Chart of accounts
- ✓ Prior year audit report and management letter, if any

VII. Accounting Staff Issues

The accounting staff is the backbone of the organization's fiscal operation, and well-qualified personnel are essential to its efficient operation. Use the following checklist to make sure your accounting department is staffed appropriately:

- ✓ We have the right qualified person in the right position.
- ✓ Management exercises its oversight responsibilities to ensure that all staff members follow accounting policy and procedures.

- ✓ We have clear lines of authority, responsibility and communication regarding financial management issues; management and staff are aware of them.
- ✓ Management interacts with the accounting staff in a positive manner when exercising oversight and control responsibilities.

VIII. Information Technology Issues

When used properly, the information technology system can be an integral part of an organization's accounting system. Personnel should be well-trained in system use, including upgrades.

Organizations that use manual accounting systems should ask themselves if they can afford not to convert to an automated one. Automation has been shown to improve the efficiency of the accounting and financial management functions and reduce the stress on the accounting personnel. In a study of 265 chief financial officers, released by Cap Gemini Ernst & Young and CFO Research Services, 56% said that inadequate IT systems are obstacles to transforming their companies' financial-accounting methods.² Chances are there is an appropriate accounting software package for your organization, no matter what your size.

2. As reported by Eric Chabrow in "Financial Execs ID Tech Barriers," *Information Week*, August 19, 2002.

UNIT 5:

Legal Issues and Grant Management

Purpose:

To learn about legal responsibilities and how to minimize exposure.

Learning Objectives:

By the end of this unit, learners will be able to:

- ✓ Identify the legal issues regarding the fiscal management of grants.
- ✓ Develop steps to manage the impact of these responsibilities.
- ✓ Understand the post-audit responsibilities of federal grant recipients.

Sound grant management will help to ensure that your program objectives are achieved and will reduce the possibilities of costly mistakes that can damage the reputation of your staff and organization.

The organization's board and management have both legal and regulatory responsibilities to ensure that award funds are properly spent, recorded and reported.

As noted, these responsibilities closely parallel the problem issues mentioned in the previous units. Three basic steps, offered here as guidelines only (not as a substitute for legal advice), can help keep you out of audit trouble.

- ✓ **Step 1:** Obtain a complete understanding of the terms of the grant award, regulations governing the award, reporting requirements and budgetary limitations.
 - Board and management must read and become thoroughly familiar with the complete award agreement — not just the funding paragraphs.
 - Make the accounting personnel aware of funding requirements and other award conditions that might affect financial record-keeping requirements.
 - Make adjustments as required to account for special award requirements.
- ✓ **Step 2:** Thoroughly document expenditures in accordance with the budget.
 - Monitor actual time-specific expenditures against a budget. Periodic (monthly, quarterly, etc.) spending reports should be prepared and reviewed and organization expenditures adjusted accordingly. Diligent monitoring provides an early warning to potential problems.
 - Document and monitor all expenditures.
- ✓ **Step 3:** Stay focused on your organization's program goal and objectives.
 - Grants are awarded to help you accomplish specific program goals and objectives within a specific budget and time frame. Make sure your financial documents reflect the specified budget and deadlines set and that your accounting system facilitates staying within these pre-set constraints.

Observation

It is the responsibility of the organization to ensure that the audit is completed and submitted by the required due date. It should be scheduled as soon as practical at the end of the fiscal year.

**POST-AUDIT
REQUIREMENT**

The actions required by regulations that must be completed by an organization and auditor at the end of an audit conducted according to the requirements of Circular A-133.

**AUDIT REPORTING
PACKAGE**

The package submitted to the federal audit clearinghouse upon completion of an audit conducted under the requirements of Circular A-133. The reporting package consists of:

- The organization's financial statements and schedule of expenditure of awards
- Summary schedule of prior audit findings
 - Auditor's report
- Corrective action plan

Post-audit Requirements

The organization has survived the financial statement audit process. What happens next?

Upon completing the audit, the auditor develops and issues a draft of the required reports, which allows the organization to address, and hopefully resolve, problems/areas of concern.

Once the auditor issues the final copies of the required reports, the following post-audit steps must be taken by the organization:

- ✓ The organization must provide a schedule of expenditures of federal awards for the period covered by the financial statements that lists individual federal programs by agency, provides total federal awards expended for each individual federal program and Catalog of Federal Domestic Assistance (CFDA) number, and includes notes that describe the accounting policies used in preparing the schedule.
- ✓ The organization must develop a summary of prior audit findings, if any, and show follow-up and corrective actions taken. When prior audit findings have not been corrected, or only partially corrected, this schedule must describe the planned corrective action as well as any partial corrective action taken.
- ✓ The organization must prepare a corrective action plan to address each finding in the current year's auditor report. The corrective action plan must provide the name(s) of the contact person responsible for corrective action, the corrective action planned and the anticipated completion date. If the organization does not agree with the audit findings or believes that corrective action is not required, then the corrective action plan must include an explanation of why in the organization's opinion it's unnecessary.
- ✓ A data collection form is completed (usually by the auditor) which provides information about the organization, its federal programs and the results of the audit. A senior representative of the organization and the auditor both need to sign this agreement.
- ✓ The organization should develop in-house plans for addressing items identified in the management letter, if one was issued by the auditor. Management letters bring to the attention of management less significant areas of weakness noted during the audit and provide workable solutions for improvement.

The last post-audit step is for the organization to submit an audit reporting package to the federal clearinghouse which includes: financial statements and a schedule of expenditure of federal awards, a summary schedule of prior audit findings, auditor's reports, and a corrective action plan.

Observation

Audits required under Circular A-133 must be performed annually. The reporting package and data collection form must be submitted to the clearinghouse within 30 days after receipt of the auditor's report or nine months after the end of the audit period, whichever comes first — unless a longer period is agreed to in advance by the federal funding agency or its agent.

Post-training Assessment

The following answers to the Pre-training Assessment presented earlier in the manual should be used as a review to re-test your knowledge after using this guide.

Post-training Assessment

Please determine whether the following statements are True or False.

1. **True** **False** Preparation of the financial statements is the responsibility of the auditor.
2. **True** **False** "Audits" are only undertaken to examine financial statements.
3. **True** **False** A private, nonprofit organization receiving federal funds is not impacted by federal standards governing cost principles and fiscal management policies.
4. **True** **False** Sound internal controls cannot prevent all instances of waste, fraud and abuse.
5. **True** **False** Accounting policies and procedures do not have to be written as long as the staff is aware of them.
6. **True** **False** Tax-exempt organizations must file tax returns.
7. **True** **False** Only an organization's management has legal and regulatory responsibility for fiscal management of grants.
8. **True** **False** Organizations have follow-up responsibilities on financial statement and/or compliance audit findings.

APPENDIX A

Glossary

Accounting “Books”: The ledgers that hold an organization’s recorded and classified financial transactions.

Audit: A review and objective examination of a program or practice. Generally, the purpose of an audit is to express an opinion on or reach a conclusion about the subject reviewed. In financial accounting, it is usually the financial statements of the entity that are the subject of an audit.

Audit Reporting Package: The package submitted to the federal audit clearinghouse upon completion of an audit conducted under the requirements of Circular A–133. The reporting package consists of:

- ✓ The organization’s financial statements and schedule of expenditure of awards
- ✓ Summary schedule of prior audit findings
- ✓ Auditor’s report
- ✓ Corrective action plan

Compliance Requirements: The laws, rules, regulations and award terms that regulate an organization’s activities as a federal grant recipient.

Control Environment: The overall attitude and actions of the organization’s board of directors and management regarding the effectiveness of specific controls. It is the tone that influences the control consciousness of the organization’s staff.

Financial Statements: Statements that reflect the collection, tabulation and final summarization of accounting data. Financial statements for a nonprofit organization should include statements of financial position, activities and cash flow.

Generally Accepted Government Auditing Standards (GAGAS): Auditing standards issued by the General Accounting Office that must be followed by auditors of federal programs when required by law, regulation, agreement or contract.

Internal Controls: The process established by an organization’s board of directors, management and other personnel and designed to provide reasonable assurance that the organization will efficiently and effectively achieve its objectives, reliably report finances and comply with applicable laws and regulations.

OMB Circulars: Documents issued by the Office of Management and Budget (OMB) as instructions or information to federal agencies. Three circulars in particular provide required guidance to nonprofit organizations regarding their financial management operations as federal award recipients. They are:

- ✓ Circular A-110, *Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non-Profit Organizations*
- ✓ Circular A-122, *Cost Principles for Non-Profit Organizations*
- ✓ Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*

Post-audit requirements: The actions required by regulations that must be completed by an organization and auditor at the end of an audit conducted according to the requirements of Circular A-133.

APPENDIX B

Frequently Asked Questions

1. What are a nonprofit organization's tax responsibilities?

Most nonprofit organizations are classified by the Internal Revenue Service (IRS) as tax-exempt organizations. With a tax-exempt status, the organization may not be liable for any federal income tax for tax-exempt programs but must still file Form 990 or 990-EZ and pay tax only on the net profit from unrelated activities. For payroll taxes, the nonprofit organization must file quarterly 941s and annual W2s /W3s.

Upon receiving an IRS tax determination letter stating that the organization is exempt from federal income taxes, organizations can apply for an exemption from state taxes. Depending upon where located, the organization may also be able to claim an exemption for income from fund-raising activities that meet specific criteria, income from charitable or educational activities, and an exemption from organization sales. The use of real property usually determines its exemption.

Your accountant can provide guidance on your specific locality's tax requirements.

2. Why is internal control so important?

Internal control is designed by an organization's management to assure the reliability of financial reporting, ensure compliance with applicable laws and regulations, and ensure the effectiveness and efficiency of operations.

3. Does the size of the organization have an effect on the types of internal controls installed?

The greater the complexity of operations, the more complex the internal control systems are likely to be. However, even small organizations with relatively simple operations should have an internal control system in place.

4. Why is the control environment component of internal control so important?

The control environment conveys the organization's ethics, integrity and management style and sets the tone of an organization influencing the organization's personnel.

5. How should our organization prepare for a financial statement audit?

The audit should only start when the organization is ready or when management and staff can answer "yes" to the following questions:

- ✓ Have we collected all of the items and prepared all of the schedules requested by the auditor?
- ✓ Is other supporting documentation readily available?
- ✓ Do our schedules add up arithmetically? Do the supporting schedules agree with the summary schedules? Does the trial balance "balance"?
- ✓ Do we have time to work with the auditors? Are there other demands on management and key staff's time (i.e., leaves of absence; out-of-town trips; requests for time by other activities) that will impede their participation in the audit process?

6. What is the purpose of a "management letter"?

The management letter is issued by the auditor to help the organization improve its operations. It identifies less significant weaknesses in operations and provides recommended solutions. Addressing identified issues early on can prevent them from becoming major problems down the road.

APPENDIX C

Bibliography

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National Minority AIDS Council
Technical Assistance, Training and Treatment Division
1624 U Street, NW
Washington, DC 20009
(202) 234-5120
www.nmac.org