INTERNAL CONTROL IN NOT FOR PROFIT ORGANIZATIONS
WHAT YOU NEED TO KNOW AND WHY YOU NEED TO TAKE ACTION
PRESENTED BY TOM TURNER ON JUNE 20, 2008

New Auditing Standards Issued For Auditors of Not for Profit Organizations

Since the collapse of Enron, WorldCom and several other highly publicized companies, the accounting industry has rushed in to shore up auditing standards, improve internal controls, and prevent further erosion of investor confidence. One of the first regulations imposed following this turmoil was the Sarbanes-Oxley Act of 2002, which was aimed at public companies operating under SEC governance. Because of the disparity in standards between public and private entities, the American Institute of Certified Public Accountants (AICPA), the national professional organization for certified public accountants, issued nine new Statements on Auditing Standards (SAS). Their goal was to make the standards used for audits of private companies and not-for profit organizations consistent with those already in place for audits of public companies.

We are going to discuss two of the standards that will have a significant impact on your approach to corporate governance, your accounting staff and your audit. In addition, ***the standards may affect you certification from donors such as the United Way***. These new standard are effective for the FY07 fiscal year external financial audit.

Prior to AICPA issuing these new standards, your auditors were not required to evaluate the organizations internal control as part of the audit. The new standards require your auditors to understand, evaluate and document internal controls. They also require your auditor to issue a written report to management (Management Letter) describing any significant deficiencies and material weaknesses in internal control identified in an audit. The relevant requirements of SAS 109 and 112 are summarized below.

The Requirements of SAS No. 109

SAS 109 provides guidance to the auditor on understanding the organizations environment and internal controls, assessing the risks of a material misstatement and performing audit procedures in response to assessed risks. The specific provisions that affect you are the requirements that your auditor:

- Obtain and understanding of your organization’s internal control
- Evaluate the design of the internal controls
- Determine whether the internal controls have been implemented
- Document their understanding of the internal control system

The Requirement of SAS 112

SAS 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. It is applicable whenever an auditor expresses an opinion on financial statements. In particular, this standard:

- Requires your auditor to communicate, in writing, to management and those charged with governance, significant deficiencies and material weaknesses in internal control identified in an audit (Management Letter).
- Defines the terms *significant deficiency* and *material weakness*. See hand out for definitions and examples.
- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements. See hand out for and examples.

How Will SAS 109 and SAS 112 Effect My Organization

- Management and the Board of Directors will have to become familiar with and focus their attention on corporate governance and internal controls.

- Your organization will have to establish and document an internal control system. This is a time consuming process and your staff may not have the time and knowledge to complete these tasks.

- You may need to engage consultants to assist you with this process. Your auditor can not be part of the organizations internal control. The auditor can not design and implements their client's internal control system.

- If the organization has not established and maintained an adequate system of internal control, then the external auditor will issue a report to management identifying the organizations significant deficiency and material weakness. Management will then be faced with explaining the organizations lack of corporate governance and internal controls to donor's, government agencies and other stakeholders. ***Your organization may be defunded and wind up with a damaged reputation.***

What Can Management Do To Prepare

1. Educate your audit and/or finance committee, as well as your board of directors. This step is important because it will help set management expectations so that any forthcoming auditor communications are not a surprise.

2. Establish a written code of conduct and ethics. Review this document with your employees and require all employees and managers to acknowledge their understanding and agreement.

3. Set up a "hotline" that employees and management can use to anonymously report suspected violations of the code of conduct and ethics.

4. Develop a policies and procedures manual and make it available to everyone. Start with areas that pose the greatest risk of misstatement, such as policies governing authorization and approval limits, and work from there.

5. Consider purchasing tools that are available to assist you efficiently complete this process. For example COSO Internal Reporting Guidance for Smaller Public Companies, the AICPA Audit Committee Tool Kit- Not for Profit Organizations, the AICPA Audit and Accounting Guide for Not for Profit and software that is designed to assist you with the documentation and evaluation of internal controls. (See additional information in handout)

6. Conduct your own risk assessment. Identify the financial statement line items, accounts and disclosures most susceptible to the risk of a material misstatement. Then, identify the risks (including fraud) and ask your self what could go wrong. Finally, identify the controls that prevent those risks from occurring, or detect them if they have been realized. (See handout for examples)

7. Document the organization business cycles, accounting process and key internal controls. The documentation can be done using narratives and or flowcharts.

8. Improve your segregation of duties. We are including a Segregation of Duties Matrix with our handouts. You can use this matrix to indentify conflicts that you must address.

9. Review access to your accounting and reporting system. Avoid vesting incompatible functions into the hands of a single individual. Make sure your user roles and rights for key financial applications are consistent with the segregation of duties you are trying to establish.

10. Recognize that your staff may not have the time and skills required to complete the project. Evaluate the cost and benefits of engaging consultants to assist you complete the project.

The Future Impact of Corporate Governess & Internal Controls on Not for Profit Entities

- **Reputation & Survival-**. For nonprofits, fraud or misstatements in financial statements that result from poor governance can be devastating. An organization can wind up with a damaged reputation, mismanaged, or broke. When that happens all people associated with the organization suffer.

  BOD- The reputation of individuals who serve as voluntary board members is tarnished

  Recipients of Services- These people no longer get the services they need

  Donors- Feel that their money and or services were squandered

  Employees- They loose their jobs

- **Funding –** Inadequate corporate governance and internal controls may affect the amount of funds you receive from organizations such as ***the United Way.***
- **Legal Liability-**Advisors to nonprofit organizations are beginning to suggest that, in the current environment, prosecutors, plaintiffs, and courts may hold management and nonprofit boards to the higher standards of corporate governance imposed by Sarbanes-Oxley.
- **Compliance-** Government Auditing Standards issued by the Comptroller General of the United States require that the organization's independent auditors issue a report on their consideration of internal control over financial reporting and their test of the organizations compliance with certain provisions of laws, regulations, contracts and grants. Government Auditing Standards apply to a very large number of nonprofits, because so many of these entities receive federal funding. IRS Form 990, which is the tax return that most not for profits are required to file, has been revised for 2008. The draft of the revised form includes 20 questions related to your organizations governance, policies and disclosure.

Examples of Fraudulent Activity

A recent study discussed in the New York Times estimated that money lost as a result of fraud in not for profit organizations amounted to $40 billion in 2006. If this figure is accurate, the fraud losses equaled the combined giving by corporations and foundations in 2006 according to The Independent Sector, which is America's leading coalition representing nonprofits. Fraud losses and non-compliance fines have been reported by the following organizations:

- The Baptist Foundation of Arizona (1996-1998)- Fraud loss of $590M
- Goodwill Industries (1998)- Fraud loss of $25M
- The World Jewish Congress (1995-2004)- Fraud loss of $5M
- The Southampton Soccer Association (2007)- Fraud loss of $250K
- The Juvenile Diabetes Research Foundation of MI (2007)-Fraud loss of $250K
- The North Carolina Small Grain Growers Association (2005)- Fraud loss of $250K
- The North Carolina Sheriffs Association (2004)- Fraud loss of $200K
- The Ridge Road Baptist Church of Raleigh (2007)- Fraud loss of $170K
- The Chapel Hill Historic Society (2005)- Fraud loss of $50K
- The Mayo Foundation (2005)- Grant fraud compliance fine of $6.5M
- Cornell University Medical School (2005) Research fraud compliance fine of $4.3M
- Harvard University (2004)-Compliance fine of $2.6M