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Not-for-profit organizations audit manual, Volume 1

Charles Kirkland

O. Ray Whittington

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Not-for-Profit Organizations Audit Manual

INTEGRATED PRACTICE SYSTEM

VOLUME 1

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VOLUME 1

Not-for-Profit Organizations Audit Manual

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VOLUME 1

Not-for-Profit Organizations Audit Manual

Authors:
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O. Ray Whittington, CPA

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VOLUME 1

Not-for-Profit Organizations Audit Manual

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The manual is issued as a nonauthoritative kit of practice aids and is not intended as a substitute for professional judgment or for authoritative technical literature.

The documentation in the manual is not a substitute for development and implementation by a firm of a system of quality control that is appropriately comprehensive and suitably designed in relation to the firm's organization structure, its policies, and the nature of its practice.

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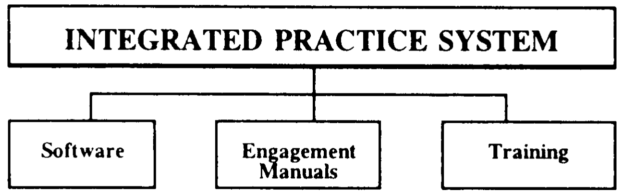
The AICPA Integrated Practice System:
For CPAs Concerned About Quality and Profitability



The Integrated Practice System gives practitioners the tools they need to conduct high-quality and cost-effective engagements. How? By enabling CPAs to anticipate engagement problems and by putting the solutions to these problems — integrated engagement manuals, software products, and training resources — within their grasp.

ONE SYSTEM, ONE SOLUTION

This innovative system is the *first* integrated system that is specifically designed to enhance the quality of your practice. It offers guidance on the day-to-day management of client engagements and provides practical discussions on the applicability of authoritative literature. Each element of the system — manuals, software, and training — was developed by CPAs who recognized the need to provide a comprehensive, hands-on approach to engagement planning and performance. Working alone or as a unified system, Integrated Practice System products provide the solutions needed for a firm to achieve top-quality performance and bottom-line profitability.

INTEGRATED PRACTICE SYSTEM — IN A CLASS BY ITSELF

Significant advantages distinguish these tools from other commercially available products. The Integrated Practice System tools —

- **Represent an integrated, synergistic system** that is state-of-the-art.

- **Include access to technical support hotlines** that put you in touch with professionals who can answer your technical questions. Just call the following numbers:

  Engagement Manuals 800-TO-AICPA (800-862-4272)

  Software Products 800-226-5800

  Training 201-938-3061

- **Receive ongoing field-testing and evaluation** from a task force of the AICPA's Private Companies Practice Section (PCPS) — CPAs who confront similar challenges in their practices and who represent the interests of local and regional firms.

- **Include a 60-day "no-questions-asked" return guarantee** that allows you the time to try the Integrated Practice System products and find out for yourself how your firm and staff can benefit from them.

ENGAGEMENT MANUALS: THE SMART KID ON THE BLOCK

Finally, there is a reliable, step-by-step approach for managing and performing your engagements. The Engagement Manuals point you in the right direction with the time-saving tools you need to conduct high-quality engagements with the greatest efficiency. Right from the start, the Engagement Manuals show you a direct route to protecting your bottom line. You can minimize on-site field work and put an end to "over-auditing" because our exclusive "ABC System" helps you evaluate risk in the critical planning stage. You'll find important guidelines to use in evaluating your client, so that you can adjust the level of testing to the internal controls employed by the client.

The Engagement Manuals feature a practical, "how-to" approach that enables you and your staff to cut through the clutter and focus on what's important. By eliminating time-consuming guesswork, they chart the course to the most cost-effective, efficient way of proceeding with your engagement. Plus, the manuals include ready-to-use forms, programs, checklists, and questionnaires — even sample correspondence to speed your work.

Each Engagement Manual includes —

- Guidance based on the most recent relevant authoritative and non-authoritative literature;
- Integrated work programs and checklists;
- Model letters ready for your use;
- Time-saving worksheets that capture important information and also help users identify opportunities for other services that can be provided to existing clients, such as consulting and tax services and the preparation of prospective financial information.
- Diskettes, in WordPerfect format, that include all the sample letters and accountant's/auditor's reports included in the manual.

What's more, the Engagement Manuals ease the process of quality review by helping you develop the documentation you need.

The Engagement Manuals can be easily used as stand-alone practice aids. Or, you can use them in conjunction with the full complement of software products — including the AICPA's very successful Accountant's Trial Balance (ATB) and Audit Program Generator (APG). It's the flexibility you need for a cost-efficient, high-quality engagement.

The AICPA recognizes your need to be up-to-date on issues that affect your clients — that's why subscribers automatically receive annual updates for the engagement manuals. Our goal, pure and simple: to provide the answers to your questions even before you ask them.

Because the AICPA has an ongoing commitment to developing the practice aids you need to serve your clients, it will continue to release new industry-specific manuals. These will contain the same kind of practical tools and how-to guidance that are the hallmarks of the Engagement Manuals.

Comprehensive Engagement Manual

The *Comprehensive Engagement Manual* can help practitioners manage most engagements. Designed to be the accountant's companion to audit, review, and compilation engagements, this manual includes checklists, forms, flowcharts, questionnaires, tables, and all the documentation necessary for any size client.

This four-volume set covers engagement performance, documentation and reporting, and helps you make key decisions, including —

- Assessing risk and establishing materiality limits;
- Selecting the most cost-beneficial audit approach;
- Designing the most economical auditing procedures; and
- Making sampling decisions that maximize efficiency.

The *Comprehensive Engagement Manual* features the unique and highly-popular "ABC System" that enables practitioners to identify the most cost-beneficial mix of tests of controls, substantive tests of balances, and analytical procedures for specific engagements. This manual is ideal for firms that want a system they can apply to the full spectrum of audit engagements — whether they plan to perform tests of controls or a totally substantive audit.

Small Business Audit Manual

The two-volume *Small Business Audit Manual*, an alternative to the *Comprehensive Engagement Manual*, walks you through each step of the audit of a small business client. Designed for firms that use a substantive testing approach on all of their audits, the *Small Business Audit Manual* helps you to:

- Plan a cost-effective and time-efficient engagement;
- Verify all financial statement assertions using substantive tests;
- Understand a client's internal control structure;
- Better understand how to apply authoritative standards to small business audits;
- Evaluate a small business' computer needs.

The *Small Business Audit Manual* also puts at your fingertips sample audit programs, questionnaires, model letters, time sheets, workpapers, and audit reports for a small business audit engagement — organized in the sequence they will be used. If your firm's audits rely totally on substantive testing, this is the manual for you.

Bank and Savings Institutions Audit Manual

The three-volume *Bank Audit Manual* can help you cope with the high risk generally associated with bank audits and the complexity of bank operations. It is designed to enable you to perform high-quality engagements with maximum time savings. Based on the unique "ABC System," this manual allows you to design the most efficient and cost-effective mix of tests of controls and substantive tests of balances, and analytical procedures. It does so by including:

- A framework to help practitioners design the most cost-effective audit strategy;
- Worksheets and forms to help auditors understand a bank's internal control structure and assess risk during engagement planning;
- Programs for interim work;
- Sampling documentation and discussions of professional standards that affect the sampling decision;
- Worksheets for various analytical procedures that can help to identify errors and irregularities;

Construction Contractors Audit Manual

You'll find this two-volume manual your most valuable practice aid when working on engagements for construction contractors. It contains:

- Two audit approaches—the "System's Walk-through Approach" for substantive audits and the "ABC System" — to help you design the most efficient and effective audit strategy for each engagement;
- Practical, how-to guidance for completing construction contractor audits;
- A chapter dedicated to the surety industry to help you understand what the surety wants and needs;
- All the necessary audit programs, forms, checklists, sample correspondence, and working papers to comply with today's quality control standards;
- A supplemental tax preparation checklist specific for construction contractors;
- The AICPA Audit and Accounting Guide, *Construction Contractors*, which contains discussions on the applicability of specific professional standards to engagements for construction contractors.

Compilation and Review Manual

This two-volume set gives you a step-by-step system to help you conduct high quality compilation and review engagements — profitably and in compliance with all current applicable professional standards. It contains:

- Programs, checklists, and sample correspondence for performing compilation and review engagements;
- Reporting guidance for OCBOA and personal financial statements;
- Guidance on performing and reporting on prospective financial information.

Credit Union Audit Manual

The two-volume set outlines the most efficient way to approach audits of credit unions and contains guidance on conducting them in compliance with current professional standards. This manual uses the "ABC System" and a newly designed audit strategy for small credit unions, which allows you to choose the best mix of tests of controls and substantive tests of balances, and analytical procedures for each engagement. This manual contains:

- Audit programs, forms, checklists, working papers, and illustrations necessary to perform credit union audits and supervisory examinations;
- The AICPA Audit and Accounting Guide, *Audits of Credit Unions*;
- The most recent checklists and illustrative financial statements for credit unions.

Quality Control Manual for CPA Firms

The *Quality Control Manual for CPA Firms*, gives you a step-by-step practical approach to establishing and maintaining your quality control system. Written by CPAs who have extensive peer review experience, it provides all of the guidance and forms you will need, without overburdening you with unnecessary and complex documentation. This manual can be used by firms of all sizes, but its simple approach was designed with the small-to-medium-size firm in mind.

Not-for-Profit Organizations Audit Manual

The two-volume *Not-for-Profit Organizations Audit Manual* contains everything you need to conduct high-quality audits—audit programs, forms, checklists, and sample auditor's reports and financial statements developed especially for not-for-profit organization audits. Also discussed in this manual are two recently-released FASB Statements of Financial Accounting Standards on contributions and not-for-profit organizations' financial statements, as well as FASB's exposure draft on investments, the proposed AICPA Statement of Position on joint activities, and the AICPA's proposed Audit and Accounting Guide for not-for-profit organizations. The manual also helps you efficiently test the compliance requirements of the Yellow Book and OMB Circular A-133.

Auto Dealership Engagement Manual

The *Auto Dealership Engagement Manual* guides you through the twists and turns of an auto dealership audit. Developed to help you conduct effective and efficient engagements in this turbulent industry, it provides guidance that until now has been lacking. This manual includes:

- Two audit approaches — the All Substantive Approach for primarily substantive audits and the unique "ABC System" for audits in which it is efficient to test controls;
- An overview of the industry, including operating characteristics;
- Tailored audit programs and internal controls questionnaire;
- Discussion of auto dealership's unique accounting principles and practices;
- Sample auditor's reports and financial statements; and
- Tax information, including complex LIFO calculations and extended warranty service revenue recognition rules.

SOFTWARE — THE ELECTRONIC EDGE

The AICPA's software products — ATB Write-Up, Accountant's Trial Balance (ATB) and its modules, Audit Program Generator (APG), Engagement Manager (EM) and Depreciation, among others — put the solutions to daily practice problems at your fingertips. Together with the Engagement Manuals, they streamline engagement planning and performance, and enable you to more effectively monitor your staff and your budget. Most importantly, they prevent you from reinventing the wheel each time you plan and conduct an engagement.

It's easy to put these products to work for you. The software requires an IBM PC, XT, AT, PS/2 or IBM-compatible system and DOS version 3.1 or higher. A team of professionals is available to answer any of your questions; simply call the Software Support Hotline at 800-226-5800 or use the Software Express FAX service at 800-226-6868.

ATB Write-Up

ATB Write-Up features powerful options that let you analyze information and generate reports and financial statements quickly and easily. ATB Write-Up takes all of the power and flexibility of ATB, ATB Financial Statements, and ATB Consolidations and adds to it. ATB Write-Up offers:

- Period Reporting — Use up to 13 periods per year. This gives you the flexibility to generate annual, semiannual, quarterly or monthly reports.

- Departmental Reporting — Set up as many departments as you need. ATB Write-Up will print most workpapers and reports by department, in total for all departments, or for a selected range of departments.
- Financial Statements — Up to 16 columns, each custom-definable to include periods, departments, year-to-date, percentages, add columns together, and more.
- Consolidations — Link and combine accounts of related groups into one consolidated company.

Accountant's Trial Balance

ATB, the best-selling, most-used accounting software in the profession today, is an integral part of the IPS family. Designed ***by*** accountants ***for*** accountants and used by approximately 9,000 accounting firms, ATB automates much of the routine work associated with trial balance and financial statement preparation. Specifically, it:

- Generates picture-perfect working papers, including trial balances, journals, lead schedules, user-definable grouping schedules, and analytical review worksheets;
- Enables users to prepare trial balances based on GAAP, federal tax, state tax, or other user-selected accounting bases;
- Keeps up to five years of data on file for any one client, enabling you to generate a variety of comparative reports quickly and simply.

Modules for Use with ATB 3.0

- *ATB Financial Statements* — This powerful report writer enables you to produce final financial statements quickly and easily.
- *ATB Consolidations* — This module enables you to consolidate trial balances from up to nine individual companies into one ATB company trial balance — with ATB automatically keeping track of all activities.
- *ATB Conversion* — With ATB Conversion you can transfer any data electronically from a number of general ledger and working paper packages to ATB and from ATB to leading corporate tax preparation packages.

Audit Program Generator

The Audit Program Generator (APG) enables you to customize an audit program or a checklist to a particular client. Its unique features help you save time and unnecessary expense in conducting audits. Since its introduction in 1987, over 8,000 firms have used APG.

APG Version 2.0 enables you to —

- Create a variety of programs and checklists, including audit programs, disclosure checklists, and compliance checklists;
- Tailor the audit program to the needs of your specific client;
- Customize programs from a wide variety of sample AICPA work programs available in electronic format;
- Quickly link your audit procedures and financial statement assertions;
- Use a full-text editor to customize titles and footers and create appropriate tabular formats.

Engagement Manager

The Engagement Manager (EM) software package can assist you in planning, analyzing, documenting, and correcting engagement management problems — and free up valuable staff time in the process. Most importantly, it handles the details of creating and modifying budgets, recording actual time and expenses, and comparing results so you can devote your energy to other aspects of your business. With EM's help, you can:

- Anticipate potential budget variances and delays through a variety of analytical reports;
- Spot potential problems while there is time to take action;
- Determine the effectiveness of individual staff members by analyzing their efficiency in assigned areas.

Depreciation

Depreciation provides a simple and efficient means of calculating and tracking how assets are depreciated. It calculates depreciation for six separate reporting bases: book, federal, state, AMT, ACE, and "other." What's more, it lets you apply various methods of depreciation to any of these reports and prints out complete worksheets showing changes in various property accounts and the necessary journal entries to record depreciation for the year. Now, with its pull-down menus, Depreciation is easier to use than ever.

Reports generated through AICPA Depreciation include:

- Depreciation schedules by category, G/L account number, system, or convention
- Summarized worksheet information for Forms 4255, 4562, 4626, 4797, 6252, and Schedule D
- AMT preference calculation
- ACE adjustment calculation
- Fully depreciated assets report
- Amortization report
- Section 179 deduction report
- ITC-taken report
- Basis comparison
- Depreciation account reconciliation
- Amortization account reconciliation
- Schedule M-1 information
- Overridden calculations

TRAINING RESOURCES: MAKING THE INTEGRATED PRACTICE SYSTEM WORK FOR YOU

Whether you're a user of one or more of the Integrated Practice System products or you're looking for ways to more effectively manage engagements, Training Resources can benefit you. You'll learn how the Engagement Manuals and Software can help your practice run more smoothly and how the system works to facilitate productivity, efficiency, and quality performance by you and your staff.

The Training Resources come in three formats: self-study or self-administered group study; customized in-house group study; and conferences. Here is what's available in each format:

Self-Study or Self-Administered Group Study

An *Orientation and Technical Update Seminar* is a formal group study-program designed to assist firms with initially implementing the Integrated Practice System Engagement Manuals. It also provides a monitored self-study orientation on the manuals for new staff. The seminar materials can help you to better understand and apply common SASs in the most efficient manner. You'll learn how to design tests, auditing procedures and sample sizes to collect the right amount of evidence needed for particular engagements.

Accountant's Trial Balance — CPE Edition is a self-study course that teaches you how to automate your working papers for all types of engagements. You'll earn eight hours of CPE credit as you become familiar with ATB and its most used features for audits, reviews, compilations, and tax working papers.

Accountants Trial Balance With Financial Statement Generator — CPE Edition is a self-study course that enables you to rapidly learn the basics of ATB and the Financial Statement Generator add-on module. The recommended CPE credit for this course is eight hours.

Customized In-House Group Study

Special in-firm training is available to demonstrate how your firm can put the Integrated Practice System products to use. And you'll see immediate results. That's because the training leader will use a current client engagement ***you select*** as the training model. Whether you select a one- or two-day training program, you'll learn how IPS products can help you address real client needs and resolve specific client problems.

AICPA Conferences

Training sessions focusing on the Engagement Manuals are part of many AICPA conferences designed for local and regional practitioners, including the highly rated PCPS Conference and the National Accounting and Auditing Advanced Technical Symposium.

To schedule in-firm training or to obtain more information about the Integrated Practice System Training Resources, including dates and locations of these conferences, call the AICPA Technical Information Division at (201) 938-3060.

AICPA INTEGRATED PRACTICE SYSTEM
NOT-FOR-PROFIT ORGANIZATIONS AUDIT MANUAL

PREFACE

The AICPA Not-for-Profit Organizations Audit Manual is a complete guide to performing and reporting on audits of not-for-profit organizations' financial statements. This Manual provides two approaches—the unique ABC System approach for engagements in which tests of controls will be performed to reduce substantive tests and the All Substantive Approach, which is a primarily substantive audit approach. You select the approach that will be the most efficient and effective for each audit engagement.

This Manual is designed to comply with all applicable authoritative pronouncements. References are made throughout to AICPA Statements on Auditing Standards, AICPA audit and accounting guides for not-for-profit and voluntary health and welfare organizations, and FASB Statements of Financial Accounting Standards.

This two-volume Manual contains all of the documentation, including quality control and engagement supervision documentation, needed to perform an audit of a not-for-profit organization's financial statements. The following is a listing of some of the documentation included in this Manual, which has been tailored to meet the unique operations of not-for-profit organizations.

- Client Acceptance and Continuance Form
- Audit Planning Memorandum
- Sample Engagement Letters
- Materiality Computation Form
- Risk of Potential Misstatements Evaluation Form
- Internal Controls Questionnaire
- Audit Programs for Tests of Controls, Tests of Balances, and Analytical Procedures
- Supervision and Review Form
- Sample Client Representation Letters
- Sample Auditor's Reports, including reports on internal controls and compliance with laws and regulations
- Financial Statement Disclosure Checklist and Illustrative Financial Statements of Not-For-Profit Organizations

Also included in this Manual is guidance on the special compliance requirements for organizations that receive federal financial assistance, including the reporting requirements under Government Auditing Standards (the "Yellow Book") and OMB Circular A-133. Special compliance testing programs are included, as well as examples of the many special reports required in these audits. Copies of OMB Circulars A-110, A-122, and A-133, the OMB Compliance Supplements, and PCIE Statements are included in the Appendices of this Manual.

ABOUT THE AUTHORS

O. RAY WHITTINGTON, CPA

O. Ray Whittington, CPA, Ph.D., is the director of the school of accountancy at San Diego State University and a partner with the CPA firm of Fitzgerald, Dubina & Co., a local firm in San Diego, California. From 1989 through 1991, he was the director of auditing research for the AICPA. Previously, he was on the audit staff of KPMG Peat Marwick. Mr. Whittington is a member of the Accounting and Review Services Committee of the AICPA and has written numerous articles, books, and CPE courses.

Mr. Whittington received his M.S.—Accountancy from Texas Tech University and his Ph.D. from the University of Houston. He has served on numerous professional committees and task forces, including the AICPA Statistical Audit Subcommittee and the Audit of Accounting Estimates Task Force.

CHARLES KIRKLAND

Charles Kirkland, CMA, MBA, CPA is the President of the firm of Kirkland & Associates which conducts a full service practice in Northwest Indiana and also conducts a regional practice in the Chicago area specializing in providing accounting and consulting services to not-for-profit organizations.

Mr. Kirkland received his MBA from Augusta College (Georgia) and his BA from Wake Forest University. He is the former Chairman of the AICPA Not-for-Profit Organizations Committee, has been the executive director of two organizations, has served on the boards of many firms (local, regional, and national), and has taught accounting and financial management to nonprofit executives for the University of Illinois (Chicago). He has been a full-time faculty member at Purdue University (Calumet Campus) and is a frequent speaker on nonprofit accounting matters. Mr. Kirkland also authored the AICPA's continuing education course, *Performing Cost-Efficient Audits of Not-for-Profit Organizations*.

PEER REVIEW OF THE AICPA INTEGRATED PRACTICE SYSTEM

NOT-FOR-PROFIT ORGANIZATIONS AUDIT MANUAL

In keeping with our commitment to give you reliable practice aids, we engaged the CPA firm, Baird, Kurtz & Dobson, to perform a peer review of the *Not-for-Profit Organizations Audit Manual*. Using quality control materials that have been peer reviewed serves two purposes: (1) it provides reasonable assurance that the materials are reliable practice aids; and (2) it helps to minimize the cost of your firm's peer review.

A copy of Baird, Kurtz & Dobson's unqualified peer review report is included on the following page. This report has been accepted by the Private Companies Practice Section and the SEC Practice Section of the AICPA's Division for CPA Firms. Although the report addresses the 1994 edition of this Manual, it is valid for three years.

Baird,
Kurtz &
Dobson

Certified
Public
Accountants

January 24, 1995

The Board of Directors
American Institute of Certified
Public Accountants

We have reviewed the system of quality control for the development and maintenance of the 1994 edition of the *Not-For-Profit Organizations Audit Manual* (materials) of the **AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)** in effect for the year ended December 31, 1994 and the resultant materials in effect at December 31, 1994, in order to determine whether the materials are reliable aids to assist users in conforming with those professional standards the materials purport to encompass. Our review was conducted in accordance with the standards for reviews of quality control materials promulgated by the peer review committees of the Private Companies Practice Section and the SEC Practice Section of the AICPA Division for CPA Firms.

In performing our review, we have given consideration to the following general characteristics of a system of quality control. An organization's system for the development and maintenance of quality control materials encompasses its organizational structure and the policies and procedures established to provide the users of its materials with reasonable assurance that the quality control materials are reliable aids to assist them in conforming with professional standards in conducting their accounting and auditing practices. The extent of an organization's quality control policies and procedures for the development and maintenance of quality control materials and the manner in which they are implemented will depend upon a variety of factors, such as the size and organizational structure of the organization and the nature of the materials provided to users. Variance in individual performance and professional interpretation affects the degree of compliance with prescribed quality control policies and procedures. Therefore, adherence to all policies and procedures in every case may not be possible.

Our review and tests were limited to the system of quality control for the development and maintenance of the aforementioned materials of the AICPA and to the materials themselves and did not extend to the application of these materials by users of the materials nor to the policies and procedures of individual users.

In our opinion, the system of quality control for the development and maintenance of the quality control materials of the AICPA was suitably designed and was being complied with during the year ended December 31, 1994 to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards the materials purport to encompass. Also, in our opinion, the quality control materials referred to above are reliable aids at December 31, 1994.

Baird, Kurtz & Dobson

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SUGGESTED REVISIONS TO NOT-FOR-PROFIT ORGANIZATIONS AUDIT MANUAL

Please submit all suggestions to improve the quality of the Not-for-Profit Organizations Audit Manual as they arise. We value users' input and will give all comments consideration when revising the manual.

To:
Susan Menelaides, CPA, Director
Technical Information Division
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

From:

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(Name)

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(Firm)

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(Telephone No.)

Suggested Revisions:

Page No.	Comments

(Please attach additional sheets if necessary)

AUDIT MANUAL ADVISORY TASK FORCE

The manuals in the AICPA Integrated Practice System are monitored by a special PCPS Audit Manual Advisory Task Force. Task force members use the manuals in their audit and accounting practices and continuously provide the AICPA staff with recommendations to enhance the manuals from the perspective of the small- and medium-sized firm.

MEMBERS OF THE AICPA PRIVATE COMPANIES PRACTICE SECTION (PCPS) AUDIT MANUAL ADVISORY TASK FORCE

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AICPA INTEGRATED PRACTICE SYSTEM
NOT-FOR-PROFIT ORGANIZATIONS AUDIT MANUAL

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CHAPTER 1

INTRODUCTION

1.000 PURPOSE OF THE MANUAL

1.001 The purpose of this Manual is to provide engagement-oriented documentation for use in not-for-profit organization audit engagements, specifically audits of entities covered by the AICPA Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations* (AAG-NPO), and the AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (IAG-VHW). The types of organizations covered by the AICPA's *Audits of Certain Nonprofit Organizations* include, but are not limited to:

- Cemetery organizations
- Civic organizations
- Environmental protection organizations
- Fraternal organizations
- Labor unions
- Libraries
- Museums
- Other cultural institutions
- Performing arts organizations
- Political parties
- Private and community foundations
- Private elementary and secondary schools
- Professional associations
- Public broadcasting stations
- Religious organizations
- Research and scientific organizations
- Social and country clubs
- Trade associations
- Zoological and botanical societies

The AICPA's Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, contains the following description of the types of organizations it covers:

> Basically, they are organizations formed for the purpose of performing voluntary services for various segments of society. They are 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 organizations 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 organizations include those nonprofit organizations 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.

1.002 This Manual is written for CPAs as an aid in conducting audits of these types of not-for-profit organizations, and for those who hold positions of responsibility in not-for-profit organizations or who provide them with accounting or advisory services. Included are many useful checklists and questionnaires to incorporate in audits of not-for-profit organizations.

1.003 Chapter 1 discusses not-for-profit organizations and the environment in which they operate, including some of the unique accounting, tax, and operational challenges they face.

1.004 Chapter 2 deals with specific accounting principles for not-for-profit organizations and gives related audit insights. Included in this chapter are detailed discussions of Statements of Financial Accounting Standards (SFAS) Nos. 116 and 117, *Accounting for Contributions Received and Contributions Made* and *Financial Statements for Not-for-Profit Organizations*, issued by the Financial Accounting Standards Board (FASB) in June 1993, as well as other recently issued authoritative pronouncements. The chapter also includes discussion of the FASB Exposure Draft, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, the AICPA proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Government Entities that Include a Fund-Raising Appeal*, and the AICPA exposure draft of the Audit and Accounting Guide, *Audits of Not-for-Profit Organizations*.

1.005 Chapter 3 covers the considerations involved in deciding whether to accept or continue a relationship with a not-for-profit organization and audit planning requirements. Included are discussions of client acceptance and continuance, planning documentation, budgeting tools, and risk assessment.

1.006 Chapter 4 addresses compliance auditing for not-for-profit organizations. This chapter also contains information about Office of Management and Budget (OMB) Circular A-133, which requires that all organizations receiving federal funds in excess of certain amounts (even if the funds flow through a state or local government) have their financial statements (or at least the federally funded programs) audited. OMB Circular A-133 requires that the auditor report not only on the financial statements, but also on the organization's compliance with laws, regulations, and grant requirements and on the organization's internal controls. In addition, a description of AICPA Statement of Position (SOP) 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, is provided in this Chapter, including examples of special reports required by this pronouncement.

1.007 Chapter 5 describes the two audit approaches presented in this Manual—the unique "ABC System," and the All Substantive Approach (formerly the Small, Noncomplex Engagement Approach). The ABC System provides a framework for assessing control risk, obtaining an understanding of the internal control structure, and designing an audit strategy. Emphasis is placed on a flexible method of customizing audit procedures and documentation. The All Substantive Approach is appropriate for engagements in which you determine that a primarily substantive approach will be the most cost effective audit approach (Chapter 3 discusses how to select the appropriate audit approach for each engagement). These two approaches are also followed in the AICPA's Integrated Practice System Comprehensive Engagement Manual, and in the other industry-specific manuals in the Integrated Practice System series.

1.008 Chapter 6 discusses the internal control structure of the not-for-profit organization. Included in this chapter are useful tools that will assist in documenting and evaluating the control structure and performing tests of controls.

1.009 Chapter 7 includes guidance on substantive testing for not-for-profit organizations as well as analytical procedures and test of balances programs designed for not-for-profit organizations.

1.010 Chapter 8 contains information about the final phases of the audit. Covered in this section are a sample representation letter, and checklists documenting the supervision and review of the audit work performed.

1.011 Chapter 9 deals with financial statement presentation and disclosure requirements and auditor's reporting requirements. It includes illustrative financial statements, disclosure and auditor's report checklists, and sample auditor's reports.

1.012 Chapter 10, **added this year**, highlights certain consulting services than an auditor can provide to not-for-profit clients such as assisting in the implementation of SFAS Nos. 116 and 117 and advising on general ledger software selection.

1.013 Chapter 11 is a four credit hour self-study course. The topic of this course is the recently issued SFAS Nos. 116 and 117. This course will enable up to three members of your firm the opportunity to earn these four credits, while learning the challenging new concepts that these Statements deal with.

1.014 The authors hope that you find this Manual useful and easy to use. We would appreciate your comments and suggestions.

1.100 USE OF THIS MANUAL

1.101 This Manual is designed as a nonauthoritative practice aid. It is intended to provide users with practical how-to guidance in applying authoritative accounting and auditing literature in their not-for-profit organization audit engagements.

1.102 The sample audit programs, forms, and checklists included in this Manual should be tailored to each engagement's circumstances, and also to your firm's quality control policies and procedures.

Updating of the Manual

1.103 This Manual is updated annually to provide users the most current authoritative guidance. This third edition reflects the authoritative guidance issued through May 1995, including those issued up to:

- Statement on Auditing Standards (SAS) No. 74
- SFAS No. 121
- SOP 95-1
- FASB Interpretation No. 41
- FASB Technical Bulletin No. 94-1
- Emerging Issues Task Force (EITF) Consensuses adopted up to and including the March 23, 1994 EITF Meeting

1.104 Users should be alert for pronouncements issued subsequent to those listed above that could affect their engagements.

References to Authoritative Literature

1.105 Throughout this Manual, references to the publications containing authoritative literature have been included to help users in performing research. The explanation of these references follows:

AC = references to the sections in FASB *Accounting Standards — Current Text*

AU = references to the sections in the AICPA *Professional Standards* — Volume 1

ET = references to the Code of Professional Conduct in the AICPA *Professional Standards* — Volume 2

PC = references to the quality control standards in the AICPA *Professional Standards* — Volume 2

SFAS = Statement of Financial Accounting Standards

SOP = AICPA Statement of Position

ARB = Accounting Research Bulletin of the AICPA Accounting Principles Board

APB = AICPA Accounting Principles Board Opinion

AAG-NPO = AICPA Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*

IAG-VHW = AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*

1.200 USE OF FORMS IN ELECTRONIC FORMAT

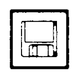
WordPerfect

1.201 Enclosed with this year's edition of the Manual is a complementary disk that contains the sample engagement letters, representation letters, sample auditor's reports, and other correspondence illustrated in this Manual. The documents on the disk are in WordPerfect format to allow you to easily customize them for each client.

Lotus 1-2-3

1.202 Also included on the complementary disk is the Summary of Possible Journal Entries Form in Lotus 1-2-3 (release 3.1 with wysiwyg or release 3.4 and higher). This file allows you to easily post unrecorded misstatements and it contains formulas to calculate totals and percentages. If you do not have access to Lotus 1-2-3, you may copy the Form included in the section 8.904 of Chapter 8 for inclusion in your workpapers.

1.203 These documents are identified in the manual by the following icon:



Audit Program Generator

1.204 Many subscribers to the Integrated Practice System Engagement Manuals are also users of the AICPA's Audit Program Generator (APG), a specially designed software program that allows you to customize a variety of AICPA work programs and checklists for each client.

1.205 If you are already an APG user, you may purchase the Library Volume containing the programs and checklists included in this Manual. To order APG and/or the APG Libraries for the Integrated Practice System Engagement Manuals, call the AICPA's Order Department at 1-800-862-4272, sub-menu #1. The product number for the Library Volume for not-for-profit organizations is 016988 and is priced at $46.50 ($51.00 for nonmembers). For APG product information, call the AICPA Software Connection at 1-800-226-5800.

1.206 The programs and checklists that are available in the APG Library Volume are identified by the following icon:

1.300 DISTINGUISHING NOT-FOR-PROFIT ORGANIZATIONS FROM COMMERCIAL ENTITIES

1.301 Now that you have been introduced to the Integrated Practice System, and have an understanding of how to use this Manual as a tool in your practice, we will take the opportunity to introduce you to the unique aspects of not-for-profit organizations. The sections that follow address the differences between not-for-profit organizations and commercial entities, and some characteristics that you might encounter in your dealings with not-for-profit organizations.

1.302 There are over one million not-for-profit organizations in the United States that provide a wide variety of charitable and noncommercial services. In our society, when people think of not-for-profit organizations, most think of entities like churches, shelters for the homeless, zoos, environmental advocates, symphony orchestras, to name a few.

1.303 The distinguishing features of not-for-profit organizations are the absences of long-term profit motives and ownership interests. They exist to provide goods or services, often to defined constituencies. Frequently, these functions would not be lucrative enough to attract commercial entities. The absence of a long-term profit motive frees not-for-profit organizations from the need to provide an adequate return on investment to shareholders or investors. Thus, an organization can establish operational structure and capacity, can decide whether or how much to charge for its goods or services, and can reach out to its constituency without the necessity of being profitable.

1.304 Both commercial and not-for-profit entities have assets, liabilities, equity, revenue and expenses. Both have cash receipts, cash disbursements, and accounting controls, and can engage in almost any financial transaction (except that not-for-profit organizations do not engage in shareholder transactions). Both may be subject to income taxes, fraud and management manipulation of the financial statements.

1.305 There are two features that frequently are present in not-for-profit organizations and distinguish them from commercial entities. First, many organizations receive contributions. SFAS No. 116 defines contributions as follows:

> An unconditional transfer of cash or other assets to an entity or a settlement or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.

1.306 Second, many not-for-profit organizations are exempt from federal, and usually state and local, income taxes. This exemption is based on criteria that Congress enacted to encourage specific public benefit purposes. The auditor needs to be aware that an organization may meet the accounting criteria of what is considered a not-for-profit organization and yet fail to meet the tax criteria. In such instances, the auditor should consider whether adequate tax provisions are included in the organization's financial statements.

The Need for an Audit

1.307 Many not-for-profit organizations are parties to mortgages, loans, or bonding contracts that require audited financial statements just as they would for a commercial entity. But there are also other reasons for organizations to engage auditors. Some states require all not-for-profit organizations with revenues in excess of specified amounts and operating within their jurisdiction to be audited. Also, many funders, such as the United Way and most governmental entities, require not-for-profit organizations to submit audited financial statements. Other not-for-profit organizations voluntarily have audits performed as part of their stewardship responsibilities.

1.400 THE MISSION AND PERFORMANCE MEASUREMENT

1.401 The concept of an entity foregoing a profit motive is built on its commitment to accomplish a public benefit. An organization's mission is the focus of its planning and operations and is the centerpiece of its effort to attract contributions.

1.402 An organization's mission is usually stated in its articles of incorporation and by-laws. Some are specific (such as to provide shelter to the homeless of the City of Los Angeles) while others are very broad (such as to provide shelter and counseling for the homeless of Los Angeles and other activities allowed under Section 501(c)(3) of the Internal Revenue Code).

1.403 Since the goal of a commercial entity is to provide a return for its owners, net income is used as the primary measurement of its efficiency and success each year. However, a not-for-profit organization's efficiency and success must be measured by performance, not profit.

1.404 Therefore, users of not-for-profit organizations' financial statements do not use the same analytical methods used in evaluating commercial entities' performance. Unique ways to analyze the financial efforts of not-for-profit organizations have been developed and are covered in the Analytical Procedures Program — Not-for Profit Organizations in Chapter 7. Many not-for-profit organizations report additional information in their financial statements to allow users to understand how resources are applied to their mission-directed operations.

1.405 The FASB, in issuing SFAS No. 117, has made an attempt to standardize the financial statements of all not-for-profit organizations. This has been done to provide the users with consistent information to make funding, lending and other business decisions. This Statement is discussed in greater detail in section 2.300 of Chapter 2.

1.500 STRATEGIC PLANNING TO ACCOMPLISH THE MISSION

1.501 In order to define operational and financial goals, well-managed not-for-profit organizations develop annual and long-range plans, just as commercial entities do. The following is a partial list of factors that a not-for-profit organization would consider in the planning process:

- Volume of services to be provided
- Allocation of resources
- Required staff levels
- Cash flow
- Fund-raising campaigns and promotion efforts
- Board member recruitment
- Capital purchases
- Cost center or profit center budgeting

1.502 Planning in a small organization may be as simple as preparing a cash-basis budget for approval by the governing board. In a large organization, there may be a formal multiyear plan encompassing all facets of organizational management.

1.503 Frequently, in not-for-profit organizations, budgeting plays not only a planning role, but also a very central control function. In commercial entities, products or services are priced to achieve a certain profit margin; selling more products or services than planned provides more revenue. However, many not-for-profit organizations do not receive more revenue when they provide increased services; therefore, it is essential that they closely monitor and control the level of services they provide. Frequent comparison of actual to budgeted performance is often a key tool in this control.

1.600 REVENUE SOURCES

1.601 Not-for-profit organizations earn revenue in many forms from a variety of sources, such as:

- Sales of goods or services
- Investment income (interest, dividends, gains and losses)
- Subscription fees (such as for magazines or research privileges)
- Membership fees (such as for fitness centers)

1.602 They may also have nonreciprocal transfers. SFAS No. 116 defines nonreciprocal transfers as follows:

> A transaction in which an entity incurs a liability or transfers an asset to another entity (or receives an asset or cancellation of a liability) without directly receiving (or giving) value in exchange.

Examples of transactions that could be considered nonreciprocal transfers are:

- Contributions
- Donations
- Grants
- Volunteer services
- Donated materials or equipment

1.603 Many not-for-profit organizations receive government funding, either as grants or contracts. Often, acceptance of these grants obligates an organization to burdensome monthly or quarterly reporting, to governmental inspection of facilities and qualitative evaluation of services, and to compliance with audit requirements in excess of generally accepted auditing standards (GAAS). Each government (city, state, or federal) that issues grants and contracts may establish its own rules, guidelines, and requirements.

1.604 Many states require not-for-profit organizations operating within their borders to register, usually with the Secretary of State, and to file reports annually. These reports may take the form of financial statements or selected financial information, or may be informational, such as names of board members. The auditor should be aware of the specific filing requirements of each state in which the organization is registered. Usually, these requirements are based on the state's perceived responsibility to protect potential donors within its borders from organizations that use little of their revenue for public benefit purposes, and also to ensure that constituents within the state receive the services that donors intend to fund. Some states require organizations or individual employees to register as professional fundraisers.

1.605 The National Association of Attorneys General has encouraged all states to adopt its model Uniform Not-for-Profit Organization Act. Many states have done so, but with numerous local amendments and adaptations. Not-for-profit organizations must become informed about any such regulatory requirements in states where they solicit funds or provide services.

1.606 Organizations and their boards must fully explore the operational and reporting requirements attached to any government funding. Auditors of not-for-profit organizations must consider whether not-for-profit organizations have complied with all the requirements of such grants, and what affect noncompliance would have on the organization's financial statements.

1.700 THE GOVERNING BOARD AND VOLUNTEERS

1.701 The governing board of a not-for-profit organization has the ultimate legal authority and responsibility to make decisions in the name of the organization. Some organizations are able to attract very highly qualified and experienced professionals (attorneys, accountants, CEOs, marketing specialists) to join their boards, giving them access to expertise and a network of connections they may not otherwise be able to acquire. Often, these volunteer board members provide other professional services to the organization at no or reduced cost.

1.702 Planning for board member recruiting is essential to maintaining a balance of both outside professionals and individuals with specific knowledge about the not-for-profit organization's mission. Often constituents, staff members, and volunteer workers are selected for board membership. It is important for an organization to evaluate the skills, experience, insights, abilities, and fundraising capacities it needs on its board. This mix will not be the same in all organizations.

1.703 From the auditor's point of view, it is important to consider the role of the board in the organization's internal control structure. In audits of privately owned businesses, ownership self-interest, especially if the owner also manages the entity, gives the auditor a significant amount of assurance that compliance with the internal controls is monitored. Depending on the knowledge, experience, and dedication of board members, they may or may not monitor internal control compliance with as much interest as an owner.

1.704 In a not-for-profit organization, it is important that the board have adequate competence to establish policy over and monitor both financial and operational activities. Some of a board's audit-related responsibilities may include:

- Financial oversight
- Financial planning
- Budget approval
- Selecting and receiving communications from auditors
- Filling of financial staff vacancies
- Salary review
- Monitoring compliance with donor restrictions

- Monitoring compliance with reporting obligations

1.705 In many organizations, volunteers are the backbone of the organization. The ability to obtain and keep this dedicated work force is crucial to the organization's continued existence. Many volunteers serve the organization for longer periods of time than the permanent employees. They carry the history of the organization with them.

1.706 The impact of volunteers on the internal control structure varies from organization to organization. On one hand, because volunteers have a strong commitment to the overall mission of the organization, they are generally less likely to participate in defalcations. However, volunteers at times can be less responsive to the need to comply with control policies and procedures, and the organization may have less leverage to force volunteers to comply than it would with paid employees. Sometimes in organizations there is a revolving door of temporary volunteers who may not have adequate training, longevity, or loyalty to ensure good compliance with controls. Management must consider how best to design control procedures to adapt to its particular situation.

1.800 UNIQUE ACCOUNTING NEEDS OF NOT-FOR-PROFIT ORGANIZATIONS

1.801 Not-for-profit organizations face a number of unique accounting challenges. Their auditors must understand these challenges in order to be able to design appropriate auditing procedures.

Fund Accounting

1.802 Fund accounting is a technique used to track the assets, liabilities, equity, revenue, and expenses related to a given purpose. This technique was developed for governmental entities which often levy taxes for specific earmarked uses, such as the police fund, the fire fund, or the municipal retirement fund. Fund accounting issues may still be applicable for organizations that have adopted SFAS No. 117 because SFAS No. 117 neither requires nor prohibits financial statement presentation on a disaggregated fund basis.

1.803 Each fund is treated as a separate accounting entity, with a separate general ledger. Therefore, each fund could have its own complete set of financial statements. Large not-for-profit organizations may have thousands of funds, one for each restricted contribution they receive. Prior to the issuance of SFAS No. 117 not-for-profit organization financial statements would usually group funds into one or more of the following:

- Restricted Funds - funds whose use is limited by donor-imposed stipulations.
- Endowment Funds - funds that donors have stipulated may not be spent but should be held in perpetuity, or for a specific amount of time, for the production of income.
- Fixed Asset Fund - the fund in which buildings, equipment, and furniture and related accumulated depreciated are reported.
- Unrestricted Fund - funds that do not have donor-imposed restrictions, and over which the organization has discretion.

The recording of transactions into the restricted or endowment funds results from only donor-imposed restrictions. These requirements are discussed further in Chapter 2.

1.804 SFAS No. 117 requires presentation of net assets according to the following classifications:

- Unrestricted,
- Temporarily Restricted, and
- Permanently Restricted.

Similar to reporting prior to the issuance of this Statement, the restricted nature of funds is still determined based on the donor's intent. Further discussion of the reporting requirements for not-for-profit organizations who have elected to adopt SFAS No. 117 is found in section 2.700, in Chapter 2.

Functional Expense Reporting

1.805 SFAS No. 117 requires that all not-for-profit organizations report expenses by function, because that information is necessary for users to gain an understanding of a not-for-profit organization's service efforts. SFAS No. 117 requires all voluntary health and welfare organizations to report expenses both by function and by natural classification, in a matrix format in a separate financial statement. SFAS No. 117 requires all other not-for-profit organizations to report expenses by function either in the statement of activities or in notes to the financial statements and encourages them to provide information about expenses by their natural classification.

1.806 Functions are the types of activities in which an organization engages such as major classes of program services and supporting activities. Program services are the activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Supporting activities are all activities other than program services. Generally they include management and general, fundraising, and membership development activities. See Chapter 9 for examples of financial statements that report expenses functionally.

1.900 CONCLUSION

1.901 It is important to our overview of the not-for-profit organization environment to realize that many factors affect the operations and management of a not-for-profit organization, including donor restrictions, strings attached to governmental funding, volunteers' longevity and loyalty, tax exemption requirements, and relationships to other organizations. Accountants involved with not-for-profit organizations need to understand all of these factors in order either to participate in management as an officer or board member, or to conduct an audit.

Audit & Accounting Issues

CHAPTER 2

ACCOUNTING AND AUDITING FOR NOT-FOR-PROFIT ORGANIZATIONS

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CHAPTER 2

ACCOUNTING AND AUDITING FOR NOT-FOR-PROFIT ORGANIZATIONS

2.000 INTRODUCTION

2.001 Most auditors find it challenging to keep up-to-date with all of the generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) that apply to their not-for-profit organization audit engagements. This challenge has increased with the issuance of SFAS Nos. 116 and 117 and it will continue to escalate over the next few years as the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) issue additional not-for-profit-related exposure drafts and final pronouncements that will supersede, amend, and add to existing GAAP and GAAS.

2.002 This Chapter enumerates the various pronouncements that are currently effective and those that are proposed. It also provides detailed discussions of:

- accounting and auditing considerations for the various types of contributions that not-for-profit organizations receive,
- specific accounting and auditing topics that are either particularly important in audits of not-for-profit organizations, or that represent differences from those encountered in audits of commercial entities, and
- the exposure draft of the proposed AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*.

2.003 The forms and checklists in this edition of the Manual have been updated to encompass Statements of Financial Accounting Standards (SFAS) Nos. 116 and 117, *Accounting for Contributions Received and Contributions Made* and *Financial Statements of Not-for-Profit Organizations*, respectively, and presume that organizations have adopted them. The discussions in this Chapter focus on the principles from these Statements, however, the accounting treatment that would be followed for organizations following Statement of Position (SOP) 78-10 and AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (VHW Guide),are also presented for those entities not yet adopting SFAS Nos. 116 and 117.

2.004 A discussion of the issues organizations should consider as they prepare to adopt SFAS Nos. 116 and 117 is included in Chapter 10 of this edition of the Manual, along with insightful tips for auditors to consider in helping clients make informed policy decisions.

2.100 AN OVERVIEW OF EXISTING AND PROPOSED ACCOUNTING AND AUDITING GUIDANCE — SPECIFIC TO NOT-FOR-PROFIT ORGANIZATIONS

Accounting Guidance for Not-for-Profit Organizations

2.101 Existing authoritative guidance issued by the FASB and the AICPA that specifically apply to not-for-profit organizations are as follows:

1. SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*, establishes standards for general-purpose external financial statements provided by a not-for-profit organization. It is effective for fiscal years beginning after December 15, 1994 and interim periods within those fiscal years, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Earlier application is encouraged.

2. SFAS No. 116, *Accounting for Contributions Received and Contributions Made*, establishes GAAP for contributions for all types of entities, both for-profit and not-for-profit. It is effective for fiscal years beginning after December 15, 1994 and interim periods within those fiscal years, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Earlier application is encouraged.

3. SFAS No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, requires all not-for-profit organizations to record depreciation for capitalized tangible assets except for certain works of art and historical treasures.

4. AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (VHW Guide), establishes GAAP applicable to financial reporting by those types of not-for-profit organizations. Although many provisions of this guide have been superseded by SFAS Nos. 93, 116, and 117, SOP 87-2, and SOP 94-3, its remaining provisions represent authoritative guidance for these types of organizations. This Guide is expected to be superseded by a new AICPA Audit Guide, *Audits of Not-for-Profit Organizations*. The exposure draft of this guide was released in April 1995 and the final guide is expected to be issued in the second quarter of 1996. See section 2.700 for a discussion of the exposure draft.

5. AICPA Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*, (NPO Guide) and SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, recommends financial accounting principles and reporting practices for all not-for-profit organizations, except hospitals, colleges and universities, voluntary health and welfare organizations, state and local governmental units, and not-for-profit entities that operate essentially as commercial businesses for the direct economic benefit of members or stockholders. Although many provisions of this guide have been superseded by SFAS Nos. 93, 116, and 117, SOP 87-2, and SOP 94-3, its remaining provisions represent authoritative guidance for adopting organizations. This Guide is expected to be superseded by a new AICPA Audit Guide, *Audits of Not-for-Profit Organizations*. The exposure draft of this

guide was released in April 1995 and the final guide is expected to be issued in the second quarter of 1996. See section 2.700 for a discussion of the exposure draft.

6. AICPA SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, amends portions of the VHW Guide and SOP 78-10 and establishes guidance for allocating the joint costs of materials and activities that include a fund-raising appeal among fund-raising, program or management, and general functions. This SOP is expected to be superseded by a new SOP (see sections 2.103–2.105) in the fourth quarter of 1995.

7. AICPA SOP 94-2, *The Application of the Requirements of Accounting Research Bulletins, Opinions of the Accounting Principles Board, and Statements and Interpretations of the Financial Accounting Standards Board to Not-for-Profit Organizations*, was issued to clear up confusion about the applicability of ARBs, APBs, and FASB Statements and Interpretations to nonprofit organizations. It states that not-for-profit organizations should follow APB, ARB, and FASB guidance unless a pronouncement explicitly exempts not-for-profit organizations or its subject matter precludes such application, which parallels the guidance provided by SFAS No. 117. The SOP also provides specific guidance on the application of APB No. 16, *Business Combinations*, and APB No. 21, *Interest on Receivables and Payables*. It states that, even though nonprofits generally do not issue common stock, they are permitted to report business combinations under the pooling of interest method under certain circumstances. It also indicates that the provisions of ABP No. 21 should be applied to the discounting of unconditional promises to give in accordance with SFAS No. 116. Appendices list pronouncements according to whether they exempt nonprofits, generally do not apply to nonprofits or are subject to additional AICPA or FASB guidance. The SOP also indicates that nonprofits that engage in specialized operations (such as broadcasting) for which there is specific guidance should follow that industry's specific guidance, even if the guidance does not contemplate nonprofits. The SOP is effective for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the SOP is effective for fiscal years beginning after December 15, 1995. Early application is permitted and for organizations that adopt SFAS No. 117 prior to its effective date, earlier application of this SOP is encouraged.

8. AICPA SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, amends portions of the VHW Guide, College and University Guide, Guide for Audits of Certain Nonprofit Organizations and SOP 78-10. It directs an organization to consolidate another organization in which it has a controlling financial interest through direct or indirect ownership of a majority of voting interest, or if it has both control of the other organization and an economic interest in the other organization. Other provisions guide the reporting of related for-profit entities, and disclosure requirements for relationships that do not meet the consolidation requirements. See sections 2.426–2.433 for further discussion.

9. AICPA Industry Audit Guide, *Audits of Colleges and Universities* (College Guide), and SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*, establish accounting guidance for post-secondary educational institutions. Audits of these entities are not covered in this Manual. Although many provisions of this Guide have been superseded by SFAS

Nos. 93, 116, and 117, SOP 87-2, and SOP 94-3, its remaining provisions represent authoritative guidance for adopting organizations. This Guide is expected to be superseded by a new AICPA Audit Guide, *Audits of Not-for-Profit Organizations*. The exposure draft of this guide was released in April 1995 and the final guide is expected to be issued in the second quarter of 1996. See section 2.700 for a discussion of the exposure draft.

10. AICPA Audit and Accounting Guide, *Audits of Providers of Health Care Services* (Health Care Guide), sets accounting and auditing principles pertaining to hospitals, clinics, individual practitioners, continuing care retirement communities, HMO's, home health agencies, and most nursing homes. Audits of these entities are not covered in this Manual. Although many provisions of this Guide have been superseded by SFAS Nos. 93, 116, and 117 and SOP 87-2, its remaining provisions represent authoritative guidance for adopting organizations. This guide is expected to be superseded by a new Audit Guide for *Health Care Providers* currently being prepared by the AICPA. The exposure draft of this guide was released in April 1995 and the final guide is expected to be issued in the second quarter of 1996.

11. FASB Statement of Financial Accounting Concepts (SFAC) No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, describes the objectives of general purpose external financial reporting by nonbusiness organizations. SFAC No. 4 explains that Statements of Financial Accounting Concepts do not establish 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 are the basis for developing accounting standards. They may also provide some guidance in analyzing new or emerging accounting and reporting problems in the absence of applicable authoritative pronouncements.

12. 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; e.g., assets, liabilities, net assets, revenues, expenses, gains, losses, etc. The Statement defines three classes of net assets for not-for-profit organizations and changes in those classes during the period; i.e., changes in permanently restricted, temporarily restricted, and unrestricted net assets.

Outstanding Exposure Drafts — Accounting

2.102 As mentioned in section 2.001, the AICPA and the FASB have undertaken several important projects that would significantly change some accounting and disclosure requirements for many not-for-profit organizations. The following are summaries of an exposure draft of an AICPA Statement of Position and an exposure draft of a FASB Statement, along with their current status as of the publication date of this Manual, June 1995.

2.103 AICPA Exposure Draft — Joint Activities. A proposed SOP, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal*, would supersede SOP 87-2. The exposure draft:

- Requires reporting of the costs of all materials and activities that include a fund-raising appeal as fund-raising expenses unless a bona-fide program or management and general function has been conducted in conjunction with the appeal for funds.
- Requires that the joint costs of those activities be allocated if a bona fide program or management and general function has been conducted in conjunction with an appeal for funds. Costs that are clearly identifiable with fund-raising, program, or management and general functions should be charged to that cost objective.
- Sets forth the criteria of purpose, audience, and content in order to conclude that a bona-fide program or management and general function has been conducted.
- Describes and illustrates some commonly used and acceptable allocation methods, though no methods are prescribed.
- Requires disclosure of certain information if joint costs are allocated.

2.104 The most significant difference between the exposure draft and SOP 87-2 is that the ED covers *all* costs of materials and activities that include a fund-raising appeal, including costs that are otherwise clearly identifiable with program or management and general functions. SOP 87-2 covers only joint costs of joint activities. To illustrate this difference, assume that an organization sends a mailing that includes both a request for contributions and a pamphlet on positive ways to discipline your children. The mailing is sent to only targeted contributors and, therefore, the mailing does not meet the audience test of the exposure draft. As a result, the *entire* cost of the mailing (including costs clearly attributable to the program pamphlet) is charged to fund-raising. Under SOP 87-2, only the joint mailing costs are considered fund-raising and the costs attributable to the program pamphlet are charged to the particular program.

2.105 The final SOP is expected to be issued in the fourth quarter of 1995. The effective date has not yet been determined.

2.106 FASB Exposure Draft — Investments. This proposed statement, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, would require that investments in equity securities with readily determinable fair values and all investments in debt securities be reported at fair value, with gains and losses included in the statement of activities. It also would require certain disclosures about investments and the return on those investments and would establish standards for reporting losses on investments of an endowment fund that is created by a donor's stipulation that requires investment of the gift in perpetuity for a specified term. This proposed statement will standardize the guidance for reporting of investments held by not-for-profits. Currently, organizations covered by the Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations,* may report investments at either cost or fair value and organizations covered by the Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations,* report investments at cost, market value, or lower of cost or market value based upon the type of investments and whether or not they will be held to maturity. The pronouncement would be effective for fiscal years beginning after December 15, 1995, with earlier application encouraged.

Auditing Standards That Specifically Apply to Not-for-Profit Organizations

2.107 In addition to auditing guidance contained in the AICPA Guides, *Audits of Voluntary Health and Welfare Organizations* and *Audits of Certain Other Nonprofit Organizations*, auditors of not-for-profit organizations should be familiar with the following:

- SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, was issued in February 1995. It supersedes the guidance in SAS No. 68. In contrast to SAS No. 68, which contained the many reporting requirements of Government Auditing Standards, the Single Audit Act, and OMB Circular A-133, SAS No. 74 merely refers to these requirements. As a result, the SAS no longer needs to be amended each time one of these requirements changes. There are no other significant differences between SAS No. 74 and SAS No. 68.
- AICPA Auditing Interpretation, *Reports on the Financial Statements Included in Internal Revenue Form 990, 'Return of Organizations Exempt from Income Tax'*. This Interpretation provides reporting guidance specifically applicable to not-for-profit organizations.
- AICPA SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*. This SOP amends the AICPA Industry Audit Guide, *Audits of College and Universities*, for matters concerning student financial assistance and provides auditing and reporting guidance for all not-for-profit organizations receiving federal awards. SOP 92-9 is currently being revised for the 1994 revision to Government Auditing Standards (the Yellow Book). Conforming changes to the SOP will be issued in the third quarter of 1995.
- The AICPA *Code of Professional Conduct*, which includes one interpretation and several rulings relating to independence issues for accountants for not-for-profit organizations (described in Chapter 3, section 3.114). All members of the AICPA are required to adhere to the Code, which is found in the AICPA Professional Standards, Volume 2.

Special Requirements of Organizations That Provide Funding

2.108 Organizations that provide funds to not-for-profit organizations often attach certain restrictions and requirements to those funds. These restrictions and requirements often relate to specific reporting requirements or auditing and compliance procedures the auditor should perform, such as:

1. Performing specific audit procedures on "supplemental information."
2. Performing audit procedures beyond those required under GAAS.
3. Reporting on whether an organization's financial statements comply with specialized accounting principles prescribed by the funder that differ from GAAP.
4. Reporting on matters such as internal controls and compliance with specialized accounting principles other than GAAP.

2.109 Some of the most widely applicable of these audit requirements are those attached to government funding, especially federal funds that flow from the federal government either directly to the not-for-profit organization, or indirectly through a state or local government to the not-for-profit organization. It is management's primary responsibility to ensure that the organization meets the funders' special reporting requirements. However, the auditor should be aware of the most common requirements. A listing of publications that discuss these requirements and a brief description of their content is located in Chapter 4, section 4.011.

Other Recently Issued Authoritative Pronouncements

2.110 The following sections summarize some important authoritative pronouncements issued since the previous edition of this manual.

2.111 SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of.* In March 1995, the Financial Accounting Standards Board issued SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, which is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is prohibited. The Statement establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets for both assets to be held and used and assets to be disposed of. SFAS No. 121 amends several existing pronouncements (see paragraphs 20–33 of the Statement).

2.112 Assets to Be Held and Used. According to the Statement, an entity is required to review its long-lived assets, such as buildings and equipment, for impairment whenever events or changes in circumstances relating to the assets ("triggering events") indicate the carrying amount of an asset may not be recoverable. In other words, an event or change in circumstances, such as a significant decrease in the market value of an asset, a significant change in the extent or manner in which an asset is used or a significant physical change in an asset occurs, may indicate that an asset has been impaired.

2.113 If a triggering event is present, the entity then determines if an impairment loss should be recognized by measuring the expected future cash flows[1] (undiscounted and without interest charges) to be generated from the use of the asset and its eventual disposition. If the sum of the expected future cash flows is less than the carrying amount of the asset, then an impairment loss should be recognized.

2.114 The amount of the impairment loss to be recognized is measured by calculating the difference between the carrying amount and the fair value of the asset. The fair value is defined as the amount at which the asset could be bought or sold in a current transaction between willing parties. If quoted market prices in active markets are not available, SFAS No. 121 discusses various methods of determining the fair value of the assets including using estimates of expected future cash flows discounted at a rate commensurate with the risks involved.

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[1] Future cash flows is defined as the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. When estimating expected future cash flows, assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

2.115 Once an impairment is recognized, the reduced carrying amount of the asset is the new cost basis that should be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

2.116 **Assets to Be Disposed Of.** If management has committed to a plan to dispose of long-lived assets (whether by sale or abandonment), has the authority to approve the action, and this action is not covered by APB Opinion No. 30, *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, the asset should be reported at the lower of carrying amount or fair value less cost to sell. Fair value is measured the same as for assets to be held and used. The cost to sell an asset includes incremental direct costs, such as broker commissions, legal and title transfer fees, and closing costs. Assets to be disposed of should not be depreciated while they are held for disposal.

2.117 Subsequent revisions to the estimates of fair value less cost to sell should be reported as adjustments to the carrying amount of the asset to be disposed of, not to exceed the carrying amount of the asset before an adjustment was made.

2.118 The presentation and disclosure requirements for both assets to be held and used and assets to be disposed of are included in the Financial Statement Disclosure Checklist in Chapter 9.

2.119 **SAS No. 73, *Using the Work of a Specialist.*** In July 1994, the AICPA issued SAS No. 73, *Using the Work of a Specialist,* to provide guidance to an auditor who uses a specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions. SAS No. 73, which supersedes SAS No. 11 and its two interpretations, is not expected to dramatically change current practice for auditors who use the work of a specialist. However, the Statement (1) clarifies the applicability of the guidance, (2) provides updated examples of situations that might require using the work of specialists and types of specialists being used today, and (3) provides guidance on using the work of a specialist who is related to the client.

2.120 Auditors may use specialists' work as evidential matter in performing substantive tests to evaluate material financial statement assertions such as actuaries (to determine employee benefit obligations), appraisers, engineers, and environmental consultants. When using the work of a specialist, the auditor should—

- Evaluate the professional qualifications of the specialist.
- Obtain an understanding of the nature and scope of the work and the assumptions used by the specialist and test, as considered appropriate, the data provided to the specialist, taking into consideration the auditor's assessment of control risk.
- Evaluate the relationship of the specialist to the client to ensure that the specialist's objectivity was not impaired. If objectivity may have been impaired, the auditor should perform additional procedures to determine that the findings are not unreasonable.
- Consider whether the specialist's findings support the related assertions in the financial statements. If there is a difference between the findings and the assertions, the auditor should apply additional procedures, which may include obtaining the opinion of another specialist. If the difference still cannot be resolved, the auditor should qualify the opinion or disclaim an opinion because of a scope limitation. If the auditor concludes that the assertions are not in conformity with GAAP, the auditor should issue a qualified or adverse opinion.

2.121 Auditor's Report. Generally, the auditor's report should not refer to the work of the specialist. However, if the report is modified or an explanatory paragraph is added as a result of the report or findings, the specialist may be referred to and identified.

2.122 Testing Related to Specialists. The Tests of Balances Program in this Manual includes audit procedures the auditor should perform when using the work of an actuary or another specialist.

2.123 Effective Date. SAS No. 73 is effective for audits of financial statements for periods ending on or after December 15, 1994. Early application is encouraged.

2.124 SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties.* In December 1994, the AICPA issued SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, in response to the need for improved disclosure of significant risks and uncertainties brought about by a volatile business and economic environment. Many of the disclosure requirements of this SOP supplement or overlap the requirements of other authoritative pronouncements, such as SFAS No. 5, *Accounting for Contingencies.*

2.125 Disclosures. The SOP requires the following disclosures for all entities, which need be made only for the most recent period presented:

- The nature of the organization's operations—principal services performed by the organization and the revenue sources for such services.
- The fact that financial statements prepared in accordance with GAAP require the use of management's estimates.

2.126 The following disclosures, relating to estimates used in the preparation of financial statements, also are required if (a) it is at least reasonably possible that the estimate(s) will change in the near term, and (b) the effect(s) of the change will be material:

- The nature of uncertainties inherent in estimates such as those used to determine the carrying amounts of assets and liabilities, or used to disclose gain or loss contingencies.
- That a material change in the estimate could occur in the near term. Examples are estimates regarding inventory or equipment subject to rapid technological obsolescence, and litigation-related obligations. "Near term" is defined as a period of time not to exceed one year from the financial statement date.
- If the estimate involves a loss contingency covered by SFAS No. 5, *Accounting for Contingencies,* an estimate of the possible loss or range of loss, or a statement that such an estimate cannot be made. Also, consider disclosure of the factors that cause the estimate to be sensitive to material change.

2.127 The following disclosures, relating to concentrations, also are required if the concentrations (a) exist at the financial statement date, and (b) could cause the entity a near-term severe impact: ("Severe impact" is defined as an event having a significant financially disruptive effect on the normal functioning of the entity. It has a higher threshold than materiality).

- Concentrations in the volume of business transacted with a particular customer, supplier, lender, grantor, or contributor.

- Concentrations in revenue from particular products, services, or fund-raising events.
- Concentrations in the available sources of supply of materials, labor, services, or of licenses or other rights used in the entity's operations.
- Concentrations in the market or geographical area in which an entity conducts its operations.
- Concentrations of labor subject to collective bargaining agreements, including the percentage of the labor force covered by a collective bargaining agreement and the percentage of the labor force covered by a collective bargaining agreement that will expire within one year.
- Concentrations of operations located outside of the entity's home country, including the carrying amounts of net assets and their locations.

2.128 The SOP's disclosure requirements are separate from, and do not change in any way, the disclosure requirements or criteria of SFAS No. 5. Rather, these disclosures supplement those required under SFAS No. 5.

2.129 Effective Date. The SOP is effective for financial statements issued for fiscal years ending after December 15, 1995, and for interim periods in fiscal years subsequent to the year for which the SOP is first applied. Early application is encouraged.

2.130 EITF Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, addresses the following three issues:

1. When an employer should recognize a liability for the cost of employee termination benefits that management decides to provide to involuntarily terminated employees. The scope of this issue excludes involuntary termination benefits covered by APB Opinion No. 30, *Reporting the Results of Operations — Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*, SFAS No. 43, *Accounting for Compensated Absences*, SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, and SFAS No. 112, *Employers' Accounting for Postemployment Benefits (an amendment of SFAS Nos. 5 and 43)*.

2. When an enterprise should recognize a liability for exit costs. Exit costs are those that have no future economic benefit, other than employee termination benefits, that are directly associated with a plan to exit an activity, including certain costs incurred in a restructuring. Such costs may include penalty fees for cancellation of operating leases and costs of remaining noncancelable operating lease terms after operations cease. (See the EITF Abstracts for additional examples of qualifying exit costs.)

3. What financial statement disclosures should be made for these charges.

2.131 The disclosure requirements of Issue No. 94-3 are not included in the Financial Statement Disclosure Checklist in Chapter 9 because these disclosures are rarely required for not-for-profit organizations. However, if your client is "downsizing" and incurs costs covered by EITF 94-3, consult the EITF for specific guidance on the related accounting and reporting issues.

2.132 As this edition of the Manual went to print, the EITF was attempting to reach a consensus on a related issue, Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination.*

2.200 CONTRIBUTIONS

2.201 In June 1993, the FASB issued SFAS No. 116, *Accounting for Contributions Received and Contributions Made.* This pronouncement establishes consistent standards for all not-for-profit organizations. Any guidance found in the VHW Guide, NPO Guide, and SOP 78-10 that conflicts with this Statement is superseded. Organizations must apply SFAS No. 116 to fiscal years beginning after December 31, 1994, but organizations having less than $5 million in total assets and less than $1 million in annual expenses have the option of deferring application until fiscal years beginning after December 15, 1995. All organizations are encouraged to apply the provisions of SFAS No. 116 earlier.

2.202 The discussions in this Manual presume that organizations have adopted SFAS No. 116, however, the accounting treatment for organizations that have not adopted this Statement are also provided.

2.203 One of the most unique features of not-for-profit organizations is their frequent receipt of voluntary contributions for support. Contributions (which are often referred to as "support") may be in the form of gifts, grants, bequests, promises to give, or donations of services, materials, or facilities. Not only do contributions pose some of the most complex and challenging accounting, reporting, and auditing issues in not-for-profit organization engagements, but many organizations are changing their accounting treatment for some contributions and pledges as they apply SFAS No. 116. The following sections discuss some of the unique accounting and auditing issues related to contributions.

2.204 In a broad sense, a contribution may be described as a transfer of an asset or cancellation of a liability without consideration. The significant words in this description are "without consideration," which means that contributions are *nonreciprocal* (the recipient does not give up an asset or incur a liability of commensurate value). In contrast, earned revenues are *reciprocal* transactions, because they involve an exchange of goods or services of approximately equal value. The distinction between nonreciprocal and reciprocal transactions is important because there are significant accounting and reporting differences between a contribution (or nonreciprocal transactions) and earned revenue (or reciprocal transactions).

2.205 Another distinguishing feature of contributions is that they may carry donor-imposed restrictions limiting the use of the contributed asset, or donor-imposed conditions, which give the donor the right of return of the contributed asset if a specified future event does not (or does) occur. Sections 2.212–2.226 discuss restricted contributions, and sections 2.231–2.237 discuss conditional contributions.

Contributions Versus Earned Revenues

2.206 Auditors of not-for-profit organizations should be aware of two important issues related to the difference between contributions and earned revenues: (1) the timing of revenue recognition may be different, and (2) the completeness assertion is much more difficult to test for contributions than for earned revenues.

2.207 Timing of Revenue Recognition. Recognition of earned revenue is triggered by the completion of an action, such as delivery of services sold or the transfer of ownership of materials sold. No such action is required for recognizing contributions because, by definition, contributions are nonreciprocal and involve no delivery of services or transfer of ownership. Under SFAS No. 116, recognition of contribution revenue is usually triggered by the transfer of an economic benefit, the receipt of either the contribution (cash or other economic benefit) or a promise to make a contribution in the future, even if the donor imposes restrictions on the use of the donated asset (see section 2.212 for a discussion of restrictions). If a pledge is conditioned on the occurrence or nonoccurrence of a future, uncertain event (see section 2.232), revenue is not recognized until that condition is substantially fulfilled by the event's occurrence or nonoccurrence.

2.208 Auditing the Completeness Assertion. As a general rule, the completeness assertion is much more difficult to test for contributions than for earned revenues. Because earned revenue involves an exchange of goods or services, an auditor can generally obtain assurance about completeness by comparing recorded revenue (and related records such as bank deposits, and increases and decreases in accounts receivable) to records of the goods or services sold (such as inventory records, shipping receipts, payroll records, and job files) and to independent source documents (such as cash register receipts, prenumbered sales invoices, contracts, etc). Designing audit procedures to test the completeness assertion for contributions is much more challenging.

2.209 Because contributions are often received in the form of cash, it is difficult for the auditor to obtain assurance that all contributions have been received and recorded. The auditor should obtain an understanding of the organization's control structure policies and procedures over contributions in order to determine the nature, timing, and extent of the audit tests for contributions.

2.210 As with many aspects of an internal control structure, the effectiveness of controls over contributions could be compromised if there is no segregation of duties. For instance, if one person opens the mail (or otherwise accepts contributions), prepares thank-you letters, maintains donor records, and prepares board minutes, that person might be able to embezzle contributions and conceal the embezzlement by entering the amount in the donor's record, sending the donor a thank-you letter, and omitting mention of the contribution in the board or committee meeting minutes. For organizations that lack a segregation of duties related to contributions, the auditor must carefully consider whether reliable evidence can be obtained about the completeness assertion as it pertains to contributions; if not, the auditor must consider whether to qualify the auditor's report or disclaimer an opinion.

2.211 The following are some internal control policies and procedures, and some auditing considerations, related to contributions:

1. Lockbox: A lockbox arrangement involves having contributions mailed directly to a bank or other depository institution that deposits the proceeds and furnishes the organization with a listing of the contributions and any enclosures. Solicitations should include a return

envelope addressed to the lockbox or should instruct donors to send their contributions directly to the lockbox address. The advantage to the organization is that it does not have to supervise controls or deal with temporary personnel for seasonal surges of receipts; the organization depends on the bank's controls and its employees. Auditors should consider the requirements of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* (AU 324), as to the need to review the bank's controls over receipt and recording of the mail receipts.

2. Cash reconciliations: This procedure requires that an employee who does not have access to cash compare deposits per the bank statements to independent records that support the amounts received, such as copies of prenumbered receipts supporting ticket sales or listings of mail receipts opened under dual control. Provided such records exist, the auditor can perform a fairly straightforward comparison of these records.

3. Dual control: When cash collections are counted (such as church offerings or Santa Kettle collections), the organization should require that two persons open, count, and record receipts. Organizations that receive large volumes of contributions in the mail should also use this procedure. Dual control reduces the likelihood that an individual will be able to misappropriate cash. The effectiveness of this control also depends on control over the containers the two individuals open and count (containers should be tamper-proof, prenumbered, and logged in and out), and on the trustworthiness of the individuals (checking references at the time of hiring is crucial). The auditor should determine, by inquiry or observation, that procedures for dual control over cash are appropriate and are operating as designed.

4. Acknowledgment of donations: Most organizations acknowledge contributions in some manner (with "membership" credentials, thank-you letters, listings on plaques or in publications, or recognition in public meetings). These acknowledgments serve two purposes: they encourage the donors to contribute again, and they act as a control against misappropriation of contributions. If a donor's gift were lost or stolen, the donor would probably question why he or she had not received an acknowledgment, and the defalcation could be discovered. Management of not-for-profit organizations often rely on the absence of such inquiries by donors as an indication that no significant number or amount of contributions have been misappropriated. The auditor can obtain evidence about the completeness assertion by comparing copies of these acknowledgments to the accounting records.

5. Donor confirmations: The auditor may ask clients' permission to send confirmations to donors to obtain evidence that all contributions have been received and recorded. The auditor should determine that confirmations are selected from a complete listing of possible donors. Solicitation lists, published lists of contributors, and prior year's contributors are examples of sources the auditor may use to identify possible donors for confirmation. Management may object to this procedure because donors could interpret such letters to be solicitations or indications that the auditor suspects misuse of contributions. To alleviate this concern, an auditor should develop confirmation requests that: (1) reassure the client and contributor that the confirmation process is a positive aspect of ensuring that contributions are being used as donors intended, and (2) avoid the appearance of a solicitation.

6. Review correspondence and minutes: Most organizations mention major contributions in the minutes of their governing board or committee minutes. The auditor should review these minutes and consider comparing significant contributions mentioned to the accounting records.

7. Analytical procedures: Analytical procedures can be an effective means of obtaining assurance about the completeness assertion for contributions, such as comparing current and prior year's contributions or the current year's actual and budgeted amounts.

Restricted Contributions

2.212 Frequently, donors stipulate how their gifts are to be used by placing restrictions on them. SFAS No. 116 requires recognition of contribution revenue upon the transfer of an economic benefit, usually the receipt of either the contribution (cash or other economic benefit) or a pledge (a promise to make a contribution in the future). Restrictions may be permanent, such as the establishment of an endowment in perpetuity, or they may be temporary, such as for next year's operations or a specific project.

2.213 This represents a change in the timing of the recognition of restricted contributions for those organizations that previously followed SOP 78-10, which called for restricted contributions to be recorded as deferred revenue until the restrictions were met, at which time the revenue was to be recognized. The SOP 78-10 method was an attempt to match the revenue to the same period as the effort and expense incurred to fulfill the donor's restrictions. The underlying concept of SFAS No. 116 is that receipt of restricted contributions does not amount to incurring a liability, but merely accepting limits on the future use of the contributions. The concept is based on the belief that adequate disclosure of donor-imposed restrictions and properly stated liabilities is more important than matching revenue and expenses.

2.214 Therefore, under SFAS No. 116, contributions with donor-imposed restrictions are reported as restricted revenue, which increase either permanently restricted or temporarily restricted net assets. As restrictions are fulfilled or the stipulated time period for the restriction has expired, the amount should be reclassified to unrestricted net assets.

2.215 SFAS No. 116 does, however, permit an organization the option of establishing a policy that restricted contributions whose restrictions are met in the same reporting period as they are made may be reported as unrestricted support, provided that the organization reports consistently from period to period and discloses this policy.

2.216 Regardless of the method used to recognize restricted contributions, it is extremely important that not-for-profit organizations establish appropriate internal control structure policies and procedures to ensure that donor restrictions are identified and recorded, and that the restrictions are properly met.

2.217 Identifying Restrictions. Usually, determining whether a restriction exists is not difficult. Stipulations such as, "for a scholarship for an architecture student from the state of Oklahoma," or "for sending a missionary to Brazil," or "to buy a new school bus" are fairly straightforward limitations on the use of contributed funds. Contributions are also restricted when donors respond to a specific appeal from the organization, such as, "Please send a contribution for California earthquake relief."

2.218 However, other donor communications may be less specific or less clear as to whether a restriction exists. A key factor to consider is whether the restriction limits the use of the funds. The following shows some examples of donor comments, along with the authors' conclusions as to whether the donor comment constitutes a restriction.

Donor Comment	Restriction?
1. Here is $100 for program A.	Yes
2. Here is $100, because I think program A is important.	No
3. I want to support program A, so here is $100.	Yes
4. Here is $100 because you do a great job with program A.	No

2.219 Likewise, some donor communications may sound like they impose restrictions, but the uses stipulated by the donors are so broad that they do not in fact limit the organization's discretion as to how to use the donated assets. Donor statements such as "here is $100 for the good work that you do" would be too broad to constitute a restriction. The authors believe that SFAS No. 116 would indicate that donor-imposed restrictions that relate to the ongoing operations or mission of the not-for-profit organization should be accounted as unrestricted.

2.220 Care should be exercised by the organization and the auditor to distinguish between donor restrictions and donor conditions (see section 2.232). Although conditions usually apply to promises to give, organizations may receive advances on conditional pledges that would have to be refunded if the conditions are never fulfilled. These receipts are not contributions, and should be accounted for as refundable advances until the donor's conditions are met.

2.221 Illustration No. 2-1 contains a decision chart for recognition of contributions, whether restricted or unrestricted. Illustration No. 2-2 presents a decision chart for accounting for promises to give.

2.222 Auditing Considerations for Restricted Contributions. Once the determination is made that a restriction exists, the organization should keep a record of how and when the restriction is satisfied. Obviously, the auditor cannot be physically present during the year to monitor fulfillment of the donors' restrictions; therefore, the auditor must look for other evidence about the satisfaction of the restriction. The issue of what constitutes acceptable evidence that the restriction has been satisfied depends on the restriction itself. For instance, if the restriction is to serve meals to the homeless, the auditor would look for evidence that such a program exists, and determine that the total expenses of the program equals at least the amount of restricted contributions for that program. Evidence of the existence of the program may be found, during the year or at year-end, by touring the facility, reviewing the minutes of board meetings, inquiring of employees, etc. As to whether expenses have at least equalled the restricted contributions, the auditor can review the general ledger, payroll records, etc. The auditor may also perform analytical procedures, such as: (1) comparing reported program expenses to budgets, (2) calculating cost per unit of service (per meal, bed-day, hour of counseling, etc.) and comparing the calculated unit cost to prior year's unit cost or to unit costs for similar programs of other organizations, and (3) reviewing the relationship of purported units of services to other data, such as determining whether sufficient employee hours exist to have provided the number of services reported. Remember, the purpose of these procedures would is to make a judgment about management's assertion that donors' restrictions have been satisfied.

ILLUSTRATION NO. 2-1

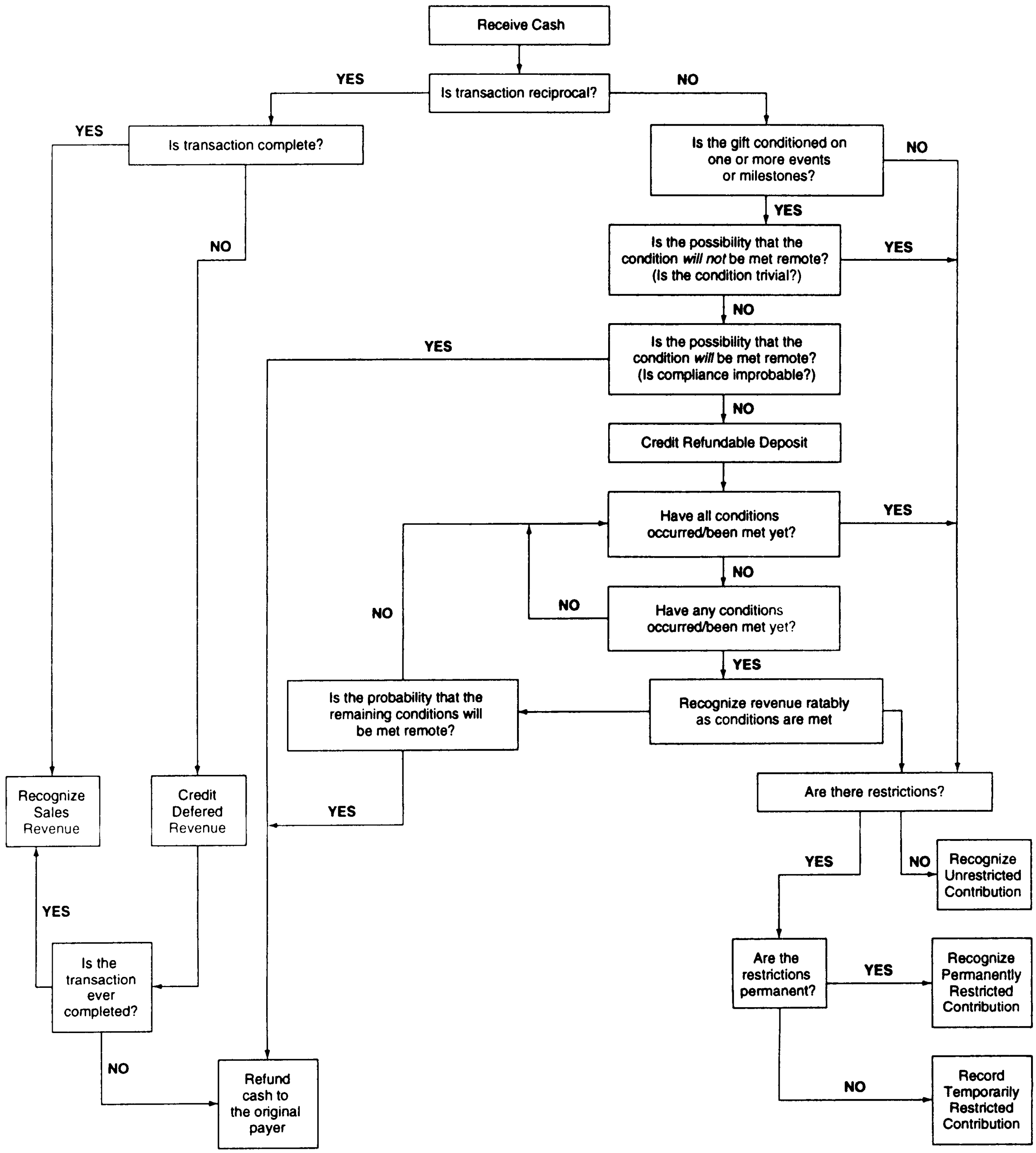
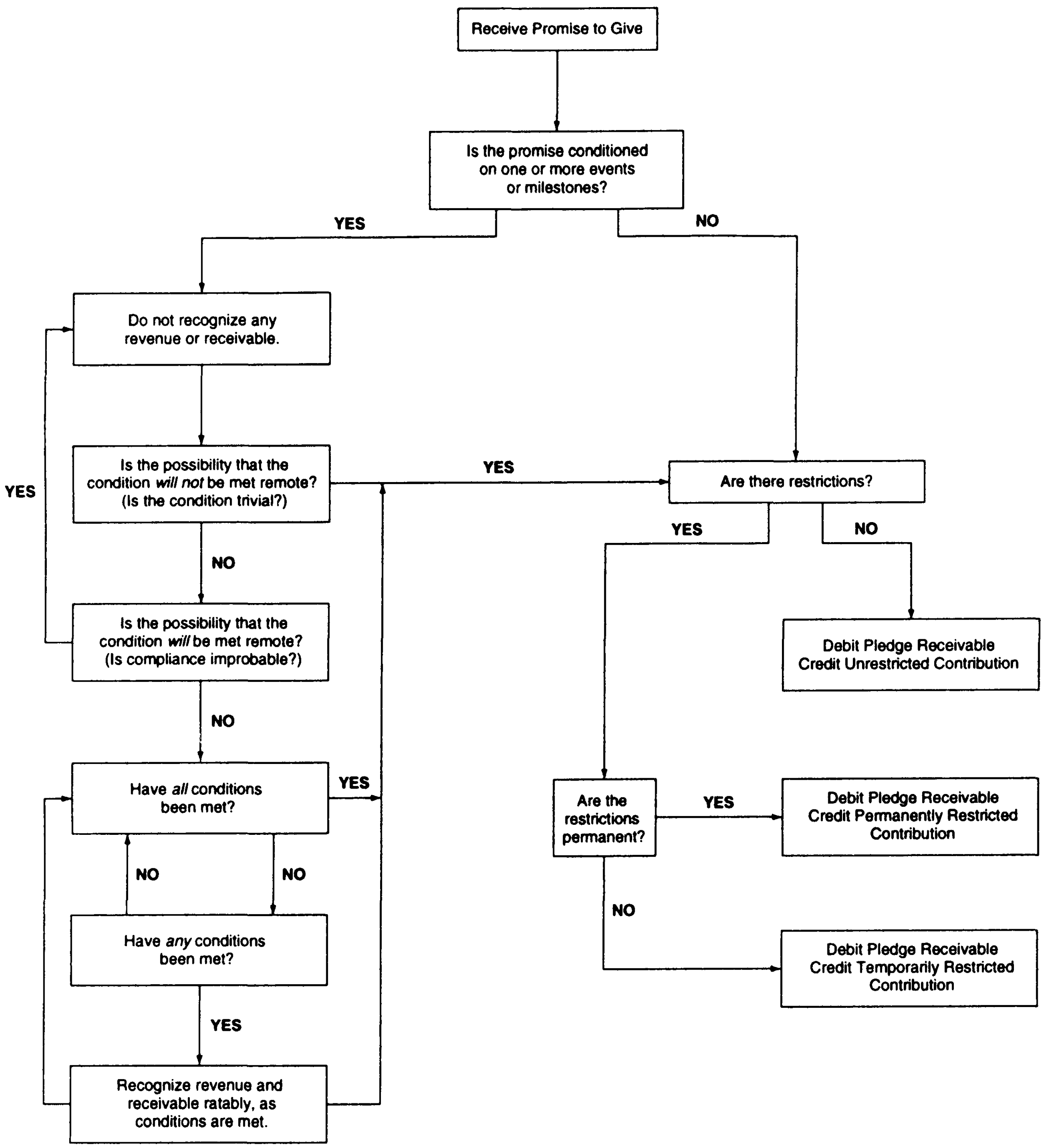


ILLUSTRATION NO. 2-2



2.223 Grants. Grants can be received from a number of sources, including individuals, corporations, governmental agencies, and private foundations. In most cases, grants are merely a type of restricted contribution — the grantor awards funds to an organization accompanied by specific restrictions as to how and when the grant proceeds may be used.

2.224 However, many not-for-profit organizations receive "grants," "awards," or "sponsorships" that on the surface appear to be restricted contributions, but are in substance reciprocal or earned revenue transactions, because they amount to a contract for the purchase of services by the grantor or sponsor. This type of earned revenue can usually be identified by provisions that stipulate that the organization will receive a fixed amount per unit of service (such as per meal, per bed-day, etc.). Frequently, under such a contract, the organization must send the grantor a "voucher", which amounts to a statement of services provided and an invoice for the amount of the grant that was earned that month. These vouchers should be recorded as receivables. Sometimes, a grantor gives an organization an "advance" under the contract, knowing that payment for each month's voucher will be not be paid for weeks or months; since the transaction is reciprocal, these advances should be recorded as deferred revenues (liabilities).

2.225 Some organizations, such as universities, may receive grants to sponsor research and development activities, with the stipulation that the grantor retains proprietary or other rights (such as patents, copyrights, or advance and exclusive knowledge of the research outcomes), or with the stipulation that the research and development activities be conducted in a manner so that the research outcome would be particularly valuable to the grantor. SFAS No. 116 points out that such transactions are earned revenue, not contributions, if the potential public benefits are secondary to the potential proprietary benefits of the grantor.

Agency Funds

2.226 At times, some donors may use an intermediary organization as its agent or trustee to transfer assets to a third-party donee. This may have the appearance of being a restricted contribution to the intermediary organization, particularly if that organization fulfills one of its purposes by distributing the assets to the ultimate donee. SFAS No. 116 indicates that, if the donor allows an intermediary organization the discretion to establish, define, and carry out programs that disburse the assets to beneficiaries, the transaction would generally be considered a contribution to the intermediary organization. SFAS No. 116 also points out, that if an intermediary organization has little or no discretion in determining how the assets will be used (such as if the intermediary organization must disburse the assets to any who meet specified guidelines, or if it must disburse to individuals identified by the donor), then such transactions should be accounted for as flow-through liability type transactions, not contributions. Traditionally, these liabilities have been called "agency funds" or "custodial funds."

Promises to Give

2.227 Under SFAS No. 116, promises to give should be recognized at fair value (as revenue and receivable) when the promise is received, even if the donor restricts the promised contribution to use in a future period, and even if the promise will not be paid until a future period. This is a change for organizations following SOP 78-10, which called for recording pledges receivable, but crediting deferred revenue (a liability) for amounts that were restricted for use in future periods or that would not be paid to the organization until a future period.

2.228 The fair value of a promise that is expected to be collected in less than one year is measured at net realizable value, which in most cases would be the face value of the promise net of any estimated uncollectible amount. Many organizations have historical data from which they calculate anticipated collection rates. Such organizations use these rates to estimate the net realizable value at which to record promises (or they may record promises at face value and then record a contra-asset account for uncollectible promises). If actual collections fall short or exceed the estimated net realizable value, the variance affects the next period's revenue.

2.229 For promises anticipated to be collected after one year, SFAS No. 116 states that fair value should be based on future cash receipts, discounted at a rate "commensurate with the risks involved." In other words, the determination of the discount rate should be based on the same criteria that would be used for a trade receivable in accordance with APB No. 21. Each period's accrual of the interest element of this discount should be accounted for as an additional contribution in the appropriate class of net assets.

2.230 SFAS No. 116 directs that promises should be recognized without regard to their legal enforceability. It points out that a promise to give carries the social, moral, and, generally, legal obligation to make the promised transfer. Following applicable state laws to determine the accounting treatment for a transaction could require the same transaction to be recorded differently in different states. Consistent accounting treatment was desired, and accordingly the Statement was written to require recording a promise to give without regard to legal enforceability.

2.231 **Conditional Promises to Give.** SFAS No. 116 describes every promise to give as either conditional or unconditional. A promise is conditional if the donor specifies a future and uncertain event whose occurrence or failure to occur gives the promisor a right of return of the assets contributed or releases the promisor from its obligation to transfer the assets promised. Conditional promises to give are recognized only when the conditions are satisfied, thus no revenue or receivable should be recognized at the time the promise is received. Only when the conditions are met would revenue and receivable be recognized. Any assets contributed before the conditions are substantially met would be accounted for as a refundable advance (liability). In the case of ambiguous donor stipulations, a promise containing stipulations that are not clearly unconditional shall be presumed to be a conditional promise.

2.232 SFAS No. 116 distinguishes conditions from restrictions as follows:

> A donor-imposed restriction limits the use of donated assets; however, a condition creates a barrier that must be overcome before assets transferred or promised become contributions received or made.

2.233 There may be instances in which a donor may impose a condition that is virtually certain to be met, such as "I will give you $100, if the sun rises next January 1," or "I will give you $1 million, provided you give me a report as to how you spend it." SFAS No. 116 states that a conditional promise is to be considered unconditional if the probability that the condition will not be met is remote. Since the probability is remote that the sun will not rise next January 1, or that the organization would risk $1 million by not giving the donor a report, both of these promises would be considered unconditional, and would result in immediate recognition of revenues and receivables.

2.234 When auditing contributions, the auditor must consider both the possibility that recorded revenue and receivables are overstated and the possibility that they are understated. Thus, the auditor must consider:

- whether some conditional promises may have been improperly recognized prior to their conditions being met, and
- whether some unconditional promises may have failed to be recognized.

2.235 In making these assessments the auditor should consider whether an organization's controls call for evaluation of promises to give for the presence of conditions, whether client personnel adequately understand the conditional criteria, and whether client personnel have complied with those controls. The Internal Controls Questionnaire — Not-for-Profit Organizations (Chapter 6, section 6.100), and Tests of Controls Programs — Not-for-Profit Organizations (Chapter 6, section 6.300), reflects these recommended controls.

2.236 Even though the concept of conditional promises to give is identified and defined for the first time in SFAS No. 116, it is not a new concept. In practice, most not-for-profit organizations have always followed the practice of not recording conditional pledges until the condition has been fulfilled. As a result, most organizations are currently following this guidance.

2.237 Illustration No. 2-1 contains a decision chart for recognition of contributions, whether restricted or unrestricted. Illustration No. 2-2 presents a decision chart for accounting for promises to give.

Donated Materials and Facilities

2.238 SFAS No. 116 extensively discusses donations of collection item (works of art, historical treasures, and similar assets added to collections) but only briefly discusses donations of other materials. The guidance indicates that donations of materials and facilities are recognized at their fair value, just as any other contribution would be, and consideration must be given to any donor-imposed restrictions or conditions attached to these contributions. In addition, particular attention should be paid for the bargain elements of transactions. SFAS No. 116 indicates that to the extent a reciprocal transaction occurs where the elements of the transaction are of unequal value (or a bargain transaction), there is a contribution element that is inherent in the transaction that should be recorded.

2.239 SOP 78-10 and the VHW Guide allows for the recognition of donated materials and facilities only when the value of the contribution is "clearly measurable." As stated in section 2.238, SFAS No. 116 requires recognition of contributions at fair value without any discussion as to the concept of "clearly measurable." The authors believe that SFAS No. 116's omission of a reference to "clearly measurable" indicates that donations meeting the criteria set forth in SFAS No. 116 should be recognized at fair value, which must be determined by a reasonably objective basis.

2.240 **Collections of Works of Art and Similar Assets.** SFAS No. 116 does permit one exception to the requirement that donated material be recognized when received. That exception applies in limited circumstances to collection items, such as works of art, historical treasures, and similar assets, if the donated items are added to collections that meet <u>all</u> of the following conditions:

a. the collections are held for public exhibition, education, or research in furtherance of public service rather than financial gain.

b. the collections are protected, kept unencumbered, cared for, and preserved.

c. the collections are subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.

2.241 Organizations that maintain collections that meet the above criteria are not prohibited from recognizing donated items—they are merely given an option. SFAS No. 116 encourages these organizations not to use the exception, but instead to recognize the contributions and to capitalize the items received, either prospectively (all items received after the adoption date of the Statement) or the combination of retroactively and prospectively. An organization's policy related to collections must apply to all of its collections, that is, it may not capitalize only selected collections or items.

2.242 The conditions above do not consider the degree of difficulty in measuring the value of the items received. This is consistent with the Statement's omission of the clearly measurable concept (section 2.239). In assigning the value to these transactions, preference should be given to clearly verifiable values as possible, such as appraisals or comparison to advertised prices. In many instances, an organization may have to rely on an estimate.

2.243 Auditing the valuation of donated assets can be pretty challenging for certain engagements. In some situations, the auditor may find it necessary to rely upon appraisals provided by specialists. As required by SAS No. 73, *Using the Work of a Specialist*, the auditor should consider the objectivity, qualifications, and reputation of the specialist, and obtain an understanding of the methods and assumptions used. (See section 2.119 for further discussion.) If the donated property is valued by an estimate of management, the auditor should consider reviewing the methods and assumptions used and inspect any supporting documentation. Whether it is necessary to obtain an appraisal of a specialist and the nature and extent of the auditor's procedures should be based on materiality and the assessed level of risk for material misstatement.

Donated Services

2.244 SFAS No. 116 establishes new criteria for recognizing donated services. Services must be recognized as contributions if <u>either</u> of the following criteria is met:

a. the services create or enhance nonfinancial assets (such as volunteers erecting a building), or

b. the services require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not provided by donation.

Contributed services and promises to contribute services that do not meet either of the above criteria may not be recognized.

2.245 SFAS No. 116 lists examples of services requiring specialized skills: accountants, architects, carpenters, doctors, electricians, lawyers, nurses, plumbers, teachers and other professionals and craftsmen.

2.246 Until the issuance of SFAS No. 116, there had been a number of inconsistencies between the VHW Guide and SOP 78-10 for recognizing donated services. Illustration No. 2-3, "Contributions Received," compares the guidance for accounting for contributions established by SFAS No. 116 with the guidance under the VHW Guide and SOP 78-10.

2.247 Paragraph 67 of SOP 78-10 stated that donated services should be recognized (as revenue and expense) only if **all** of the following criteria exist:

1. The services form an integral part of the efforts of the organization as it is presently constituted, would be performed by paid staff if not donated, and the organization would continue the program if donated services were not available.
2. The organization controls the "employment" and duties of the volunteers, and is able to influence their activities comparably to staff with similar responsibilities.
3. The organization has a clearly measurable basis for the amount to be recorded.
4. The services of the organization are not principally intended for the benefit of its members (trade associations, political parties, clubs, and religious communities).

SOP 78-10 required disclosure of the methods used in valuing, recording, and reporting these donated and contributed services and should distinguish between donated or contributed services that have and have not been recorded.

2.248 The VHW Guide required recognition of donated services when the following criteria exist:

1. The services are a normal part of the program or supporting services and would otherwise be performed by paid staff.
2. The organization exercises control over the "employment" and duties of the volunteers.
3. The organization has a clearly measurable basis for the amount.

2.249 Both SOP 78-10 and the VHW Guide precluded recognizing the services of volunteers in periodic, concentrated fund-raising drives.

2.250 The VHW Guide and SOP 78-10 conflicted as to the recording of "other services," that is, services that do not meet one or more of the conditions stated in the VHW Guide or SOP 78-10. SOP 78-10 precluded the recognition of services that do not meet the four circumstances stated in section 2.246; however, the VHW Guide did not address whether recognition of "other services" is permitted or prohibited. As a result, a voluntary health and welfare organization was allowed to recognize, at its discretion, contributed services that do not meet the three conditions stated in the VHW Guide.

2.251 In obtaining evidence about the value assigned to volunteer services, the auditor should consider his or her knowledge of prevailing rates for such services in the area. The auditor also may consider examining any documentation provided by management. Evidence may also be obtained by making inquiries of individuals in organizations in which such services are paid for, and reviewing surveys of salaries, such as those published by the U.S. Department of Labor.

Disclosure Requirements

2.252 SFAS No. 116 has several specific financial statement disclosure requirements. They are as follows:

- Recipients of unconditional promises to give should disclose the following:
  - a. The amount of promises receivable in less than one year, in one to five years, and in more than five years.
  - b. The amount of the allowance for uncollectible promises receivable.
- Recipients of conditional promises to give should disclose the following:
  - a. The total of the amounts promised.
  - b. A description and amount for each group of promises having similar characteristics, such as promises conditioned on establishing new programs, completing a new building, or raising matching gifts by a specified date.
- Organizations must disclose their accounting policy for gifts of long-lived assets.

Contributions Received — Comparison of VHW Guide, SOP 78-10, and SFAS No. 116

2.253 Illustration No. 2-3, "Contributions Received," compares the guidance for accounting for contributions established by SFAS No. 116 with the guidance under the VHW Guide and SOP 78-10.

2.300 SFAS NO. 117, *FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ORGANIZATIONS*

2.301 In June 1993, the FASB issued SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*. This Statement establishes generally accepted accounting principles (GAAP) for all general-purpose external financial statements issued by all not-for-profit organizations. This Statement is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, this Statement is effective for fiscal years beginning after December 15, 1995. Earlier application is encouraged.

2.302 SFAS No. 117 establishes what comprises a complete set of financial statements and sets the minimum level of basic information required in each statement. While requiring certain basic information, the Statement does not require any specific format for any of the financial statements, but does require that all statements, at a minimum, focus on the entity as a whole. The Statement also renders unacceptable any specialized accounting and reporting principles or practices provided in AICPA Guides that are inconsistent with this Statement.

ILLUSTRATION NO. 2-3

CONTRIBUTIONS RECEIVED

Comparison of VHW Guide, SOP 78-10 and SFAS No. 116

	VHW Guide	SOP 78-10	SFAS No. 116
1. Unrestricted contributions.	1. Recognize on receipt.	1. Recognize on receipt.	1. Recognize on receipt.
2. Restricted contributions.	2. Recognize on receipt.	2. Defer until restrictions are met.	2. Recognize on receipt.
3. Promise to give.	3. Recognize on receipt of promise.	3. Recognize on receipt of promise, only if legally enforceable.	3a. Unconditional promise — recognize on receipt. 3b. Conditional promise — defer until condition is fulfilled.
4. Discounting of pledges receivable.	4. Not mentioned.	4. Not mentioned.	4. Discount and record amortization as contributions income.
5. Donated material and facilities.	5. Recognize at fair value if measurable and objective basis for value.	5. Recognize at fair value if measurable and objective basis for value; otherwise, disclose.	5. Recognize at fair value.

ILLUSTRATION No. 2-3 (Continued)

CONTRIBUTIONS RECEIVED

Comparison of VHW Guide, SOP 78-10 and SFAS No. 116

	VHW Guide	SOP 78-10	SFAS No. 116
6. Donated services.	6. May recognize if:	6. May recognize if:	6. Must recognize if services:
	a. services are a normal part of program service and would otherwise be performed by paid staff,	a. services form an integral part of efforts of an organization, would be performed by paid staff, and organization would continue program if donated services are not available,	a. create or enhance non-financial assets or
	b. organization controls employment and duties of volunteers,	b. organization controls employment and duties of volunteers can influence their activities like paid staff,	b. require specialized skills, are provided by individuals possessing those skills, and would typically need to be purchased if not donated.
	c. organization has a clearly measurable basis for amount.	c. organization has a clearly measurable basis for amount,	
		d. services of the organization are not principally intended for the benefit of members.	
	6. Other services may be recognized.	6. Other services may **not** be recognized.	6. Other services may be recognized.

ILLUSTRATION No. 2-3 (Continued)

CONTRIBUTIONS RECEIVED

Comparison of VHW Guide, SOP 78-10 and SFAS No. 116

	VHW Guide	SOP 78-10	SFAS No. 116
6. Donated services. (continued)	6. Disclose methods of recording, evaluating, and reporting services; distinguish between those valued and not valued.	6. Disclose methods of recording, evaluating, and reporting services; distinguish between those valued and not valued.	6. Disclose programs for which services were used, including nature and extent of services received and amount recognized as revenues. Encourages disclosure of fair value of services received but not recognized.

2.303 For organizations that have adopted SFAS No. 117, a complete set of financial statements consists of:

1. Statement of financial position (balance sheet)
2. Statement of activities (revenue and expenses)
3. Statement of cash flows
4. Notes to financial statements.

Statement of Financial Position

2.304 The statement of financial position should provide information about an organization's assets, liabilities, and net assets (the term "net assets" should be used instead of "fund balance") and should focus on the organization as a whole. These amounts should be further subdivided into unrestricted net assets, temporarily restricted net assets, and permanently restricted net assets. The totals of each class of assets should agree with the statement of activities.

2.305 It is permissible to present amounts for different types (subcategories) of permanent or temporarily restricted net assets either on the face of the statement of financial position or in the notes to the financial statements. For example, amounts of board designations of unrestricted net assets (subcategories) may be shown either on the face of the statement of financial position or in the notes.

2.306 In order to provide relevant information about liquidity, financial flexibility, and the interrelationship of an organization's assets and liabilities, the assets and liabilities should be aggregated into reasonably homogeneous groups (such as cash and cash equivalents, accounts and notes receivable from service recipients, etc.). Information about liquidity must be provided by one or more of the following three methods:

1. sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity (and resulting use of cash), or
2. classifying assets and liabilities as current and noncurrent, as defined by Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, or
3. disclosing (in notes to financial statements) relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets.

Statement of Activities

2.307 The statement of activities should report the change in net assets, as well as the changes in each class of net assets (unrestricted, temporarily restricted, and permanently restricted).

2.308 All unrestricted revenue should be reported as increases in the unrestricted class of net assets. Contributions that carry donor-imposed restrictions should be reported as increasing either the temporarily restricted class of net assets or the permanently restricted class of net assets.

2.309 There is one exception to the requirement that contributions with donor-imposed restrictions be reported as increases in either the temporarily or permanently restricted classes of net assets: contributions whose restrictions are met within the same reporting period may be reported as unrestricted, provided the organization discloses that policy and follows it consistently from period to period.

2.310 All expenses should be reported as decreases in the unrestricted class of net assets. This is a significant change from current practice, in which many organizations report expenses that fulfill donor restrictions as decreases in the appropriate restricted fund. Under the new guidance, expirations of restrictions on temporarily restricted net assets will be reported as reclassifications, which simultaneously increase the unrestricted class of net assets. These reclassifications in effect reimburse the unrestricted class of net assets for expenses that (a) are charged against the unrestricted class of net assets, and (b) fulfill donor-imposed restrictions and thus should decrease temporarily restricted net assets.

2.311 An organization must provide, either in the statement of activities or in the notes to the financial statements, information about expenses reported by their functional classification, such as major classes of program services or supporting activities. Organizations are encouraged, but not required, to provide information about expenses by their natural classifications as well. Only voluntary health and welfare organizations are required to report both functional and natural classifications of expense information in a matrix format in a separate statement of functional expenses.

2.312 SFAS No. 117 states that revenues and expenses are to be reported at gross amounts in the statement of activities. The only guidance given on how to apply this requirement is that transactions that are peripheral, incidental, or beyond the control of the organization may be reported at net amounts. For example, an organization that sells land and a building it no longer uses would be able to present the gain or loss associated with the sale on a net basis in the statement of activity. This sale is considered peripheral to the ongoing operations of the organization. It is presumed that the user of the financial statements would be able to derive information related to the sale based on this presentation in the statement of activities, together with relevant information provided in the statement of cash flows.

2.313 The only exception to this requirement is for investment revenues, which may be reported net of investment expenses, provided the amount of investment expense is disclosed.

2.314 Gains and losses (when recognized under policies adopted by an organization) are to be reported as increases and decreases in the unrestricted class of net assets, unless their use is limited by donor restrictions or by a law that extends a donor's restrictions. An example of a gain or loss that would be considered restricted would be the sale of a painting that had originally been donated with the restriction that if it were ever sold, the proceeds could be used only for specified purposes.

2.315 SFAS No. 117 clarifies the question of how to report the net appreciation of investments of donor-restricted endowments:

1. If donor stipulation or the state or local law, as interpreted by an organization's governing board, places permanent restrictions on all or some part of the net appreciation, that amount should be reported as an increase in the permanently restricted class of net assets.
2. Absent relevant law to the contrary, if the donor stipulated that some or all of the net appreciation should be used only for specific purposes or in specific periods, then that amount of net appreciation should be reported as an increase in the temporarily restricted class of net assets. SFAS No. 117 states that it would not be proper to report that amount as an increase in the permanently restricted class of net assets with a subsequent reclassification from the permanently restricted to the temporarily restricted class of net assets, since such appreciation was never permanently restricted.
3. Absent relevant law or donor stipulation to the contrary, all other net appreciation on investments of donor-restricted endowments should be reported as an increase directly in the unrestricted class of net assets. SFAS No. 117 states that it would not be proper to report that amount as an increase in the permanently restricted class of net assets with a subsequent reclassification from the permanently restricted class of net assets to the unrestricted class of net assets.

2.316 The net appreciation on investments of board-designated endowments are to be reported as increases in the unrestricted class of net assets if the endowment was created from unrestricted funds.

Statement of Cash Flows

2.317 SFAS No. 117 makes a statement of cash flows a required statement for not-for-profit organizations and amends SFAS No. 95, *Statement of Cash Flows* as follows:

1. requires not-for-profit organizations to present a statement of cash flows as part of a complete set of financial statements, and
2. redefines "financing activities" to include any contributions or investment income restricted by a donor for purchasing, constructing or improving long-lived assets, or for long-term investment.

Fund Accounting

2.318 Although SFAS No. 117 does not specifically address "fund accounting," it has far-reaching implications on organizations' use of the fund accounting technique.

2.319 First, SFAS No. 117 requires that external financial reporting focus on the organization as a whole in order to allow users:

1. to assess an organization's liquidity, financial flexibility, and ability to meet obligations,
2. to understand how the organization's resources are being used to provide services, and
3. to assess the organization's ability to continue to provide those services.

It presumes that the overview of the organization presented in a complete set of financial statements best allows users to meet these goals.

2.320 Secondly, SFAS No. 117 focuses financial reporting on classes of net assets differentiated by any underlying donor-imposed restrictions, instead of the traditional focus of differentiating fund balances based on how resources will be used. This change of focus emphasizes disclosure of the discretion that an organization does or does not have as to the use of its resources, thereby allowing users to better meet the goals listed above.

2.321 Fund accounting has always been a technique for tracking stewardship of resources to be used for given purposes, and this has been and continues to be an important management tool in many organizations. GAAP, for not-for-profit organizations, has in the past required a certain degree of reporting by fund, but these requirements have frequently been misconstrued to mandate the use of fund accounting in organizations' accounting systems. SFAS No. 117 leaves the use of this powerful management tool to the discretion of organizations and their managements.

2.400 OTHER ACCOUNTING TOPICS

Fund-Raising Events

2.401 Some organizations hold fund-raising events such as banquets, dinners, and theater parties, or offer incentive gifts, such as tote bags, books or records, and umbrellas, for donors participating in fund-raising campaigns. Other organizations sell merchandise as a fund-raising technique, such as candy or T-shirts. SOP 78-10 directed that the costs of such merchandise or direct benefits to donors be netted against the revenue from those events, rather than reported as expenses. SOP 78-10 also required organizations to disclose the amount of such costs, and frequently this disclosure would be presented on the face of the statement of activity.

2.402 The VHW Guide was silent on this issue, but the nonauthoritative *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations* (the Black Book) that many such organizations follow voluntarily or by requirement, conforms with SOP 78-10. The Black Book points out that only the costs of the benefits received by the donor should be netted against revenue; other event-related costs, such as printing tickets and posters, mailings, fees and expenses of public relations and fund-raising consultants, and staff salaries, should be reported as fund-raising expenses.

2.403 SFAS No. 116 is silent on this issue, other than defining the fund-raising function (for reporting of expenses) as including "conducting special fund-raising events," it does not include any such events in its illustrative financial statements. SFAS No. 117, however, requires that all revenues be reported on a gross basis. Paragraph 138 of SFAS No. 117 indicates that organizations may report net amounts for special events only if they result from peripheral or incidental transactions.

Split Interest Gifts

2.404 At times, donors may arrange contributions so that they retain a financial interest in either the principal amount of the contribution or in the income earned by the principal amount for a specified period of time. Since both the organization and the donor have financial interests in the arrangement, the term "split interest gift" is often used to describe the transaction. In general, these arrangements are categorized by whether the organization's financial benefit precedes (charitable lead trust) or follows (charitable remainder trust) the interest of the donor.

2.405 Charitable lead trusts are usually structured so that the principal amount is contributed to a trust, which pays the organization all, or a stipulated amount, of investment income for a certain period of time, after which the principal amount reverts to the donor (or his or her heirs). Charitable remainder trusts are usually structured so that the principal amount is contributed to a trust, which pays the donor (or his or her designee) all or a stipulated portion of investment income for a certain period of time, after which the entire principal passes to the organization.

2.406 The motivation for donors to create such trusts, as opposed to merely giving the organization contributions, is usually tax oriented. U.S. tax law currently allows the donor a deduction in the year the principal is contributed to the trust for the present value of the ultimate benefit to the organization. Thus, a donor who plans to make annual contributions to an organization could instead set up a charitable lead trust and receive a deduction in the current year equal to several years of contributions. The donor would fund the trust so that it produces investment income equal to the amount of the annual contribution he or she would have made.

2.407 Neither the FASB nor the AICPA has issued any specific guidance as to how the organization should account for its interest in such trusts. The authors believe that these transactions should be recorded as follows:

1. Charitable Lead Trust: Frequently the not-for-profit organization holds the principal under agreement with the donor. If this is the case, the organization should record the original principal as a noncurrent asset with an equal noncurrent liability for the ultimate reversion of the principal to the donor. Income earned from this asset should be credited to a liability against which periodic "distributions" from the trust to the organization should be charged. Receipt of these distributions should be recorded as a credit to contributions, either restricted or unrestricted according to the provisions of the trust agreement.
2. Charitable Remainder Trust: As soon as the organization becomes aware of the trust, it should record the amount it will ultimately receive as a debit to a noncurrent receivable, and a credit to permanently restricted contributions if the trust instrument stipulates that, when

received, the principal is to be permanently restricted; otherwise, the principal should be recorded as a credit to temporarily restricted contributions, since it is not available for current use. When the principal is distributed to the organization, in addition to reducing the receivable, the organization should reclassify the principal amount from temporarily restricted net assets to unrestricted net assets, unless the trust instrument places restrictions on its use, in which case the principal amount would remain recorded as temporarily restricted net assets until the restrictions are satisfied.

2.408 Auditors should carefully examine the trust agreements under which such arrangements are made to ensure that any restrictions are properly reflected in the organization's financial statements and that any liability to the donor is properly recorded.

Capital Additions

2.409 SOP 78-10 required that capital additions (nonexpendable contributions restricted to endowment, plant, or loan funds either permanently or for extended periods of time) not be shown with revenue in the statement of activity, but be shown after a subtotal of excess of revenue over expenses. The VHW Guide does not require separate presentation of such contributions.

2.410 SFAS No. 117 supersedes this requirement of SOP 78-10, and requires that such contributions be reported along with other contributions in the appropriate class of net assets.

Depreciation

2.411 SFAS No. 93, *Recognition of Depreciation by Not-for-Profit Organizations*, requires not-for-profit organizations to record depreciation for assets whose future economic benefits or service potential will be used up. The Statement requires disclosure of:

- depreciation expense for the period,
- balances of major classes of depreciable assets, by nature or function, at the balance-sheet date,
- accumulated depreciation either by major class of asset or in total at the balance-sheet date, and
- a general description of the methods used to compute depreciation for major classes of assets.

2.412 SFAS No. 93 (AC D40.101A) provides an exemption for certain types of assets, specifically,

> . . . works of art or historical treasures whose economic benefit or service potential is used up so slowly that their estimated useful lives are extraordinarily long. A work of art or historical treasure shall be deemed to have that characteristic only if verifiable evidence exists demonstrating that (a) the asset individually has cultural, aesthetic, or historical value that is worth preserving perpetually and (b) the holder has the technological and financial ability to protect and preserve essentially undiminished the service potential of the asset and is doing so.

2.413 Typically, not-for-profit organizations use the straight-line method to compute depreciation for two reasons: (1) most funding agencies permit only straight-line depreciation expense in computing the amount to be reimbursed or funded, and (2) there is no tax motivation to accelerate depreciation. However, accounting principles that allow accelerated methods for commercial entities would apply equally to not-for-profit organizations.

Earned Revenues

2.414 Not-for-profit organizations as a group have many of the types of earned revenues that commercial entities have, such as ticket sales, contract services performed for others, sales of merchandise and publications, commissions received, investment income, etc. The financial statements illustrated in the VHW Guide show items of "revenue," with their own subtotal, separate from items of "support," and their own subtotal; however, the Guide does not specifically require this presentation.

2.415 Earned revenue of not-for-profit organizations is subject to the same accounting principles and audit considerations as the earned revenue of commercial entities. Organizations may have accounts receivables, inventories, long-term construction contracts, deferred expenses, deferred revenue, layaways, bad debt expense, and many other related transactions.

2.416 Care should be exercised in determining whether "membership" dues and fees actually amount to contributions or whether there are material benefits that "members" derive from their "dues." In cases in which membership entitles a member to receive stipulated amounts of services, merchandise, or use of facilities, dues should be treated as earned revenue.

2.417 Earned revenue that is "unrelated" to an organization's tax-exempt purposes may jeopardize its tax-exempt status or its classification as a "private foundation" for tax purposes. Since loss of tax-exempt status could result in income tax expense and liability and may raise a question about the organization's ability to continue as a going concern because donors would be unable to receive a tax deduction for their donations, an auditor should be concerned each year with the amount of "unrelated" income an organization earns.

2.418 For organizations such as clubs or lodges that are exempt under sections 501(c)(7), (8), or (10), revenue earned from nonmembers may be taxable, while income earned from members may not be; therefore those organizations should keep separate accounting for sources of earned income and their auditors should consider any resulting tax consequences.

Asset Reversions

2.419 Some grants allow the recipient to purchase assets with grant funds, often with a stipulation that if the organization ever fails to meet certain criteria (such as continuing a certain type of program) the assets purchased with grant funds will revert to the grantor. These reversion clauses are seldom enforced, but they do amount to a potential future impairment of an asset, which could be satisfied only by returning the asset to the grantor.

2.420 Auditors should carefully review the not-for-profit organization's grant award letters to determine if any assets are subject to reversion clauses and, if so, whether there is a potential loss contingency under SFAS No. 5, *Accounting for Contingencies* (AC C59). SFAS No. 5 requires accrual if a loss is probable, for example, if the organization has taken (or plans to take) an action that would trigger the reversion. If a reversion loss were reasonably possible, but not probable (for example, if the grantor were considering whether mitigating circumstances justify waiving the reversion), then disclosure of the nature of the contingency and an estimate of the possible loss should be made. The authors believe that, in most cases, as long as the chance of a reversion loss is remote (for example, if the organization intends to act so as not to trigger a reversion), no disclosure would be required. This would be particularly true if the assets were fully depreciated and no loss would result from removing the assets and related accumulated depreciation from the books.

2.421 However, even if no reportable loss would occur upon reversion, the auditor should consider whether the assets are so crucial to the operations or existence of the organization that reversion could raise a question about the organization's ability to continue as a going concern.

Net Assets and Fund Balances

2.422 Before the issuance of SFAS No. 117, a not-for-profit organization's equity was commonly referred to as "fund balance" in its financial statements. In discussing the elements of financial statements, SFAC No. 6 refers to a not-for-profit organization's equity as "net assets." The term "fund balance" could be confusing to a reader in that it implies an expendable balance, which in fact may not exist. It also implies the use of fund accounting, which may or may not be true for the organization.

2.423 SFAC No. 6 divides net assets into three components, based on the presence or absence of donor restrictions:

1. Permanently restricted net assets result from inflows whose use by the organization is limited by donor-imposed stipulations that neither expire with time nor can be fulfilled or otherwise removed by actions of the organization.
2. Temporarily restricted net assets result from inflows whose use by the organization is limited by donor-imposed stipulations that either expire with time or can be fulfilled and removed by actions of the organization.
3. Unrestricted net assets is the part of net assets that is neither permanently nor temporarily restricted. The only limits on the use of unrestricted net assets are the broad limits resulting from the nature of the organization, the purposes specified in its articles of incorporation or other comparable document, and limits resulting from contractual agreements with suppliers, creditors, and others entered into by the organization in the course of business.

2.424 SFAS No. 117 requires that an organization's balance sheet report amounts for each of these three classes of net assets instead of "fund balances," and that the statement of activities report the amount of change in each class of net assets. It also requires disclosure of information about the nature and amounts of different types of permanent and temporary restrictions, either on the face of the statements or in the notes.

2.425 Designated Fund Balance. Governing boards of not-for-profit organizations often designate a portion of the organization's unrestricted net assets for a particular purpose, such as for program expansion, debt retirement, or expansion of facilities. If the organization chooses to separately classify such designated amounts in its financial statements, it should do so only within the "unrestricted net assets" caption. Because donor restrictions deny an organization discretion over the use of temporarily or permanently restricted net assets, an organization may exercise discretion to designate only unrestricted net assets.

Related Organizations

2.426 Frequently, not-for-profit organizations establish separate entities to conduct certain activities. Examples include fund-raising foundations, whose sole purpose is to raise funds for a particular organization, or separate organizations that engage in lobbying activities.

2.427 SOP 94-3 establishes specific requirements for reporting related not-for-profit organizations and investments in for-profit entities. It makes uniform the guidance concerning reporting related entities in the following AICPA publications:

- Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*
- Industry Audit Guides, *Audits of Voluntary Health and Welfare Organizations* and *Audits of Colleges and Universities*
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

2.428 SOP 94-3 is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date shall be for fiscal years beginning after December 15, 1995.

2.429 The following discussion is based on the requirements of SOP 94-3. Organizations for whom SOP 94-3 is not yet effective, and who do not elect early application, should continue to follow the guidance in SOP 78-10. Those requirements, which will be superseded by SOP 94-3, are discussed in sections 2.432–2.433.

2.430 SOP 94-3 establishes the following reporting requirements:

Investment in a for-profit entity

- If an organization has controlling financial interest (as defined in ARB No. 51, *Consolidated Financial Statements*, and SFAS No. 94, *Consolidation of All Majority-Owned Subsidiaries*) in a for-profit entity, it should consolidate the for-profit entity's financial position, results of operations and cash flows into the organization's financial statements.
- An organization should follow the guidance in APB Opinion No. 18 as to whether it should account for an investment in a for-profit entity by the equity method.
- Organizations that are permitted to report investment portfolios at market value may continue to do so, even if this SOP would otherwise require the use of the equity method.

Relationship with another not-for-profit organization

- An organization should consolidate another organization in which it has a controlling financial interest by direct or indirect ownership of a majority voting interest.
- An organization should consolidate another organization if it has an economic interest and controls a majority of the votes on the other organization's board.
- If an organization has an economic interest in and exercises control of another not-for-profit organization by means other than a majority of the votes on the board, it is permitted but not required to consolidate the other organization. If it does not consolidate the other organization, certain disclosures are required, and SFAS No. 57, *Related Party Disclosures*, requires other related party disclosures whether or not the organization consolidates the other organization.

2.431 Appendix D of the SOP presents flowcharts and decision trees that will help accountants determine the appropriate reporting for related entities of not-for-profit organizations. These models are presented as Illustrations Nos. 2-4 and 2-5.

2.432 For organizations that have followed SOP 78-10 and for whom SOP 94-3 is not yet effective, SOP 78-10 requires that a not-for-profit organization combine related organizations into its financial statements, if the organization controls the other organizations and if any of the following circumstances exists (paragraph 42 of SOP 78-10 defines "control" as "the direct or indirect ability to determine the direction of the management and policies through ownership, by contract, or otherwise"):

1. Separate entities solicit funds in the name of and with the expressed or implied approval of the reporting organization, and substantially all of the funds solicited are intended by the contributor or are otherwise required to be transferred to the reporting organization or used at its discretion or direction.
2. A reporting organization transfers some of its resources to another separate entity whose resources are held for the benefit of the reporting organization.
3. A reporting organization assigns functions to a controlled entity whose funding is primarily derived from sources other than public contributions.

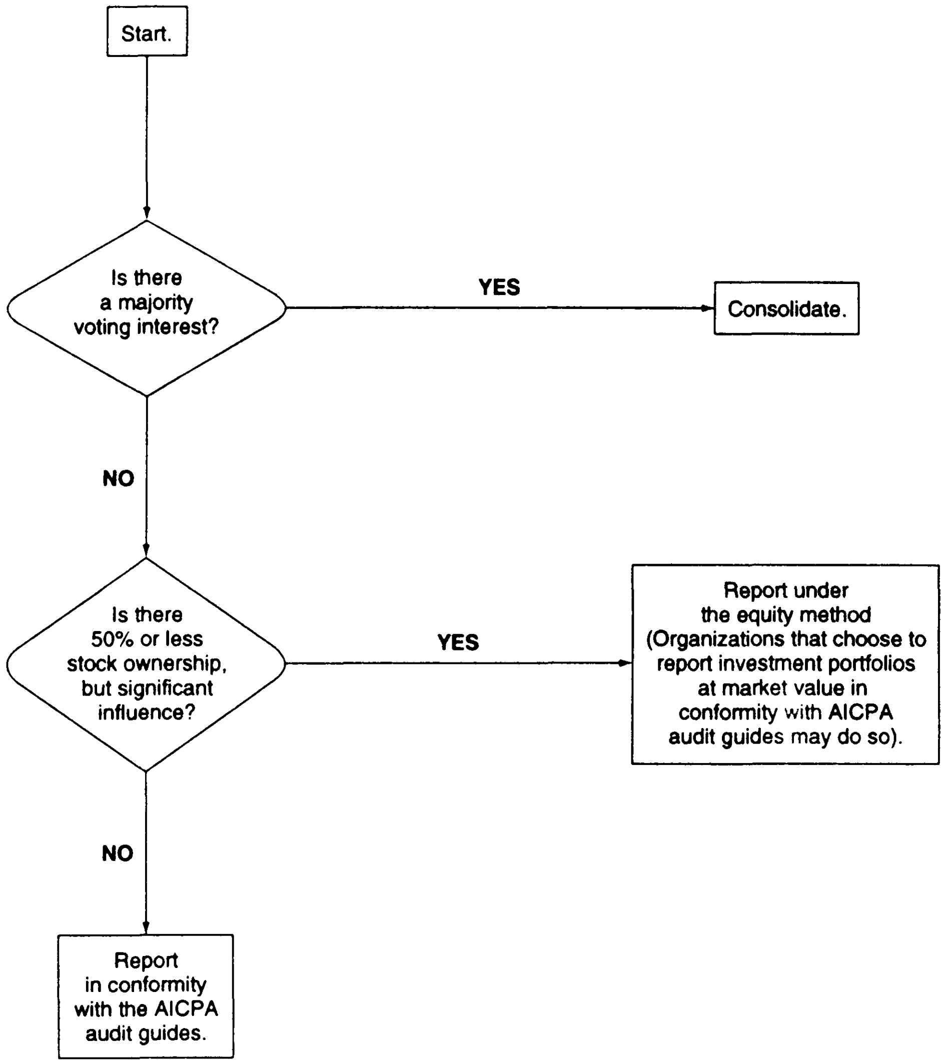
2.433 The VHW Guide is silent on whether consolidated financial statements should be presented for related organizations. For organizations that have been covered by the VHW Guide, the authors recommend that they follow the consolidation policy they have been using (the guidance in SOP 78-10 has been recommended by the authors) until SOP 94-3 becomes effective for them. They may also consider early application of SOP 94-3.

Environmental Matters

2.434 Because nonprofit organizations often receive contributions of land, environmental issues may arise. If the organization has been designated by the Environmental Protection Agency as a potentially responsible party (called a "PRP"), it may incur significant costs to clean up hazardous wastes. Even if it has not been designated as a PRP, the organization may need to consider contingent liabilities for cleanup costs.

ILLUSTRATION NO. 2-4

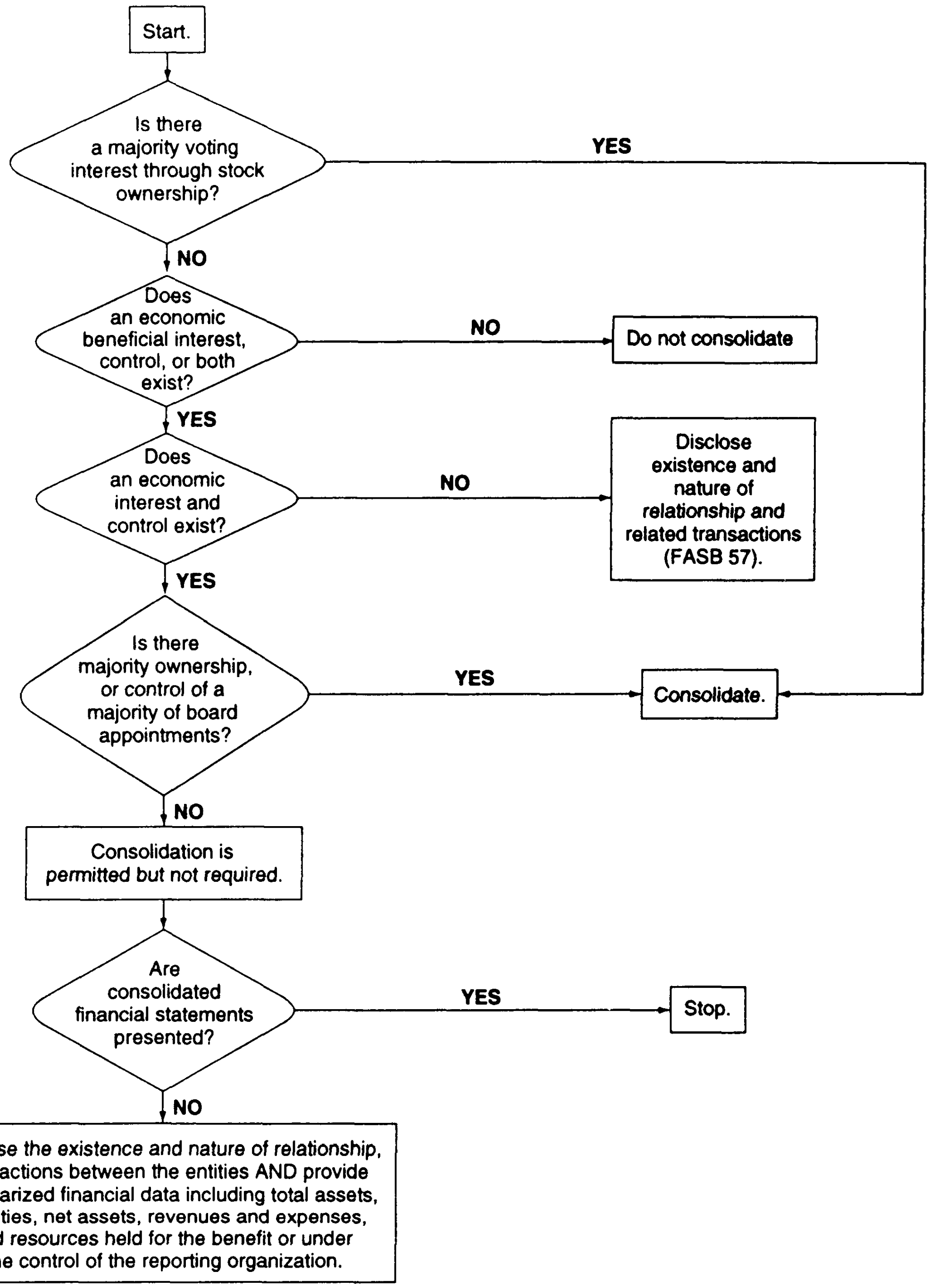
OWNERSHIP OF A FOR-PROFIT ENTITY



Source: SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, Appendix D.

ILLUSTRATION NO. 2-5

RELATIONSHIP WITH ANOTHER NOT-FOR-PROFIT ORGANIZATION



Source: SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, Appendix D.

2.435 A liability should be established if a loss relating to a cleanup is probable and can be reasonably estimated. Although the best estimate of the liability should be used, the accrual should not be delayed while the client attempts to accumulate information to arrive at a single amount as a best estimate if the loss can be estimated within a range. FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, indicates that the best estimate within the range should be accrued. If no amount within the range is better than any other amount, the *minimum* amount of the range should be accrued. In addition, the additional exposure to loss should be disclosed if there is a reasonable possibility of loss in excess of the amount accrued.

2.436 The FASB Emerging Issues Task Force determined, in Issue 93-5, *Accounting for Environmental Liabilities*, that the liability should be considered separately from any potential recovery from other potentially responsible parties. The loss arising from the recognition of the environmental liability should be reduced only when a claim for recovery is *probable* of realization. The balance sheet liability should not be offset by a recovery receivable unless the right of offset exists under FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts*.

2.437 The following example illustrates a financial statement disclosure of environmental issues:

> In February 19X1 the Organization was notified by the U.S. Environmental Protection Agency that it had been named as a potentially responsible party in connection with the cleanup of hazardous wastes at its Clark County property. Since the matter is in its preliminary stages, no assurance can be given at this time concerning the ultimate outcome of this matter. However, based on preliminary investigations to determine the Organization's potential liability and the estimated amount of remedial costs necessary to clean up the site, the Organization presently does not expect this matter to have a material adverse effect on its financial condition.

2.500 SPECIAL AUDITING ISSUES

Going-Concern Questions

2.501 Many of the factors that would raise a question about a commercial entity's ability to continue as a going-concern also apply to not-for-profit organizations. There are also some unique conditions and events that arise in many not-for-profit organizations because of their dependence on receiving the preponderance of their revenues from contributions or government contracts or grants. Examples of such matters include external events that could affect future contributions, loss of a key board member, and a high ratio of fund-raising expenses to contributions revenue. Chapter 3, sections 3.108–3.113 discusses the auditor's responsibilities for going-concern problems.

Materiality

2.502 Materiality considerations for balance-sheet items of not-for-profit organizations are similar to those of commercial entities. For example, creditors use financial information of both not-for-profit organizations and commercial entities in similar ways: to predict a debtor's ability to repay or to confirm the creditor's expectations about a debtor's ability to repay or provide adequate collateral. Materiality for both types of entities is often based on total assets.

2.503 However, not-for-profit organizations' total assets are often negligible because most organizations spend their resources on their program activities. Therefore, auditors many find that total revenues or total expenses provide a better benchmark for determining materiality.

2.504 In evaluating the effects of unadjusted misstatements at the completion of the audit, auditors should be aware that an amount that is not considered to be material in relation to the balance sheet could be material in relation to the statement of activity, program expenses, administrative expenses, etc. The following are some misstatements the authors believe auditors should give careful consideration to in determining their impact on the financial statements:

- An accrual that is not material in relation to total expenses causes a significant misstatement of a balance sheet account.
- A misclassification between contributions and earned revenues could affect the IRS "one-third support" test for nonprivate foundation status.
- A misclassification of expenses among functions affects the ratio of administrative expenses to total expenses.
- A misclassification of expenses among functions significantly affects the ratio of fund-raising expenses to program expenses.
- A misclassification of contributions significantly affects the class of net assets (permanently restricted, temporarily restricted, or unrestricted).
- A misclassification of expenses significantly affects the presentation of expenses attributable to satisfying restrictions on contributions.
- A misstatement related to a material unrecorded liability or contingent liability.

Independence

2.505 Under Rule 101 of the AICPA Code of Professional Conduct, auditors must consider their independence when they provide auditing or attest services. Not-for-profit organizations often tend to have closer relationships with their auditors than commercial entities, and they often ask the auditor to provide additional services or to serve on their governing board.

2.506 Sections 3.114–3.117 of Chapter 3 summarize the independence requirements accountants should be aware of, including special independence rulings related to situations involving not-for-profit organizations.

2.600 UNIQUE ACCOUNTING NEEDS OF NOT-FOR-PROFIT ORGANIZATIONS

2.601 Because not-for-profit organizations are subject to so many complex accounting, reporting, and compliance issues, it is important that they establish and maintain adequate accounting systems. In the following sections, some of the unique accounting needs of not-for-profit organizations are explored, such as recording and monitoring donor restrictions and board-designated equity, fund accounting, responsibility accounting, functional expense reporting, and joint cost allocations.

The Need for a Complex Accounting System

2.602 Almost all not-for-profit organizations' accounting systems are more complex than those of similar sized commercial entities. For example:

- A function may or may not coincide with a responsibility center or a fund. A restricted contribution may provide revenue for several responsibility centers or be used for expenses in several functions.
- A fund may be comprised of numerous restricted contributions.
- An organization may need to prepare financial reports for an individual project, department, grant, responsibility center, or function; and it may need to prepare financial reports for different fiscal periods for different funders or regulatory agencies.
- Controls must be established over nonreciprocal cash receipts.
- Donor restrictions must be identified and evaluated for acceptance.
- Use of restricted contributions must be monitored for propriety and for material budget fluctuations.
- Budgets and cash flow projections must be available by fund, responsibility center, or function.
- Donated goods and services must be recorded and valued.
- Funder and regulator reporting requirements must be met.
- Tax-exemption considerations must be monitored.

2.603 Because the accounting system of a not-for-profit organization may be called upon to embrace any of these complications, it must be designed to be comprehensive, flexible, adaptable, and, hopefully, relatively understandable. Accountants who serve not-for-profit organizations must understand all these complexities and more in order to serve their clients well, and to help their clients serve their constituencies.

Donor Restrictions

2.604 As discussed in section 2.212 donors frequently place restrictions on their gifts, often for the purpose of inducing not-for-profit organizations to undertake projects they might not otherwise have been able to, or to target certain constituencies donors believe should be targeted. Also, donors may just want to "see" specific results from their gifts, rather than having their contributions lost in an organization's general operating budget.

2.605 Accepting restricted contributions can result in very positive results for a not-for-profit organization. The contributions may indeed allow the organization to undertake projects it would not otherwise have been able to, or to target additional constituencies. In fact, many not-for-profit organizations intentionally solicit restricted contributions to attract funding they would not have received for their general operating budgets.

2.606 However, there can be problems connected to accepting restricted contributions. An organization may not be able to accomplish the project with the amount provided by a restricted donation. When this situation occurs, the organization should consider, before accepting the donation, whether additional funds can be raised or other revenues can be used to accomplish the project. Also, an organization may accept so many restricted contributions that it cannot afford the administrative time and expense of conducting the projects and monitoring the organization's compliance with the restrictions. In such cases, the organization may ask donors to loosen their restrictions to cover overhead expenses or attract other funding that would cover overhead expenses. The organization may even decide to reject one or more restricted contributions.

2.607 Further, in soliciting restricted contributions, an organization must be careful not to "oversell" a particular project. Collecting $100,000 for a project that will cost only $70,000 could leave the organization with legal and public relations problems. The best solution to this problem is to ask donors to revise their restrictions to cover other expenses and projects.

2.608 A further complication is that some donors prohibit certain uses of their restricted contributions within the project they intend to fund. For instance, a donor may specifically state that the donation may not be used for staff training or travel expenses, even though such costs are necessary to accomplish the project. Again, the organization would have to decide whether to use its other resources for these costs, or whether to reject the restricted contribution.

2.609 For all of these reasons, an organization must have good communications with its donors to understand the original restrictions, to understand and perhaps to negotiate how tightly defined the restriction is to be, to renegotiate if project expenses do not go as anticipated, or to diplomatically reject a donor's restrictions and convince him or her to redirect the restrictions so that the organization could accept them.

2.610 A critical factor in managing restricted resources is the method of calculating an allocation of joint costs to various projects. For a discussion of expense allocation, see sections 2.621–2.626.

Board-Designated Amounts

2.611 The managing board of an organization may designate that a portion of the organization's unrestricted net assets be set aside, or used, for a certain purpose, such as to expand its facilities. This is similar to a commercial entity's appropriation of retained earnings. The board can change its mind about this designation at any time, because such designations do not have the obligatory nature of a donor restriction. However, the organization's accounting system must be able to segregate expenses related to a board-designated project, just as it would a restricted project.

Fund Accounting

2.612 Fund accounting is a technique used to track the assets, liabilities, equity, revenue, and expenses related to a given purpose. This technique was developed for governmental entities, which often levy taxes for specific earmarked uses, such as the police fund, the fire fund, or the municipal retirement fund.

2.613 Each fund is treated as a separate accounting entity, with a separate general ledger, and therefore each fund could have its own complete set of financial statements. Large not-for-profit institutions could have thousands of funds—one for each restricted contribution they receive. In their financial statements, not-for-profit organizations traditionally group funds into one or more of the following general categories: Restricted Funds, Endowment Funds, Plant Funds (for fixed assets), or Unrestricted Funds. Some not-for-profits are required by AICPA industry guides to report some or all of these funds if they exist. (SFAS No. 117 requires that financial reporting should focus on the organization as a whole, but does not prohibit an organization from reporting disaggregated information by fund or fund group.) The recording of transactions into the Restricted or Endowment Funds results only from donor-imposed restrictions.

2.614 In governmental entities, funds are used as controls to ensure that governments do not overspend the revenue available for certain functions (such as fire or police). In not-for-profits, fund accounting usually does not have this control function; rather, it is a technique used to report how resources are used. A not-for-profit organization, for instance, can overspend a restricted grant it receives for a particular purpose and use other resources to pay for the added costs; whereas a government may be legally prohibited from overspending a fund's revenue.

2.615 Governments also frequently record "encumbrances" to account for purchases or other commitments of resources before the amounts qualify as liabilities to ensure that they do not inadvertently (and illegally) overspend a fund's available revenue. Not-for-profit organizations usually do not need to add to their accounting burden, but at times, governmental funders of not-for-profits ask for reports of encumbrances, which they often call "obligations."

2.616 Organizations that use fund accounting require a somewhat more complex accounting system. They must develop controls to ensure that transactions are recorded in the correct funds, that the debits and credits in each fund balance, that interfund transactions are properly recorded in *both* funds (sometimes called double entry accounting), and that, if funds are combined to present an overall financial statement for the organization, interfund transactions and balances are eliminated.

Responsibility Accounting

2.617 Many not-for-profit organizations with decentralized operations choose to structure their accounting systems into investment centers, profit centers, and/or cost centers, determined by operational responsibility within the organization. Although these terms are borrowed from management accounting techniques for commercial entities, they are often used extensively and with great success by not-for-profit organizations of all sizes. The following briefly describes these techniques:

> **Cost Center** — A cost center is a segment of the organization (such as a project, program, department, or location) that has control over costs (perhaps only within budget constraints), but no control over revenue or use of resources for investment-type expenditures (such as equipment, buildings, new projects, etc.) other than minimal budgeted amounts.
>
> **Profit Center** — A profit center is a segment of the organization that has control and responsibility over both costs and raising its own revenues.

Investment Center — An investment center is a segment of the organization that has control and responsibility over costs, revenues, and investments. It is at this level that decisions are made about major capital purchases, and long-term redirection of any material excess of revenue over budgeted expenses.

2.618 An organization may use both fund accounting and responsibility accounting. For instance, a large national organization may treat its California operation as a profit center or cost center; and its California operation may have numerous restricted funds in addition to its unrestricted revenue.

Functional Expense Reporting

2.619 Not-for-profit organizations must provide, either in the statement of activities or in the notes to the financial statement, information about expenses reported by their functional classification, such as major classes of program services or supporting activities. Organizations are encouraged, but not required, to provide information about expenses by their natural classifications as well. Only voluntary health and welfare organizations are required to report both functional and natural classifications of expense information in a matrix format in a separate statement of functional expenses.

2.620 Functions are the types of activities a not-for-profit does, generally identified as program, support, or fund-raising activities. "Mission-related" activities, or program services, must be reported separately from supporting services, which usually include the general and administrative and fund-raising functions. For example, an organization that serves victims of family violence may have the following functions: shelter, counseling, advocacy, public education, general and administration, and fund-raising. See Chapter 9 for examples of financial statements that report expenses functionally.

Functional Expense Allocations

2.621 The auditor of a not-for-profit organization must pay particular attention to the organization's method of assigning expenses to functions. Organizations that follow the VHW Guide, many of those that follow SOP 78-10, those exempt under section 501(c)(3) who file a Form 990, and those that must report functionally to funders, all must assign their expenses to functions.

2.622 The method of choice is direct identification; each vendor invoice should be evaluated, and a determination should be made about which function(s) caused, or were benefited by, the expense. Under this method, functional expense assignment is an ongoing process instead of merely the application of a percentage at the end of the period.

2.623 Frequently, however, the direct identification method is impractical, such as when food is purchased for a cafeteria that serves meals to clients and staff as part of several functions. In these cases, the method used is to apply an expense-related statistic that measures the proportions attributable to each function, such as number of meals served to clients/staff of each function. An organization must establish a plan in order to maintain the statistics it will need at the end of the period. An auditor must consider whether:

- the statistic chosen is a reasonable direct-measurement of the proportions in which function(s) caused or were benefited by the expense,

- there are adequate controls over the collection of the statistical data and whether compliance with those controls has been adequate, and
- whether the data was properly interpreted and allocations were properly calculated.

Other examples of related statistics upon which allocations can be reasonably based are:

- Square footage of space used, to allocate occupancy costs such as building rent or depreciation, insurance, repairs and utilities.
- Hours worked in each function, to allocate each person's wages.
- Total wages in each function to allocate FICA expense (provided wages in excess of the FICA limit are immaterial).
- Total number of staff in each function to allocate benefits such as health insurance (provided the expense is substantially equal per person).
- Number of each program's clients transported, to allocate client travel costs.

2.624 If direct identification is not practical and there is no practical way to maintain statistics that measure the proportions of an expense attributable to each function, then the method of last resort is to use an unrelated (but as closely related as possible) statistic to estimate the allocated expense to each function. An organization should use extreme care to ensure that it chooses the most appropriate statistic to use, and that basis should be used consistently from period to period unless the organization's operations change, making the basis inappropriate. An auditor must consider whether:

- there is, in fact, no practical <u>related</u> statistic upon which to base the allocation,
- the use of this particular unrelated statistic seems as reasonable as any other as a basis for allocation,
- there are adequate controls over the collection of statistical data and whether compliance with those controls has been adequate, and
- whether the data was properly interpreted and allocations were properly calculated.

2.625 Examples that illustrate appropriate uses of this method are:

- Use of the proportions of each function's total wages to allocate office supplies (if wage rates are relatively constant across all functions and if usage of office supplies is relatively equal by all employees).
- Use of the proportions of each function's full-time equivalent (FTE) number of staff to allocate office supplies (if wage rates are not equal across all functions or if some functions use volunteer staff, and if usage of office supplies is relatively equal by all workers).

2.626 If an organization establishes budgets for each function (or for specific grants, programs, locations, etc.), then some assumption about expense allocations must be built into the budget calculations. The earlier in the fiscal year that an auditor discusses the allocation plan with client personnel the better. An understanding of, and satisfaction with, a client's allocation plan will directly affect the nature and extent of audit procedures decided upon.

Joint Costs of Informational Materials and Activities That Include a Fund-Raising Appeal

2.627 SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, is the current literature that covers these types of costs. It indicates that all joint costs of informational materials or activities that include a fund-raising appeal should be reported as fund-raising expense if it cannot be demonstrated that a program or management and general function has been conducted in conjunction with the appeal for funds. If it can be demonstrated that a bona fide program or management and general function has been conducted in conjunction with the appeal for funds, the joint costs associated with the appeal should be allocated between the appropriate functions.

2.628 As mentioned in sections 2.101 and 2.103, in May 1993 the AICPA issued an exposure draft of a proposed SOP which would supersede SOP 87-2. The final SOP is expected to be issued in the fourth quarter of 1995. The effective date has not yet been determined.

2.700 OVERVIEW OF THE EXPOSURE DRAFT OF PROPOSED AICPA AUDIT & ACCOUNTING GUIDE, *NOT-FOR-PROFIT ORGANIZATIONS*

2.701 The Exposure Draft, which incorporates new accounting and auditing requirements issued by the FASB and the AICPA would supersede the following AICPA Guides and SOPs:

- Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*
- Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*
- Industry Audit Guide, *Audits of Colleges and Universities*[2]
- SOP 74-8, *Financial Accounting and Reporting by Colleges and Universities*[2]
- SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*

Effective Date

2.702 The proposed guide would become effective for financial statements for periods beginning after June 15, 1995, except for organizations with less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date would be for fiscal years beginning after December 15, 1995. Earlier application would be permitted.

Scope

2.703 The proposed guide covers not-for-profit organizations in general rather than specific types of organizations (i.e., voluntary health and welfare organizations). More specifically, it applies to nongovernmental organizations (paragraph references refer to the paragraphs in the Exposure Draft.):

[2] Certain guidance will remain applicable for governmental colleges and universities.

a. That meet the definition of a not-for-profit organization included in appendix D of SFAS No. 117. That definition includes any entity that possesses the following characteristics that distinguish it from a business enterprise:

1. contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return,
2. operating purposes other than to provide goods or services at a profit, and
3. absence of ownership interests like those of business enterprises.

(Organizations that clearly fall outside this definition include all 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.)

b. Entities that are covered by the existing VHW and NPO Guides, such as country clubs, even though they may not meet the SFAS No. 117 definition of a not-for-profit organization.

The proposed guide requires that these entities:

1. follow the guidance in SFAS Nos. 116 and 117. (pars. 1.02, 1.04, and 1.05)
2. report expenses by function, if they receive significant contributions from the general public. (The general public excludes governments.) (par. 3.15)

The proposed guide encourages, but does not require, these entities to present a statement of functional expenses if they receive significant contributions from the general public. (par. 3.15)

IMPACT OF EXPOSURE DRAFT:

Assuming that the draft will not undergo extensive changes before final issuance, the proposed guide:

- will give organizations considerable assistance in applying many of the requirements of SFAS Nos. 116 and 117 (such as netting expense against revenue for peripheral or incidental activities, and discounting of promises receivable);
- will provide guidance on some topics that are not addressed by any of the existing industry guides (such as accounting for split interest gifts); and
- will eliminate the necessity of consulting different guides for different types of organizations.

Auditors need not be concerned that the new audit guide will necessitate any major changes in audit procedures or documentation, other than those necessitated by SFAS Nos. 116 and 117. In fact, the new guide will give auditors a great deal of assistance in applying generally accepted auditing standards to some of the unique transactions and balances found in not-for-profit organizations. After discussion of each accounting topic, the proposed guide provides example procedures for meeting audit objectives related to that topic.

IMPACT OF EXPOSURE DRAFT (continued):

Auditors do need to be concerned that audit clients establish any newly-required internal control procedures early enough so that the controls are in place and operating adequately at the beginning of the fiscal year in which the new guide becomes effective. This represents an opportunity for the auditor to expand client service by providing assistance to nonprofit clients in establishing necessary controls while helping to avoid audit problems at the end of the year. See Chapter 10 for more details.

Overall, the proposed guide, along with SFAS Nos. 116 and 117, represents a tremendous advancement in relevant, up-to-date, consistent accounting guidance for not-for-profit organizations.

Investments

2.704 The existing Guides include diverse guidance concerning investments. Organizations covered by the Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations*, may report investments at either cost or fair value and organizations covered by the Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*, report investments at cost, market value, or lower of cost or market value based upon the type of investments. To standardize the guidance for reporting of investments by not-for-profits, the FASB, on March 31, 1995, issued an exposure draft of a Statement that proposes reporting investments in equity securities with readily determinable fair value and all debt securities at fair value. The proposed guide refers to the FASB exposure draft and states that, in conformity with that project, investments in equity securities with a readily determinable fair value and debt securities should be reported at fair value. (par. 8.01)

2.705 Other investments should be reported using the methods available under the existing Guides, with not-for-profits continuing to follow the guidance that was included in the Guide they were required to follow prior to the issuance of the proposed guide. (par. 8.02)

2.706 The proposed guide clarifies that using fair value for investments in equity securities with a readily determinable fair value and debt securities would not result in *all* securities being required to be reported at fair value. (par. 8.02)

2.707 The proposed guide points out that entities that do not meet the definition of a not-for-profit organization in SFAS No. 117 are required to follow SFAS No. 115 beginning with financial statements issued for fiscal years beginning after December 15, 1994. (par. 8.06)

Split Interest Gifts

2.708 Until now, there has been no specific guidance as to how organizations should account for split-interest gifts. This void would be filled by guidance which would state that not-for-profit beneficiaries of irrevocable split interest agreements should account for those transactions as part contribution and part exchange transactions. (par. 6.04)

2.709 If the not-for-profit is the trustee, the organization should recognize the assets and contribution revenue at the fair value of the assets received. A liability should be reported for the present value of the expected future cash payments to be made to other beneficiaries, if any. (par. 6.09)

2.710 If the not-for-profit is not the trustee, the organization should recognize contribution revenue and an asset measured at the present value of the estimated future cash flows to be received. (par. 6.10)

2.711 Contributions of perpetual trusts held by third parties should be reported as permanently restricted support, rather than as temporarily restricted support. The basis for this conclusion is that the trust is similar to an investment the not-for-profit does not control, rather than a multi-year promise to give. Distributions are reported as investment income in the appropriate class of net assets, and adjustments to the amount reported as an asset, should be recognized as permanently restricted gains or losses. (par. 6.22–6.24)

2.712 Revocable split interest agreements should be treated as conditional promises to give. (par. 6.06)

Subtotal for "Operations"

2.713 Current practice is diverse as to the presentation of an operational subtotal on the statement of activities, and paragraph 23 of SFAS No. 117 states that it neither encourages nor discourages a subtotal for "operations." Under the proposed guide, organizations may, but are not required to, report an intermediate measure of operations. The proposed guide does not define operations, but states that revenues and expenses that are an integral part of the not-for-profit's program or mission and supporting activities should be displayed as operating and, for items of revenue that are included in operations, the related expenses should be included in operations. (par. 3.13) (The implication appears to be that line items for revenues and expenses, such as investment income, bequests, and fundraising may be reported as operations or other than operations, depending on the nature of the item and its relationship to the not-for-profits' program or mission and its definition of operations, though that is not specifically stated in the proposed guide.)

Distinguishing Contributions from Other Kinds of Transactions

2.714 Existing audit and accounting guides have left considerable room for judgment as to whether some transactions were contributions or exchange transactions. The proposed guide summarizes the guidance in SFAS No. 116 concerning distinguishing exchange transactions from contributions and provides indicators to help users understand whether certain transactions would be contributions or exchanges. (par. 5.17 and Table 5.2)

2.715 **Membership Dues Received.** Many have felt that existing audit and accounting guides need to be clarified as to treatment of membership dues. Consistent with paragraph 51 of SFAS No. 116, which states that a single transaction may be in part an exchange and in part a contribution, the proposed guide points out that membership dues can be part exchange transactions and part contributions. The proposed guide provides indicators to help distinguish the dues portion from the contributions portion. (par. 5.18 and Table 5.3)

2.716 The proposed guide does not require any specific financial statement disclosures concerning membership dues.

2.717 Membership dues are permitted to be reported as one amount on the statement of activities, and need not be broken out between the portion of the dues that is an exchange transaction versus the portion, if any, that is a contribution. (par. 5.56) However, since deferred revenue may result from the exchange portion of membership dues but not from the contribution portion, organizations may need to separate the two portions for accounting purposes. (par. 5.56, footnote 17)

2.718 Similar to the guidance in paragraph 84 of SOP 78-10, revenue related to membership dues should be recognized over the period to which the dues relate. Nonrefundable initiation and life membership fees should be recognized as revenue in the period the fees are receivable, if future dues or fees can be reasonably expected to cover the cost of future services; otherwise the fees should be amortized to future periods based on average membership duration, life expectancy, or other appropriate methods (assuming a benefit is provided to the members and the dues are not contributions). (par. 5.19)

2.719 **Government Funding.** Due to the nature of government's missions, it may be particularly difficult to determine whether funds received from governments are received under exchange transactions or contributions, and existing audit and accounting guides do not give any specific help in making this distinction. The proposed guide provides indicators in Table 5-2 (Chapter 5 of the proposed guide) as guidance on how to classify such transactions. (par. 5.21)

Conditional Pledge Solicitations

2.720 Organizations often solicit promises to give from potential donors, but existing guidance does not address how to account for promises received in response to a solicitation that allowed donors to rescind their promises. The proposed guide states that if an organization solicits promises to give, and the solicitation explicitly allows donors to rescind their promises to give, then the promises are merely intentions or "indications" that they will give and are prohibited from being reported as contributions. (par. 5.41)

Use of Facilities

2.721 Not-for-profits may receive contributions of the use of facilities and of electric, telephone or other utilities, in transactions whereby the donor retains title to the facilities. Existing guides do not give any specific guidance about such gifts. The proposed guide indicates that these transactions should be reported as unrestricted contributions unless the terms of the transaction restrict the use of the property. If there is a restriction on the use of the property, it would lapse either (a) over the contract period or (b) over the depreciable life of the asset, if it is the not-for-profit's policy to imply time restrictions on contributions of long-lived assets. If it is probable that the not-for-profit will retain the asset at the end of the term of the transaction, the property should be capitalized. (par. 5.44 and 9.05)

2.722 If the contribution is an unconditional promise to give for a specified number of years, it should be recognized as contributions revenue that increases temporarily restricted net assets and contributions receivable. (SFAS No. 116, paragraphs 192–194.) Facilities may be required to be capitalized based on the guidance in SFAS No. 13, *Accounting for Leases*. However, because the guidance in SFAS No. 13 is intended to apply to reciprocal transactions rather than contributions, the capitalization based on the present value of the minimum lease payments may not be meaningful (e.g., if the lease payments are $1 per year). Therefore, the proposed guide requires that, in such situations, capitalization should be based on the rental value of the property, under a comparable exchange transaction. (par. 5.44 and 5.45)

Gifts in Kind

2.723 Existing audit and accounting guides include guidance on recording donated materials. The proposed guide would clarify and standardize this guidance. Contributions of items that can be used or sold should be reported at fair value. Fair value should be based on the quantity received after any applicable discounts have been considered. If the gifts have no value, as might be the case for certain clothing and furniture that cannot be used or sold by the not-for-profit organization, the item received should not be recognized. (par. 5.12)

2.724 Whether gift-in-kind items should be reported as contributions or agency transactions depends on whether the entity receiving them has discretion over the use or subsequent disposition of the asset. (par. 5.11)

2.725 Gift-in-kind transactions may be required to be disclosed if they meet the criteria of SFAS No. 57, *Related Party Transactions*. (par. 5.11)

Donor Imposed Restrictions

2.726 Existing guides are silent (or give only vague guidance) about several issues pertaining to donor restrictions on contributions. The proposed guide discusses several of these topics.

2.727 The proposed guide states that donors can impose restrictions not only on their own contributions but also on otherwise unrestricted net assets. For instance, a donor may make a restricted contribution that is conditional on the not-for-profit "restricting" a stated amount of its unrestricted net assets. If the organization complies and the new "restriction" of the portion of net assets cannot be reversed without the donor's consent, the organization should reclassify the agreed amount of its unrestricted net assets to restricted net assets. (par. 5.31)

2.728 The proposed guide states that it is possible for specific assets to be restricted. For example, land could be restricted for use as a public park. Generally, however, restrictions apply to net assets. (par. 11.04)

2.729 Paragraph 156 of SFAS No. 117 permits cash received with donor-imposed restrictions limiting its use to the acquisition of long-lived assets to be reported as "assets restricted to investment in land, buildings, and equipment," rather than being aggregated with cash that is available for current use. For organizations that prepare classified balance sheets, the proposed guide requires that *all* assets having donor-imposed restrictions that make the assets unavailable for use in the current operating cycle be reported as "assets restricted to investment in land, buildings, and equipment," or some similar title, rather than "cash and cash equivalents" or "contributions receivable." (par. 4.03) In this example, those assets should be sequenced near the "property and equipment" section of the balance sheet. (par. 3.03) Also, if the form of the assets, for example cash, is not evident from the description on the balance sheet, the form of the assets should be disclosed in the notes to the financial statements. (par. 3.03)

2.730 Paragraph 30(d) of SFAS No. 117 requires cash inflows restricted for acquisition of long-lived assets to be classified as financing activities on the statement of cash flows. The proposed guide provides further guidance by stating that because those amounts are not included in the statement of financial position accounts for cash and cash equivalents, they should be classified as outflows from investment activities in the year received, in order for the statement of cash flows to articulate with the statement of financial position. If the assets are acquired in a subsequent year, that activity should be reported as an inflow and outflow from investing activities. (par. 3.18)

2.731 In conformity with SFAS No. 5 and SAS No. 59, noncompliance with donor-imposed restrictions, including whether an appropriate composition of assets had been maintained, should be disclosed if there is a reasonable possibility that any of the following conditions exists:

a. a material contingent liability has been incurred

b. noncompliance could lead to a material loss of revenue

c. noncompliance could cause the organization to be unable to continue as a going concern. (par. 3.28, 4.05, 10.09 and 2.46)

Promises to Give

2.732 Existing guides are somewhat inconsistent in their treatment of pledges (denoted as "promises" by SFAS No. 116 and the proposed guide), and are silent on conditional pledges and discounting of pledges. The new guide would address some of these issues.

2.733 SFAS No. 116 requires unconditional promises to give to be reported as contributions, measured at fair value, with disclosure of certain information. The proposed guide provides additional guidance by stating that no additional revenue should be recognized for any increase in value between the date the promise is received and the date the asset is received. If, however, the value decreases, the decrease should be recognized in the period in which the decrease occurs. (par. 5.51)

2.734 SFAS No. 116, paragraphs 19 and 20, requires unconditional promises to give to be reported at fair value and states that the present value of estimated cash flows using a discount rate commensurate with the risks involved is an appropriate measure of fair value. The proposed guide refers to paragraph 12 of APB Opinion No. 21, *Interest on Receivables and Payables*, which provides guidance for discounting and states that the discount rate should be determined at the time the contribution is made and not be revised for market changes. (par. 5.54)

2.735 The proposed guide does not prescribe any one discount rate. The discount rate should be based upon a risk-free rate of return of the donee, rather than upon the donor's credit risk. (Donor credit risk is considered in determining the allowance for uncollectible promises to give.) (par. 5.54)

2.736 Unconditional promises to give non-cash assets that are expected to be received more than one year after the financial statement date should be measured at the present value, as of the date of initial recognition, of the assets' expected fair value at the date the asset is expected to be received. (In some cases it may be difficult to determine the asset's expected fair value at the date the asset is expected to be received. In those cases, current fair value may be the best estimate of the assets fair value at the date the assets are expected to be received.) (par. 5.51)

2.737 The ultimate recipient of a contribution that will be received through an agent acting as an intermediary should report the contribution when the ultimate recipient knows the agent has received either an unconditional promise to give or the contribution is made available. (par 5.39, footnote 14)

Earned Revenue

2.738 Revenues from exchange transactions should be reported net of any related discounts the organization provides to its customers. (par. 12.05)

Expiration of Restrictions

2.739 The proposed guide clarifies that the annual expiration of donor restrictions on long-lived assets is not necessarily equal to the amount of depreciation expense. For example, the expiration may be based on a 3-year term of the project for which it is restricted, while depreciation may be based on the 5-year economic life of the asset. (par. 9.08)

Contributed Services

2.740 SFAS No. 116, paragraph 9, requires contributed services to be recognized if, among other things, the services create or enhance nonfinancial assets. The proposed guide clarifies that "nonfinancial" has a meaning identical to "nonmonetary." (par. 5.43)

Reporting Expenses

2.741 Existing guides permit considerable diversity in reporting expenses. SFAS No. 117 established some specific requirements and the proposed guide would add other reporting standards for expenses.

2.742 The proposed guide would require disclosure of total fundraising expense and total management and general expense. (pars. 13.31 and 13.32) Furthermore, total program expense should be reported in the financial statements where expenses are reported by function (either the basic financial statements or the notes to the financial statements). (par. 13.29)

2.743 The proposed guide suggests that the guidance in SFAS No. 14, *Financial Reporting for Segments of a Business Enterprise*, may be helpful in determining what constitutes a major program, though SFAS No. 14 exempts not-for-profits from its scope. (par. 13.28)

2.744 Maintenance of plant is not a function. Amounts related to maintenance of plant, including depreciation, should be charged to the functions for which the plant is used. (par. 13.37)

2.745 Interest, including mortgage interest, should be charged to the function to which it pertains, if practicable. If it is impracticable to charge interest to particular functions, it should be charged to management and general. (par. 13.37)

2.746 Payments to affiliates should be functionalized if practicable. If payments to affiliates cannot be charged to particular functions, they should be reported on a separate line on the statement of activities and labeled as "unallocated payments to affiliated organizations." (par. 13.40)

2.747 If some expenses (such as cost of sales or direct expenses of special events) are subtracted from related revenues, then their functional nature may not be evident from the details provided on the face of the statement of activities. The components of those costs, such as direct labor and materials, are required to be presented in a note to the financial statements. (par. 13.24)

2.748 The proposed guide includes an illustration to help users articulate the statement of functional expenses with the statement of activity. (par. 13.26)

2.749 The proposed guide clarifies that fund-raising costs are period costs and should be expensed as incurred. Direct response fund-raising activities that are similar to direct response advertising activities should not be capitalized. (par. 13.07)

2.750 Some not-for-profits incur costs characterized as "public education." The proposed guide is silent concerning the definition of costs included in public education.

2.751 Some organizations allocate costs to various expense classifications. The proposed guide is silent concerning whether allocated costs should be disclosed.

2.752 Costs of soliciting funds other than contributions, including exchange transactions (whether program related or not) and costs of soliciting funds other than contributions from governments, should be classified as management and general expenses. (par. 13.31)

2.753 Not-for-profits should follow the guidance in SOP 93-7[3], *Reporting on Advertising Costs*. (par. 7.04) The proposed guide expands the definition of advertising to include activities to stimulate a desire to use the not-for-profit's products or services. (par. 13.09) Also, the proposed guide notes that:

a. fundraising is not advertising and is therefore not covered by SOP 93-7 (par. 13.07, footnote 4), and that

b. total advertising expense should be disclosed. (par. 13.08)

Special Events

2.754 Under current audit and accounting guides, accounting for special events has been open to some amount of interpretation. The proposed guide would standardize this accounting guidance by providing that costs of fundraising and special fundraising events should be expensed as incurred. (par. 13.07)

2.755 Paragraph 24 of SFAS No. 117 states that the statement of activities should report the gross amounts of revenues and expenses. (Paragraph 25 states that net amounts may be reported if they result from peripheral or incidental transactions or other events and circumstances that may be largely beyond the control of the organization.) According to the proposed guide, reporting amounts on a gross basis does not preclude displaying revenues less related expenses. Therefore, special events — as defined in paragraph 4.09 of *Audits of Voluntary Health and Welfare Organizations* — that are not peripheral or incidental may be displayed as follows:

[3] Ensure that you also follow the guidance in the AICPA Practice Bulletin 13, *Direct-Response Advertising and Probable Future Benefits*, which is an interpretation of SOP 93-7.

Special Event Revenue	XXX
Costs of Direct Benefits of Special Events	(XXX)
Net Proceeds from Special Events	XXX

Alternatively, these costs may be displayed in the same section of the statement of activities as other program, fund-raising, or management and general costs and allocated among those costs if applicable.

2.756 Even if an organization considers revenue from special events and other fund-raising activities as part exchange (for the fair value the participant received) and part contribution (for the excess of the payment over that fair value), costs must be reported by function either in the statement of activities or the notes to the financial statements, in conformity with SFAS No. 117. (par. 13.18 to 13.20, and 13.26)

2.757 Consistent with paragraph 41 of SOP 93-7, "direct costs" of events include only *incremental* direct costs incurred in transactions with third parties and payroll and payroll-related costs for the activities of employees who are directly associated with, and devote time to, the event. In the author's opinion, this seems to exclude allocated overhead and depreciation. (par. 13.19 and 13.20)

2.758 Some not-for-profits hold special events whereby contributed goods are sold by the organization. For example, an organization receives a contribution of theater tickets with a fair value of $75 from donor A and donor B buys the tickets from the not-for-profit at an auction for $100. Such contributions that can be linked to other transactions because they are in substance part of the same transaction cycle should not be "double counted." Thus, the initial contribution of the ticket should be reported at its fair value, and the ultimate sale of the ticket should be reported as a contribution for the difference between the amount paid at auction and the fair value. To illustrate—

Contributions (Contribution of the ticket, retail price)	$ 75
Contributions (Amount received at auction, in excess of retail price)	25
Total contributions	100
Cost	—
Change in net assets	$ 100

(The contributions could be displayed as one amount, $100, if the entire transaction occurs during the reporting period.) (par. 5.13)

Cost of Premiums

2.759 Some not-for-profits provide potential donors with complimentary, nominal-value premiums (e.g., coffee mugs, key chains) and the premiums may be kept by all who are solicited, regardless of whether they contribute. The cost of premiums should be accounted for as fundraising cost. Also, some not-for-profits give nominal value premiums to individuals that have made contributions. Such premiums should also be recorded as fundraising expense. For example, the organization may provide a guide to counting dietary fiber to donors making a contributions of $50. (The premium costs the NPO $1 and has a fair value of $3.) The organization should recognize contributions of $50 and fundraising expense of $1. (par. 5.15)

Federated Fundraisers

2.760 Existing audit and accounting guides give little specific guidance to federated fundraising organizations such as the United Way. The proposed guide would establish GAAP in several areas for such organizations.

2.761 Funds received by federated fundraisers that are designated for other not-for-profits, even not-for-profits that are part of the federated fundraiser's network, are received as agency funds because the not-for-profit has no discretion in distributing the funds. Such receipts should not be reported as contribution revenue when received by the federated fundraiser, and forwarding the funds to the designated not-for-profits should not be reported as expense by the federated fundraiser. (par. 5.09)

2.762 Funds retained by federated fundraisers as fees, such as administrative fees for raising the funds, should be reported as program revenue, because the federated fundraiser's program is to raise funds for others. Such fees should not be netted against the expenses of soliciting those funds. (par. 5.09)

2.763 For federated fundraisers, the statement of activity may reflect the agency transactions, but the funds received under agency transactions should not be classified as revenue. The proposed guide includes illustrations of three permissible formats for displaying funds raised by federated fundraisers. (par. 5.10)

2.764 All costs of soliciting funds, whether solicited for the not-for-profit itself or for other organizations, should be reported as fund-raising costs. (par. 13.32 and 13.41)

2.765 Contributions to agencies supported by federated fundraisers should be reported as program expense. (par. 13.27)

2.766 Agency funds held should be reported in the statement of financial position as assets and liabilities and reflected in the statement of cash flows as operating cash flows. If the statement of cash flows is presented using the indirect method, cash received and paid in such transactions is permitted to be reported either gross or net. (par. 5.07)

Other Accounting Matters

2.767 The proposed guide supplements guidance provided by SFAS No. 117 by stating that gains on the disposition of long-lived assets received as gifts and reported as restricted support based on an accounting policy that implies that restriction rather than based on a specific donor restriction should be reported as unrestricted support. (par. 5.36)

Disclosure Matters

2.768 Illustrative financial statement disclosures are included in each section of the proposed guide where a particular disclosure is discussed.

2.769 The proposed guide includes illustrations of disclosures required by SFAS Nos. 116 and 117, such as the following:

- Promises to give (par. 5.59)
- Collections (par. 7.14)
- Contributed services (par. 5.59)
- The accounting policy concerning meeting restrictions on gifts of long-lived assets (par. 5.59)

2.770 The notes to the financial statements should disclose the nature of the organization's operations, including a description of each of its major classes of programs, either in the statement of activity or in the notes. (par. 13.29)

2.771 Board designations need not be disclosed. (par. 3.05, 3.07)

2.772 If prior year comparative information is summarized and does not include the minimum information required by SFAS No. 117, the notes to the financial statements should describe the nature of the prior year information.

2.773 If the required note is omitted or incomplete, the auditor should add an explanatory paragraph to the auditor's report (following the opinion paragraph) calling the omitted or incomplete disclosure to the reader's attention. (par. 14.04 to 14.05)

2.774 If collections are capitalized, the balance sheet should display a separate line item for the total amount capitalized. For collections that do not meet the definition in SFAS No. 116, the amount capitalized should be disclosed separately on the face of the financial statements or in the notes. (par. 7.11)

Auditing Guidance

2.775 For statements of activities that include a subtotal for operations, auditors are prohibited from reporting on the subtotal. Auditors should opine on "the change in net assets." (par. 14.02)

2.776 The proposed guide further amplifies the guidance in footnote 6 to paragraph 27 of SFAS No. 117, which states that nonmonetary information about an organization's service efforts is considered supplementary information or management reporting. The proposed guide states that such information should not be included in the financial statements or related notes. (par. 14.10)

Pre-Engagement
& Audit Planning

CHAPTER 3

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

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PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

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CHAPTER 3

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

3.000 INTRODUCTION

3.001 In recent years, accountants who provide auditing, compilation, and review services have become increasingly aware of the importance of evaluating their relationships with prospective and continuing clients and the need to perform adequate planning in their audit engagements. This chapter discusses the requirements to perform client acceptance and continuance procedures and to adequately plan engagements to audit not-for-profit organizations' financial statements. Also discussed are other pre-engagement considerations.

3.100 CLIENT ACCEPTANCE AND CONTINUANCE

3.101 Although most firms want to expand their client base, this expansion should be carefully monitored to ensure that accepting a prospective client and continuing a relationship with an existing client will not harm the firm's reputation and standing in the community.

3.102 The AICPA Statement on Quality Control Standards (SQCS) No. 1, *System of Quality Control for a CPA Firm*, requires that firms establish policies and procedures for accepting and continuing clients. Specifically, paragraph 7 of SQCS No. 1 (QC 10.07) states:

> Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity.

3.103 Firms should develop, preferably in writing, quality control policies and procedures for evaluating new and existing client relationships. These policies should specify:

For prospective clients

- The procedures to be followed for evaluating a prospective client, including:
  - obtaining and reviewing the prospective client's available financial statements or information.
  - inquiring of third parties, such as the prospective client's attorneys, bankers, etc. about the organization and its management.
  - communicating with the predecessor auditor or accountant.

  - considering circumstances that would require special attention or that present special risks in the engagement.
  - evaluating the firm's independence and ability to serve the prospective client.
  - determining whether accepting the client would violate any applicable regulatory agency requirements or the codes of conduct of the AICPA or state CPA society.
- The individuals responsible for evaluating prospective clients and making acceptance decisions, and for approving such decisions.
- How appropriate firm personnel are informed of the policies and procedures for accepting clients.
- The individuals responsible for administering and monitoring compliance with the firm's policies and procedures.

For continuing clients

- The procedures followed for evaluating relationships with continuing clients, such as:
  - considering whether significant changes have occurred since the last engagement, such as changes in management, the governing board, legal counsel, financial condition, or scope of the engagement.
  - considering whether any conditions exist that would have caused the firm to reject the client had they been known at the time of initial acceptance.
- The frequency of such evaluations.
- The individuals responsible for evaluating continuing clients, for deciding whether to continue relationships with existing clients, and for approving such decisions.
- How firm personnel are informed of the firm's continuance policies and procedures.
- The individuals responsible for administering and monitoring compliance with the policies and procedures.

Each firm should design quality control policies and procedures that meet its unique organizational and operating characteristics.

3.104 The Client Acceptance and Continuance Form at section 3.501 is designed to help firms evaluate prospective and existing clients. It provides documentation of the evaluation process for new and existing clients, the decision to accept and continue clients, and approval of the decision to accept and continue clients. This Form should be modified as necessary to interface with the firm's quality control policies and procedures for acceptance and continuance of clients.

3.105 For prospective clients, Part I of the Client Acceptance and Continuance Form should be completed by the in-charge and approved by the engagement partner. Part II should be completed by the engagement partner and approved by the partner responsible for approving new clients.

Practice Tip:

The Yellow Book requires the auditor to provide to prospective clients their most recent external quality control review report.

3.106 For existing clients, the in-charge should update and revise the form, as necessary, to evaluate the desirability of continuing the relationship with the client. Multi-year sign-off space is provided to document an annual evaluation and the engagement partner's approval of the continuance (or discontinuance) decision.

3.107 Two critical factors in the acceptance and continuance decision are considering the possibility of going-concern problems and identifying potential independence impairments. These factors are discussed in the following sections.

Potential for Going-Concern Problems

3.108 Financial reporting is based on the assumption that the entity will continue as a going concern, unless there is significant information to the contrary. Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), requires the auditor to evaluate the client's ability to continue as a going concern for a period not to exceed one year beyond the balance-sheet date. To perform this evaluation, the auditor is not required to design audit procedures to detect going-concern problems; rather, the evaluation should be based on information obtained during the course of the audit about conditions or events that indicate that there is substantial doubt about the entity's ability to continue as a going concern. Examples of such conditions or events are negative cash flows, defaults on loan agreements, contraction of service levels, legal proceedings, and operating difficulties.

3.109 If the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, he or she should:

- Consider management's plan to mitigate the effects of the condition or event, and
- Assess the likelihood that the plans can be effectively implemented.

3.110 If substantial doubt remains after evaluating management's plans, the auditor should:

- Consider the adequacy of financial statement disclosures about the going concern problem, and
- Include an explanatory paragraph in the auditor's report to reflect his or her conclusion that there is substantial doubt about the entity's ability to continue as a going concern.

3.111 Whenever the auditor becomes aware of conditions or events that cause him or her to believe that there may be substantial doubt about an entity's ability to continue as a going concern, he or she should document the condition or event, the procedures followed to reach a conclusion about whether substantial doubt exists and, if applicable, the effect on the auditor's report and financial statements. If questions about an entity's ability to continue as a going concern arise in performing pre-engagement and audit planning procedures, they should be documented in the Client Acceptance and Continuance Form and the Audit Planning Memorandum. Questions identified during engagement performance should be documented in a special memorandum that includes a discussion of:

1. The nature of the condition or event that raises a going-concern question.

2. The evaluation of management's plans and other factors, and related audit evidence, that might either mitigate or aggravate the condition or event.

3. The assessment of whether substantial doubt exists about the organization's ability to continue as a going concern.

4. The evaluation of the adequacy of financial statement disclosures of the matters giving rise to the information indicating a going-concern problem and management's plans to mitigate the problem.

5. Any modifications to the auditor's report considered necessary for the uncertainty.

3.112 The following are some conditions and events that may raise a question about a not-for-profit organization's ability to continue as a going concern:

- Insufficient unrestricted revenue to provide supporting services to activities funded by restricted contributions.
- High ratio of fund-raising expense to contributions received.
- Inability to repay interfund borrowing.
- The funding of each year's cash shortage with the next year's deferred revenues.
- Activities that could jeopardize the organization's tax-exempt status and thus endanger current contribution levels.
- Loss of key board members or volunteers.
- Change in the demographic factors relating to services or products provided.
- External events that could affect funders' motivation to continue to contribute.
- Decrease in revenues contributed by repeat donors.

3.113 As mentioned above, if the auditor becomes aware of any of these conditions during the course of the audit, he or she should inquire about management's plans to mitigate the effect of the conditions or events, and should assess the likelihood that such plans can be effectively implemented. Some organizations can mitigate unfavorable situations by means not available to commercial entities, such as by appealing to potential donors for contributions or by reducing services provided, which would cause a commercial entity a loss of revenue but could be a stabilizing option for a not-for-profit organization.

Independence

3.114 Auditors must be independent of a client in order to be able to express an opinion on the financial statements. SQCS No. 1 contains a requirement that firms establish quality control policies and procedures that ensure that they comply with the professional requirements concerning independence. Specifically, paragraph 7 of this Statement states:

> Policies and procedures should be established to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rules of conduct of the AICPA. Rule 101 of the rules of conduct [ET section 101] contains examples of instances wherein a firm's independence will be considered impaired.

Also, the AICPA's *Code of Professional Conduct* "Objectivity and Independence" (ET section 55), states:

> A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

3.115 In addition to these general requirements to maintain independence, there is one interpretation and several rulings related to Rule 101 of the AICPA Rules of Conduct that deal specifically with possible independence impairments with respect to not-for-profit organization clients:

- Interpretation 101-4 of Rule 101, "Honorary Directorships and Trusteeships" (ET 101.06), states that a member who serves as a director or trustee of a not-for-profit organization and is also associated the organization's financial statements would not be considered lacking in independence, provided the position is clearly honorary and the member cannot vote or participate in board or management functions.
- Ethics Ruling 191.2, "Association Membership" (ET 191.003-.004), indicates that a member's independence would not be impaired if he or she joins a trade association that is a client. However, the member should not serve as an officer, director, or member of management for the association.
- Ethics Ruling 191.14, "Member on Board of Directors of Federated Fund-Raising Organization" (ET 191.027-.028), addresses the situation in which the member serves as officer or director of a federated fund-raising organization, such as the United Way, that provides funds to local charities. The Ruling states that a member's independence with respect to the local charity would not normally be impaired, unless the federated fund-raising organization exercises managerial control over the local charity.
- Ethics Ruling 191.16, "Member on Board of Directors of Nonprofit Social Club" (ET 191.031-.032), states that a member who serves on the board of a nonprofit social club would not be deemed to be independent.
- Ethics Ruling 191.17, "Member of Social Club" (ET 191.033-.034), indicates that a member of a social club who is required to hold an equity or debt securities ownership in the club would not be lacking in independence provided the membership is a social matter; however, the member should not serve on the club's board or take part in its management.

- Ethics Ruling 191.64, "Member on Board of Organization for Which Client Raises Funds" (ET 191.128-.129), states that a member who serves on the board of directors of a not-for-profit organization would not be independent of a fund-raising foundation that functions solely to raise funds for the organization. However, if the directorship is clearly honorary, the member's independence would not be considered to be impaired.

3.116 These independence requirements apply not only to AICPA members, but their spouses and dependents as well. Independence is generally not impaired solely because the member's spouse or dependent is employed by the client, as long as the employment is in a position that does not allow significant influence over the organization's operating, financial, or accounting policies. However, if the employment is in a position in which the person's activities are audit-sensitive (normally an element of or subject to significant internal accounting controls, such as cashier, internal auditor, or accounting supervisor), the auditor's independence would be impaired.

3.117 In addition to establishing policies and procedures to ensure that firms have adequate procedures to determine that their personnel are independent with respect to their clients, the authors believe it is advisable to also ensure that potential independence impairments have been identified and resolved before each engagement begins. As a result, the Client Acceptance and Continuance Form in section 3.501 requires that this determination be made on each engagement before deciding to accept a new client or continue a relationship with an existing client.

Practice Tip:

All practitioners, and the members of their professional staffs, must be thoroughly familiar with the Code of Professional Conduct, the interpretations of ET section 55, which appear in ET section 101, and the related individual rulings, which appear in ET section 191 ("Ethics Rulings on Independence, Integrity, and Objectivity").

3.200 ENGAGEMENT LETTERS

3.201 Adequate engagement planning includes establishing an understanding with the client regarding the nature of the firm's services, timing of field work, report deadlines, responsibilities of the client, and methods of fee determination and payment. The engagement partner should confirm, at least annually, an understanding of the nature of the engagement and the extent of the reporting responsibilities before beginning field work. If an engagement letter is not used the understanding should be documented in the working papers. If the audit is performed in accordance with *Government Auditing Standards*, these standards require this understanding to include the auditor's responsibilities for testing and reporting on internal controls and compliance with laws and regulations. Such communication will normally include an appropriate engagement letter and a pre-engagement client conference.

3.202 Currently, there are no authoritative pronouncements requiring a written engagement letter for an audit, although most firms regard their completion as good business practice. An engagement letter helps to prevent misunderstandings between the organization and the auditor regarding the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client, and in most states it becomes a legally binding contract on both parties. There are other good reasons to obtain an engagement letter, including the following:

- *Reduce the risk of litigation.* Misunderstandings with clients regarding the nature and limitations of the services provided can result in litigation.
- *Avoid misunderstandings by the staff.* The staff performing the work can review the engagement letter to obtain a clear understanding of the services to be provided and the required timing of issuance of the report.

Practice Tip:

Be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. You should also make sure that a final engagement letter is always issued in such circumstances.

3.203 The letter should be prepared by the in-charge or the engagement partner before any significant work takes place on the engagement. The partner should personally present the letter to the client to ensure that a complete understanding has been achieved. The signed copy should be filed with the current engagement's working papers.

3.204 Should the nature of an engagement change during its progress, or should the firm be engaged for additional services during the year, a new engagement letter should be prepared. A step up from a compilation to an audit engagement and a special engagement for preparing a budget and cash flow forecast are examples of changes that would require a new engagement letter.

3.205 Sections 3.502-3.504 provide examples of engagement letters for not-for-profit audit engagements, including specially designed engagement letters for engagements under *Government Auditing Standards* (section 3.503) and under OMB Circular A-133 (section 3.504).

3.300 AUDIT PLANNING

3.301 Professional standards include many general and specific planning requirements. The two basic requirements to plan engagements are:

(1) The third General Standard of Rule 201 of the AICPA *Code of Professional Conduct* states, "A member shall adequately plan and supervise the performance of professional services."

(2) The first standard of generally accepted auditing standards (GAAS) requires that "the work is to be adequately planned and assistants, if any, are to be properly supervised."

3.302 SAS No. 22, *Planning and Supervision* (AU 311), provides specific guidance to the independent auditor performing an audit in accordance with GAAS, including developing an audit program and obtaining an understanding of the organization's operations. Many other SASs also require consideration of matters such as potential misstatements, continued existence of the organization, accounting estimates, obtaining an understanding of the internal control structure, and preliminary materiality.

3.303 Audit planning is also affected by the following AICPA auditing standards:

1. SAS No. 22, *Planning and Supervision*
2. SAS No. 31, *Evidential Matter*
3. SAS No. 39, *Audit Sampling*
4. SAS No. 41, *Working Papers*
5. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*
6. SAS No. 48, *The Effects of Computer Processing on the Audit of Financial Statements*
7. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
8. SAS No. 54, *Illegal Acts by Clients*
9. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*
10. SAS No. 56, *Analytical Procedures*
11. SAS No. 57, *Auditing Accounting Estimates*
12. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
13. SAS No. 67, *The Confirmation Process*
14. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*
15. SAS No. 73, *Using the Work of a Specialist*
16. SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistant*[1]

3.304 Achieving both engagement quality and profitability requires extensive planning. Engagement planning should begin well before the field work begins and continue until completion of the engagement. The engagement partner should be involved at strategic times during the planning, performance, and completion of an engagement. Early and frequent partner involvement in program design and in related judgment decisions will help develop the in-charge and other staff personnel, will identify problems timely, and will contribute to a high-quality, profitable engagement.

3.305 Complying with all applicable professional standards and achieving maximum audit engagement profitability can only be accomplished through effective planning. Effective planning for audits of not-for-profit organizations must include, among other things, these five basic audit planning activities:

[1] In February 1995, the AICPA Auditing Standards Board issued SAS No. 74, which supersedes SAS No. 68. There are no significant differences between SAS No. 74 and SAS No. 68. In contrast to SAS No. 68, which contained the many reporting requirements of Government Auditing Standards, the Single Audit Act, and OMB Circular A-133, SAS No. 74 merely refers to these requirements. As a result, the SAS no longer needs to be amended each time one of these reporting requirements changes.

1. Obtain an understanding of the organization's internal control structure.

2. Determine the level of overall engagement risk, the risk of potential misstatements, and the overall materiality limit.

3. Make judgments about the staffing of the engagement, the extent of supervision and the degree of professional skepticism.

4. Decide on the most cost-beneficial audit approach based on the risk assessment and materiality decisions.

5. Determine the nature of the service to be rendered (for example, a report on consolidated or consolidating financial statements, GAAS audit, Yellow Book audit, or OMB Circular A-133 audit).

Obtain an Understanding of the Type of Audit Required

3.306 As discussed in Chapter 2, section 2.226, not-for-profit organizations that receive funds from governmental agencies and other organizations are likely to be subject to special reporting, compliance, and auditing requirements beyond those required by GAAS. Section 4.011 in Chapter 4 contains a listing of publications that contain special requirements related to federal programs. Auditors should also be aware of the unique requirements attached to funds received from other organizations, such as private foundations and state and local governmental agencies. Although the organization has primary responsibility to meet the funding agencies' requirements as to special reports and financial statements, auditors of not-for-profit organizations should also make the necessary inquiries during pre-engagement planning to ensure that all such requirements have been identified. Identifying these requirements at an early stage of the engagement allows auditors to design the most efficient and effective auditing and compliance procedures.

Practice Tip:

The Office of Management and Budget (OMB) is currently revising Circular A-133. The OMB expects to publish the revised Circular A-133, which will be effective for fiscal years beginning on or after January 1, 1996, in the *Federal Register* in the fourth quarter of 1995. This edition of the Manual incorporates the provisions of the most recently issued Circular A-133 (March 8, 1990). Be alert for the upcoming changes before you plan any audits for which the revised Circular A-133 will be effective. See Chapter 4, section 4.009 and Illustration No. 4-1 for further details.

Obtain an Understanding of the Internal Control Structure

3.307 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, requires that auditors obtain an understanding of the client's internal control structure sufficient to plan the audit. Paragraph 16 of SAS No. 55 (AU 319.16) states:

> The auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure [the control environment, accounting system, and

control procedures] to plan the audit of the entity's financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to—

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatements.
- Design substantive tests.

3.308 The 1994 revision of the Yellow Book states that internal control over safeguarding of assets against unauthorized use or disposition (safeguarding controls) could have a material effect on the organization's financial statements. Therefore, an understanding of safeguarding controls may be essential to planning the audit. An understanding of the controls can help auditors recognize risk factors, such as the following:

- Failure to adequately monitor decentralized operations;
- Lack of control over activities, such as lack of documentation for major transactions;
- Lack of control over computer processing, such as a lack of controls over access to applications that initiate or control the movement of assets;
- Failure to develop or communicate adequate policies and procedures for security of data or assets, such as allowing unauthorized personnel to have ready access to data or assets; and
- Failure to investigate significant unreconciled differences between reconciliations of a control account and subsidiary records.

3.309 An understanding of internal control is required in all audits; however, it is extremely important in audits of not-for-profit organizations subject to the special reporting and compliance requirements of the Yellow Book and Circular A-133. Completion of the Internal Controls Questionnaire in Chapter 6, section 6.100, or the All Substantive Approach Questionnaire in Chapter 5, section 5.703, provides a basis for obtaining an understanding of the client's internal control structure sufficient to plan the audit.

Assess Risk

3.310 Overall engagement risk has four primary components:

- Integrity of management.
- Use of financial statements.
- Auditability of the entity.
- Business environment.

3.311 Overall engagement risk will subjectively affect the desired level of assurance in the financial statements taken as a whole. Specifically, it will affect the acceptable levels of risk of incorrect acceptance and risk of assessing control risk too low in the substantive tests of balances and tests of controls sample size determinations.

3.312 Evaluating overall engagement risk as high or low will result from considering each component. The rationale behind the evaluation should be documented in the Audit Planning Memorandum illustrated in section 3.508.

3.313 **Integrity of Management.** SAS No. 58, *Reports on Audited Financial Statements,* states, "The financial statements are the responsibility of management." SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, states, "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty." SAS No. 53 also states, "Management integrity is important because management can direct subordinates to record transactions or conceal information that can materially misstate financial statements."

3.314 The integrity of management should be evaluated as part of the client acceptance or continuance decision and noted on the Client Acceptance and Continuance Form, section 3.501. Approval of this Form by designated partners is an indication that the integrity of management is considered adequate and that no circumstances have come to their attention that would require special auditing procedures to detect and report errors and irregularities or illegal acts.

3.315 Any significant matters related to management's integrity that arise during the planning or performance of the audit should be documented in a special memorandum containing a description of:

1. The matters designated for further consideration.
2. The risk of material misstatement in the financial statements.
3. The additional or changed auditing procedures considered necessary to mitigate such risks.
4. The results of performing such procedures and their effect on the auditor's reports.

3.316 **Use of Financial Statements.** The risk associated with the use of audited financial statements is usually high because the auditor cannot control their ultimate distribution or the purposes for which users rely on them. The risk is even higher in circumstances such as the following:

- The organization receives large amounts of federal financial assistance.
- Statements are used to induce new or increased contributions.
- Statements are used in legal proceedings.
- The organization must comply with OMB Circular A-133.
- Statements used to demonstrate compliance with restrictions in notes or debentures.
- Statements used for obtaining credit.

3.317 The expected use of financial statements should be documented annually on the Client Acceptance and Continuance Form.

3.318 **Auditability of the Entity.** A firm should consider the auditability of the entity prior to deciding whether to accept or retain a client. Although a potential client may request an audit and users of the financial statements may require an audit, certain factors may preclude an auditor from being able to express an opinion on the financial statements.

3.319 If a client's accounting system does not provide sufficient evidence to support the recorded transactions, or if the client's accounting records have been destroyed or lost, the entity may be unauditable.

3.320 For a new client, auditability can usually be determined through discussions with management and the predecessor auditor or accountant. The auditor should inquire as to the accounting system and how management determines that the policies and procedures for processing financial information are followed. For a continuing client, auditability is determined by discussions with management as well as through prior experience.

3.321 **Business Environment.** The auditor should also consider the business environment in which the organization operates. Is the client in a financial position where bankruptcy, lack of funding, or sudden collapse could occur? All of these concerns should be addressed when an auditor decides to accept or retain a client.

Risk of Potential Misstatements

3.322 The risk that potential misstatements will occur results primarily from weaknesses in the internal control structure, inherent risks in certain transactions or account balances, material and unusual account balances, and the organization's history of misstatements. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* refers to these risks as inherent and control risks. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* refers to errors and irregularities as unintentional and intentional misstatements of financial statements, respectively. These risks will be evaluated and documented on the following forms, which are included in Chapters 5 and 6 of this Manual:

- ABC System: Internal Controls Questionnaire, Planning Matrix, Risk of Potential Misstatements Evaluation Form, and Tests of Controls Programs.
- All Substantive Approach: All Substantive Approach Questionnaire and Tests of Controls Programs.

The level of risk of potential misstatements will directly affect the desired level of assurance in the affected transaction or balance. High risk requires a higher level of assurance which requires more evidence. Low risk means less evidence is necessary.

3.323 **Errors and Irregularities.** SAS No. 53 (AU 316) requires auditors to assess the risk that errors and irregularities that have material effect on the financial statements could occur, and to design and perform the audit to obtain reasonable assurance that such errors and irregularities will be detected during the audit. It also discusses the impact of errors and irregularities on the auditor's report, and the auditor's requirement to communicate errors and irregularities to the audit committee or its equivalent.

3.324 Paragraph 2 of SAS No. 53 (AU 316.02) defines errors as "*unintentional* misstatements or omissions of amounts or disclosures in financial statements." In paragraph 3 (AU 316.03), irregularities are defined as "*intentional* misstatements or omissions of amounts or disclosures in financial statements."

Because irregularities are intentional (and, as a result, may involve forgery or collusion), they are usually more difficult to detect than errors.

3.325 Because auditors' opinions are based on the concept of reasonable assurance, they cannot guarantee that financial statements are free from material misstatements due to errors and irregularities. However, they must exercise due care in planning, performing, and evaluating the results of the audit and must apply the appropriate level of professional skepticism to achieve reasonable assurance that the material errors and irregularities will be detected.

3.326 As part of audit planning, auditors should assess the risk that errors and irregularities may cause the financial statements to be materially misstated. The auditor's concern about the risk of material misstatements is either heightened or mitigated by the auditor's understanding of the internal control structure.

3.327 SAS No. 53 (AU 316.10) cites a number of management, operational, industry, and engagement characteristics that might cause the auditor to believe that there is an increased risk that material errors and irregularities could occur. Several of these characteristics, as they apply to not-for-profit organizations, are listed below:

- Management's attitude towards financial reporting is unduly aggressive.
- Operating and financing decisions are dominated by a single person.
- The entity operates in a declining industry, with many organizations failing.
- Many contentious or difficult accounting issues are present.
- Significant and unusual related-party transactions or balances are present.
- A large number of complex laws and regulations have a direct and material effect on the financial statements.
- Internal or external matters exist that raise substantial doubt about the entity's ability to continue as a going concern.

Completing or updating the Client Acceptance and Continuance Form (section 3.501), the Audit Planning Memorandum (section 3.508), the Internal Controls Questionnaire (Chapter 6, section 6.100) and the Risk of Potential Misstatements Evaluation Form (Chapter 5, section 5.701) provide a basis for assessing the risk that material errors and irregularities could occur.

3.328 **Design of the Audit.** Based on this assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that could have a material effect on the financial statements. This strategy might involve placing more experienced staff on the engagement, increasing supervision and review of assistants' work, testing more items, performing procedures at year end rather than at interim dates, or modifying the nature of auditing procedures to obtain more reliable evidential matter.

3.329 Evaluating the Audit Test Results. Auditors are accustomed to evaluating the impact of differences between the client's accounting records and the auditor's findings. This evaluation is emphasized in SAS No. 53 because irregularities have implications beyond their direct monetary effects.

3.330 SAS No. 53 requires that when the auditor concludes that a potential audit adjustment is related to an irregularity, but is not material to the financial statements, he or she should refer the matter to at least one level of management above those involved in the irregularity, and should be satisfied that the irregularity has no implications on other aspects of the audit. An example of an irregularity that would generally not be material to the financial statements is a misappropriation of petty cash.

3.331 If the auditor believes that the irregularity is or could be material to the financial statements, he or she should:

1. Consider the implications for other aspects of the audit.
2. Discuss the matter and the approach to further investigation with an appropriate level of management at least one level above those involved.
3. Attempt to obtain sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.
4. If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law.

3.332 Effect of Irregularities on the Auditor's Report. If financial statements affected by a material irregularity are not revised, the auditor should express either a qualified or adverse opinion, explaining all substantive reasons for the opinion. If the auditor is unable to perform necessary auditing procedures related to the irregularity, or if the auditor is unable to reach a conclusion about the financial statement effect of the irregularity, he or she should issue a disclaimer of opinion, or a qualified opinion due to a scope limitation. If management refuses to accept a modified auditor's opinion due to an irregularity, the auditor should withdraw from the audit.

3.333 In any event, the auditor should ensure that matters involving errors and irregularities are communicated to the audit committee or its equivalent. In addition, in the audit of a not-for-profit organization that receives financial assistance, the auditor may have a responsibility to communicate the irregularities to a funder or regulatory agency. The auditor should consider whether an understanding as to disclosure of any errors or irregularities discovered should be addressed in the engagement letter.

Illegal Acts

3.334 SAS No. 54, *Illegal Acts by Clients* (AU 317), prescribes the nature and extent of consideration an auditor should give to the possibility that the client has committed illegal acts, and also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

3.335 Paragraph 2 of SAS No. 54 (AU 317.02) defines illegal acts as "violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity." Determining whether an act is illegal is normally beyond the auditor's professional competence and would generally be based on an attorney's advice or on the findings of a court of law.

3.336 Of key importance to applying SAS No. 54 is an understanding of the difference between direct and indirect effects of laws and regulations. Direct effect laws and regulations are those that affect financial statement line items. For example, requirements concerning the individuals eligible for federal financial assistance have a direct effect on the amounts that will be reimbursed. Indirect effect laws and regulations are those that relate more to the organization's operations than to its financial statements, such as occupational safety and health and equal employment. While violations of these laws do not directly affect financial statement line items, they can result in monetary fines, penalties, and damages that could require adjustment to or disclosure in the financial statements. Understanding these two concepts is important because the auditor's responsibilities to detect and report direct-effect laws and regulations in a GAAS audit are different from the responsibilities to detect indirect-effect laws and regulations. Specifically, the auditor's responsibility to detect misstatements from illegal acts that have a direct and material effect on the financial statements is governed by SAS No. 53 (discussed in sections 3.322-3.326). SAS No. 54 applies to illegal acts related to indirect effect laws and regulations (hereinafter called simply "illegal acts").

3.337 The 1994 revision of the Yellow Book describes the auditor's responsibilities for detecting instances of noncompliance other than illegal acts. These other types of noncompliance include violations of provisions of contracts, grants, or agency policies and procedures. The Yellow Book indicates that the auditor should design the audit to provide reasonable assurance of detecting other instances of noncompliance that have a direct and material effect on the amounts in the financial statements.

3.338 SAS No. 54 does not require the auditor to design tests to detect illegal acts; however, the auditor must be aware that illegal acts may have occurred and must perform certain audit procedures to confirm the existence of illegal acts if such specific evidence is discovered. The Statement indicates that the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. If information provided by management is insufficient to determine whether an illegal act has occurred, the auditor should:

- Consult with the client's attorneys or other specialists about the application of laws and regulations relevant to the circumstances, and the possible effects on the financial statements.
- Apply additional procedures, if necessary, to obtain further understanding of the nature of the act.

3.339 If the auditor concludes that an illegal act has occurred, he or she must consider the implications (both qualitative and quantitative) of the illegal act on the auditor's report and the financial statements. Improper accounting or inadequate disclosure of a material illegal act could result in a qualified or adverse opinion, disclosing all substantive reasons for the opinion. If the auditor is unable to obtain sufficient competent evidential matter about a possible illegal act, the auditor would generally disclaim an opinion on the financial statements. If the client refuses to accept a modified auditor's report in these situations, the auditor should consider withdrawing from the engagement, and should communicate the reasons for withdrawal to the audit committee or its equivalent, or to the governing board.

3.340 In audits in accordance with the Yellow Book or OMB Circular A-133, the auditor has additional responsibilities regarding illegal acts. In an audit under the Yellow Book, the auditor must issue a report on the organization's compliance with laws and regulations based on the tests performed in the audit of the organization's financial statements. In an audit in accordance with OMB Circular A-133, the auditor must perform additional procedures for detecting violations of laws and regulations that could have a material effect on the organization's major and nonmajor federal award programs. The auditor must also perform tests of the specific requirements related to each major program and of the general requirements related to all programs. These additional procedures and reporting requirements are described in Chapter 4, "Compliance Auditing."

Make Preliminary Judgment About Materiality Levels

3.341 Overall Materiality. Under SAS No. 22, auditors are required to plan their audits to provide reasonable assurance that material misstatements will be detected. In meeting this requirement, auditors should establish a preliminary materiality threshold for the purpose of planning the appropriate auditing procedures to detect material misstatements in the financial statements.

3.342 Materiality Table. Obviously, quantifying the materiality level is a matter of professional judgment. Most auditors of not-for-profits base the preliminary materiality level on a percentage of some component of the client's financial statements, generally the greater of total assets or the sum of total revenues and other financial assistance. The following is a suggested scale that may be used in making a preliminary judgment about materiality.

Materiality Base — Greater of Total Assets or Total Revenues and Support: Over	But Not Over	Percentage of the Base
$ 0	$ 30,000	6.00%
30,000	100,000	$ 1,800 + 5.00% in excess of $ 30,000
100,000	300,000	$ 5,300 + 3.00% in excess of $ 100,000
300,000	1,000,000	$ 11,300 + 2.00% in excess of $ 300,000
1,000,000	3,000,000	$ 25,300 + 1.50% in excess of $ 1,000,000
3,000,000	10,000,000	$ 55,300 + 1.00% in excess of $ 3,000,000
10,000,000	30,000,000	$ 125,300 + 0.50% in excess of $ 10,000,000
30,000,000	100,000,000	$ 225,300 + 0.25% in excess of $ 30,000,000
100,000,000	300,000,000	$ 400,300 + 0.20% in excess of $ 100,000,000
300,000,000	—	$ 800,300 + 0.15% in excess of $ 300,000,000

3.343 As an illustration of the application of the table, assume that a not-for-profit organization has total assets of $80,000 and total revenues and support of $150,000. Using the larger materiality base, materiality for planning purposes would be calculated as follows:

$5,300 + [(150,000-100,000) x 3.0%] = $6,800

3.344 Because many audits are begun prior to year end, it is often necessary to estimate the financial statement bases (total assets and total revenue and support) for use in calculating planning materiality.

Usually these estimates are made based on the organization's year-to-date results, and considering any audit adjustments that are likely to be made. Audit adjustments from the prior period are often good predictors of adjustments that will be necessary in the current year.

3.345 Considering Adjustments to the Financial Statement Base. The materiality percentages presented above are those some firms use for audits of commercial businesses. Because of the unique aspects of the financial statements of not-for-profit organizations, the authors recommend that the auditor consider some adjustments to these bases. For example, interfund receivables and assets held in agency funds may inflate total assets; therefore, the auditor should consider deducting the amount of these assets in computing the materiality base. If total revenues and support is used as a base, the auditor may consider deducting from the base the value of any donated materials or services.

3.346 Some not-for-profit organizations report much smaller amounts of one financial statement base than another. For instance, an organization that tries to use as much of its resources as possible each year to accomplish its mission might have negligible total assets but sizable total revenues and support. Such an organization might have total assets of $50,000, and total revenue and support of $3,000,000. Use of total revenues and support in the sliding scale above would result in a preliminary materiality judgment of $55,300, which might lead to the conclusion that nothing on the balance sheet is material. On the other hand, a materiality calculated on the total assets base would be $2,800, which would be unrealistically low.

3.347 In these cases, the authors believe that using the larger of total assets or total revenue may still be appropriate. However, the auditor may want to consider reducing overall materiality somewhat to reflect the extreme difference between the two financial statement bases. As a matter of judgment, the auditor may consider adjusting the materiality to an amount that a creditor or other financial statement user would consider material. For instance, in a situation like that noted above (in which total assets are considerably less than total revenues and support), a reduction in the calculated overall materiality may be appropriate if there are significant assets that are used as collateral on loans.

3.348 This is affirmed by the Yellow Book, which states that "in an audit of the financial statements of an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions."

3.349 Materiality for OMB Circular A-133 Audits. In an audit of compliance with requirements governing major federal award programs in accordance with OMB Circular A-133, the auditor's consideration of materiality differs from that in an audit in accordance with GAAS. In a GAAS audit, materiality is considered in relation to the financial statements being audited (that is, at the total asset or total revenue level). However, in auditing an organization's compliance with requirements governing major federal award programs in accordance with Circular A-133, the materiality must be considered in relation to the total assets or total revenues of each major program. Therefore, planning materiality should be considered individually in designing the compliance tests for each major program. Materiality for a program that is being reported on separately is often set at five percent of total expenditures. A Materiality Computation Form for Major Programs is in section 3.510.

3.350 Using the Materiality Computation Form. A Materiality Computation Form is in section 3.509. This schedule should be used to compute the overall materiality limit, the basic allowance for unknown misstatements to be used in substantive tests of balances sampling, and the lower limit for individually significant items. The lower limit for individually significant items can be used to determine immaterial sampling populations and account balances for which no auditing procedures are necessary.

3.351 The overall materiality limit should be entered on the Summary of Possible Journal Entries Form (Chapter 8, section 8.904) during engagement planning. It is general guidance, rather than absolute and represents the allowance for both known and unknown misstatements. Known and unknown misstatements are considered to comprise 100% of the overall materiality limit; known misstatements being 1/3 and unknown misstatements being 2/3. The rationale used to establish engagement materiality limits should be documented on the Materiality Computation Form (section 3.509) and in the Audit Planning Memorandum (section 3.508).

Staff the Engagement and Plan for Supervision

3.352 As part of the planning process, the auditor should ensure that persons who work on a not-for-profit organization audit possess the appropriate technical training and proficiency. SQCS No. 1 states the basic quality control requirement for assigning personnel to engagements:

> Policies and procedures for assigning personnel to engagements should be established to provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for direct supervision.

3.353 The following should be considered in making assignments of individuals to not-for-profit engagements:

- Staffing and timing requirements of the specific not-for-profit engagement.
- Evaluation of qualifications of personnel regarding experience, position, background, and special expertise.
- The planned supervision and involvement by supervisory personnel.
- Projected time availability of individuals to be assigned.
- Situations where independence problems and conflicts of interest may exist or may appear to exist, such as assignment of personnel to engagements for clients who are former employers or are employers of certain kin.
- Continuity of personnel to provide an efficient audit, balanced against rotation of staff to provide other personnel with different experience.

3.354 Supervising personnel on an engagement is an ongoing process. However, at the initial planning stage of the engagement, supervision of personnel requires developing realistic estimates of the time that will be needed to perform and review the staff's work. Use of budgeting and time control documents facilitate effective engagement supervision and management. Although not required by professional standards, budget and time control analyses can help improve engagement profitability by identifying problems and inefficiencies early. Staff time should be recorded weekly on the Time Accumulation Sheet (section 3.505), with total engagement time summarized on the Time Summary Form (section 3.506) and compared to budget. These documents have been designed for use in all audit engagements of not-for-profit organizations in excess of forty hours. Used consistently, they will make staff more conscious of the efficient use of time, cause staff to become more creative in performing engagements, create opportunities for communicating problems to engagement partners, and contribute to increased engagement and firm profitability.

3.355 For budgets to benefit the firm and engagement personnel, they must first be realistically prepared. Budgets must be based on engagement circumstances, not on fees. All time spent on engagements must be charged to the client and entered on the Time Accumulation Sheet in section 3.505. At the completion of the engagement, the Time Accumulation Sheet should be reconciled to the firm's client Time Summary Form in section 3.506 and to the firm's billing records. For engagements extending beyond one week of field work, the time should be accumulated and recorded on the Time Accumulation Summary. If the staff becomes aware of ways to reduce audit time in the future, the suggestions should be noted on the Summary of Time Savings for Next Year Form found in section 3.507.

Decide on the Most Cost-Beneficial Audit Approach

3.356 Two audit approaches are presented in this Manual: the ABC System and the All Substantive Approach. The ABC System should be used if the organization has a good accounting system, and strong internal control structure policies and procedures. This system allows the auditor to assess control risk at below the maximum for each major audit area, and to design an audit strategy that achieves the appropriate mix of tests of controls, analytical procedures, and substantive tests of balances. It also provides for testing at interim dates.

3.357 Under the ABC System, completion of the following documents helps the auditor develop a cost-beneficial audit approach:

- The Client Acceptance and Continuance Form and the Audit Planning Memorandum, which require the auditor to inquire about situations that could affect the audit approach.
- The Internal Controls Questionnaire, which provides an understanding of the organization's control structure and a preliminary decision about the assessed level of control risk.
- The Risk of Potential Misstatements Evaluation Form, which is used to assess the risk that errors and irregularities could occur.
- The Planning Matrix, which combines the findings from the above forms and results in an audit strategy (that is, nature, timing, and extent of tests) for each major audit area.

The ABC System should be used on all engagements that require compliance testing under OMB Circular A-133.

3.358 The All Substantive Approach should be used on engagements for which a substantive approach is the most cost-beneficial. Under this approach, control risk is assessed at the maximum (or slightly below the maximum) and no or little reliance is placed on tests of controls. This approach requires that all testing be done as of the balance-sheet date. If the organization is subject to the requirements of OMB Circular A-133, this approach would not be appropriate.

3.359 Completion of the following forms will help the auditor plan the most cost-beneficial approach under the All Substantive Approach:

- The Client Acceptance and Continuance Form and the Audit Planning Memorandum, which require the auditor to obtain information about situations that could affect the audit approach.
- The All Substantive Approach Questionnaire, which provides an understanding of the organization's control structure and an evaluation of the risk of potential misstatements.

Perform Analytical Procedures

3.360 SAS No. 56, *Analytical Procedures* (AU 329), provides that analytical procedures be used for the following three purposes:

- In the planning stage, to plan the nature, timing, and extent of other auditing procedures.
- As a substantive test, to obtain evidential matter about financial statement assertions.
- In the final review stage, as an overall review of the financial information.

3.361 The purpose of analytical procedures performed during the planning stage of an audit is to identify unusual transactions or events and any areas that represent specific risks, so that the auditor can plan an appropriate audit strategy, i.e., the appropriate nature, timing, and extent of tests.

3.362 Analytical procedures performed during planning are often very simple. For example, they may consist of a review of fluctuations in account balances using the current and prior year's trial balances. Larger, more sophisticated not-for-profit organizations may warrant a review in greater detail, using quarterly or monthly financial information or information for each location or program.

3.363 The auditor should document the procedures and results of the planning analytical procedures performed in the Audit Planning Memorandum in section 3.508, and communicate his or her observations to the audit team. Further audit testing should be modified based on the results of the analytical procedures performed. The auditor should also document the modification of audit testing as a result of planning analytical procedures. Analytical procedures performed as a substantive test and at the final review stage are discussed in Chapters 7 and 8, respectively.

3.400 DOCUMENTING AUDIT PLANNING DECISIONS

3.401 The Audit Planning Memorandum in section 3.508 is the culmination of the planning process and should be prepared for all audit engagements for not-for-profit organizations. It is critical to achieving both engagement quality and profitability. The Memorandum should be prepared by the engagement in-charge and approved by the engagement partner before engagement personnel begin field work. It can be prepared using the form in section 3.508 or in a handwritten or typed narrative.

3.402 The Audit Planning Memorandum is comprised of Section I, Engagement Administration, and Section II, Technical Audit Planning Decisions. A few words about section subheadings follow:

I. A. Presentation of Engagement Letter

The engagement letter is a primary tool for obtaining client understanding of the firm's and client's responsibilities. A good understanding before the engagement begins can prevent misunderstandings later. To gain a good understanding, the engagement partner should deliver the letter and discuss its contents with the organization's audit committee or persons of equivalent authority, such as the governing board, or with management.

I. B. Use of Client Assistance or Paraprofessionals

The schedule attached to the Client Acceptance and Continuance Form lists possible areas of client assistance. Client assistance should be used to the maximum extent possible on every engagement. When client personnel are unavailable, the use of firm paraprofessionals to perform any necessary accounting services and clerical work in connection with the engagement should be considered.

I. C. Planning for Proper Work Space and Equipment

The engagement in-charge has responsibility for arranging adequate work space before the field work begins. Poor lighting, lack of adequate heat or air conditioning, desks or tables that are too small, or work locations that are not near client accounting personnel are examples of situations that hinder the efficient completion of an engagement.

I. D. Assignment of Staff

A basic element of a good quality control system is assigning personnel to engagements and to tasks that are commensurate with their capabilities. Assigning the right people to engagements also helps complete the engagements in the minimum amount of time.

Whenever possible, the prior year's engagement personnel should be reassigned and rotated to new positions on the engagement each year. When reassignment is not possible, an attempt should be made to assign new staff with experience with not-for-profit organizations. When inexperienced personnel, or personnel unfamiliar with not-for-profit organizations, are assigned to an engagement, the in-charge or partner is responsible for providing appropriate training.

I. E. Target Dates

Setting target dates during planning is the first step to achieving timely engagement completion. These target dates should also become the input to the firm's staff scheduling system.

I. F. Use of Specialists

The firm should consider using outside specialists whenever audit procedures require knowledge or skills beyond the auditing firm's expertise. Such areas may include actuarial computations for pension funds, appraisals of collections of art or other similar items, questions of law, or audits designed using clients' EDP systems.

I. G. Use of Audit Software

Audit software should be used to the maximum extent practical on all engagements. This section should list the specific, planned applications.

I. H. Audit Budget

The audit budget should be prepared, at least tentatively, prior to beginning field work. The budget should be based on circumstances, not on fees. The budget documents should be summarized in this section for discussion with the partner.

I. I. Other Special Considerations:

This section is provided to document any significant engagement administration circumstances or problems not covered above.

II. A.-F. Technical Audit Planning Decisions

Each section should present the results of the decisions, as well as the rationale, or judgments, behind them. Detailed computations or explanations should be either included or incorporated by reference to other working papers or forms. Section II.E. must include documentation about the assessed level of control risk if the assessed level of control risk is below the maximum.

II. G. Planning Analytical Procedures

Analytical procedures used in planning the audit should focus on enhancing the auditor's understanding of the client's operations and transactions and events that have occurred since the last audit, and on identifying areas that may present significant audit risks. Such procedures range from reviewing changes from the prior year to the current year's working trial balances, to more extensive analyses using quarterly financial information. Documentation should include a description of the types of analytical procedures used, a summary of the results obtained and the impact these procedures have on the nature, timing and extent of audit procedures to be performed.

II. H. Other Special Considerations

Special risks of misstatements, irregularities, or illegal acts, or any other accounting or auditing problems discovered during planning, should be discussed in this section. The situation, its possible impact on financial statements, and the planned modification of auditing procedures should be detailed for consideration and approval by the partner.

3.500 DOCUMENTATION ASSISTANCE

3.501

Client Acceptance and Continuance Form— Not-for-Profit Organizations	Part I
Client: ____________	
Financial Statement Date: ____________	

INSTRUCTIONS:

Part I: Part I of this form should be completed for all prospective not-for-profit organization clients for which an audit is to be performed. This Form should be prepared as a basis for initially accepting the client, and should be updated and reviewed annually as a basis for deciding to retain the client.

Part II: Part II of this Form should be completed by the engagement partner and concurring partner to document the firm's decision to accept or reject the client.

CLIENT'S LEGAL NAME:

ADDRESS:

PHONE:

FEDERAL I.D. NO.:	STATE I.D. NO.:

1. Describe the nature of the organization's activities (and locations, if other than above address):

2. List officers and directors of the organization:

Name	Position

3. Identify any related businesses, organizations or individuals, and for any related organizations, describe the client's control, if any, of the other organization, and the client's financial interest, if any, in the other organization:

Name	Nature of Relationship

4. Identify the client's predecessor accountants:

Name:
Address:
Phone:
Contact Person:

5. Indicate the results of our inquiries of the predecessor accountants regarding the following:

a. Reasons for change of accountants: ______________________

b. Integrity of management or governing board: ______________________

c. Disagreements on accounting principles and auditing procedures: ______________________

d. Fee disputes: ______________________________

6. Describe the client's relationships with financial institutions: ______________________________

Institution	Type of A/Cs or Loans	Account Executive & Phone

Results of inquiries: ______________________________

7. Describe the services to be provided: ______________________________

Service	How Often? Monthly	Quarterly	Annually	Report Deadlines

8. Describe below any special auditing procedures, reports, and/or financial statement formats the organization is required to provide to funding agencies or grantors (such as special compliance procedures and reports required under OMB Circular A-133 for organizations that receive federal awards):

____

9. Will the financial statements and reports be used for high-risk purposes, to obtain or renew significant amounts of credit or for solicitation of funds? If so, describe use of the financial statements: ______________________________

____

10. Read the latest financial statements and tax (or information) returns and indicate findings:

Item Reviewed	As of	Findings

11. Does the client have potential going-concern problems? If so, describe them:

12. Identify the client's legal counsel:

Name:
Address:
Phone:
Contact Person:

Results of inquiries: ______________________________

____

13. State name(s) of other third parties contacted concerning management's reputation, attitude, ability, and integrity:

14. Describe any significant engagement performance, accounting, or tax problems with which we should be concerned:

15. Describe any pending litigation against the client, management, or its governing board members:

16. Describe the fee/billing arrangements:

17. Describe any potential independence problems with respect to the client:

18. Describe any other major changes not mentioned above since our last evaluation of this client. Also describe any other matters that have come to our attention that would have caused us to reject the client had we been aware of them at the time of our initial acceptance of this client.

	19__	19__	19__	19__	19__	19__	19__
Prepared or Updated by: In-Charge	___	___	___	___	___	___	___
Reviewed by: Partner	___	___	___	___	___	___	___

Client Acceptance and Continuance Form—Not-for-Profit Organizations — Part II

Client: ____________________

Financial Statement Date: ____________________

	Yes	No
1. Is there any reason to doubt the integrity of management or the governing board?	☐	☐
2. Are we aware of any significant disagreements between management or the governing board and the predecessor accountant?	☐	☐
3. Does there appear to be any potential fee collection problems?	☐	☐
4. Are the client's needs beyond our capabilities or staffing abilities?	☐	☐
5. Are we aware of any independence problems that may affect our ability to meet the client's needs?	☐	☐
6. Are there high-risk factors related to the engagement that may affect our decision to accept the client?	☐	☐
7. Is there a potential problem with management or governing board not fully understanding the limitations of the services to be provided (e.g., for the detection of fraud)?	☐	☐

For any "Yes" answers, explain how we plan to mitigate the problem (for example, by assigning more experienced personnel to the engagement, obtaining outside consultants, obtaining a retainer from the client, etc.):

Acceptance Decision:

Yes _____ No _____

Engagement Partner: ____________________ Date: __________

Concurring Partner: ____________________ Date: __________

3.502

ENGAGEMENT LETTER— AUDIT OF FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ORGANIZATIONS IN ACCORDANCE WITH GAAS

[CPA Firm Letterhead]

[Date]

____
____
____

This will confirm our understanding of the arrangements for our audit of the financial statements of ______________________________ [name of organization], for the year ended ________ [financial statement date].

We will audit the Organization's statement of financial position at ________ [financial statement date], and the related statements of activities and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed an cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

We will review the Organization's federal and state [identify states] information and tax returns for the fiscal year ended ____________ [financial statement date].

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fees for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We are pleased to have this opportunity to serve you.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

[Partner's Name]
[Firm's Name]

Acknowledged:

____
[Client Representative's Name]

____
[Title]

____
[Date]

3.503 ENGAGEMENT LETTER— AUDIT OF FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ORGANIZATIONS UNDER GOVERNMENT AUDITING STANDARDS

[CPA Firm Letterhead]

[Date]

____
____
____

This will confirm our understanding of the arrangements for our audit of the financial statements of ______________________ [name of organization], for the year ended ________ [financial statement date].

We will audit the Organization's statement of financial position at ________ [financial statement date], and the related statements of activities and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards and the standards for financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence that supports the amounts and disclosures included in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed an cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

We will prepare a separate written report on our understanding of the organization's internal control structure and the assessment of control risk made as part of the financial statement audit. Our report will include (1) the scope of our work in obtaining an understanding of the internal control structure and in assessing control risk; (2) the organization's significant internal controls or control structure, including the controls established to ensure compliance with laws and regulations that have a material impact on the financial statements; and (3) the reportable conditions, including the identification of material weaknesses identified as a result of our work in understanding and assessing control risk.

Compliance with laws, regulations, contracts, and grants applicable to _______ [name of organization] is the responsibility of _______ [name of organization]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we will perform tests of ____________ [name of organization]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective is not to provide an opinion on overall compliance with such provisions.

As required by *Government Auditing Standards*, we will report on our tests of compliance with applicable laws and regulations. Our separate report will contain a description of all irregularities or illegal acts noted unless clearly inconsequential and all other instances of noncompliance that are material to the financial statements.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

We understand that our reports on the internal control structure as part of the financial statement audit and on compliance with laws and regulations are intended for the information of the audit committee, management, and within _________ [name of organization] and ___________ [specify legislative or regulatory body].

We will review the Organization's federal and state [identify states] information and tax returns for the fiscal year ended ____________ [financial statement date].

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fees for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We are pleased to have this opportunity to serve you.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

[Partner's Name]
[Firm's Name]

Acknowledged:

____
[Client Representative's Name]

____
[Title]

____
[Date]

3.504 ENGAGEMENT LETTER— AUDIT OF FINANCIAL STATEMENTS OF NOT-FOR-PROFIT ORGANIZATIONS UNDER OMB CIRCULAR A-133

[CPA Firm Letterhead]

[Date]

____
____
____

This will confirm our understanding of the arrangements for our audit of the financial statements of ____________________ [name of organization], for the year ended ________ [financial statement date].

We will audit the Organization's statement of financial position at ________ [financial statement date], and the related statements of activities and cash flows for the year then ended, for the purpose of expressing an opinion on them. The financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on the financial statements based on our audit.

We will conduct our audit in accordance with generally accepted auditing standards and the standards for financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and with the provisions of Office of Management and Budget Circular A-133, dated March 8, 1990.[1] The objective of an audit carried out in accordance with such standards and regulations is (1) the expression of an opinion concerning whether the financial statements are free of material misstatement; (2) the issuance of a report on whether the internal control structure provides reasonable assurance of compliance with federal and other laws and regulations; and (3) the expression of an opinion on whether the organization complied with specific terms and conditions of its major federal award programs. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit will provide a reasonable basis for our opinion.

Our procedures will include tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventories, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and banks. At the conclusion of our audit, we will request certain written representations from you about the financial statements and matters related thereto.

[1] The Office of Management and Budget (OMB) is currently revising Circular A-133. The OMB expects to publish the revised Circular A-133, which will be effective for fiscal years beginning on or after January 1, 1996, in the *Federal Register* in the fourth quarter of 1995. See Chapter 4, section 4.009 and Illustration No. 4-1 for further details.

Although the audit is designed to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements, it is not designed and cannot be relied upon to disclose all fraud, defalcations or other irregularities. However, we will inform you of any material errors, and all irregularities or illegal acts, unless they are clearly inconsequential, that come to our attention.

We will prepare a separate written report on our understanding of the organization's internal control structure and the assessment of control risk made as part of the financial statement audit. Our report will include (1) the scope of our work in obtaining an understanding of the internal control structure and in assessing control risk; (2) the organization's significant internal controls or control structure, including the controls established to ensure compliance with laws and regulations that have a material impact on the financial statements; and (3) the reportable conditions, including the identification of material weaknesses identified as a result of our work in understanding and assessing control risk. As required by OMB Circular A-133, we will also prepare a written report on our understanding, assessment, and testing of the internal control structure as it relates to major (and nonmajor, if applicable) federal award programs.

Compliance with laws, regulations, contracts, and grants applicable to _______ [name of organization] is the responsibility of _______ [name of organization]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we will perform tests of ____________ [name of organization]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, our objective is not to provide an opinion on overall compliance with such provisions.

As required by *Government Auditing Standards*, we will report on our tests of compliance with applicable laws and regulations. Our separate report will contain a description of all irregularities or illegal acts noted unless clearly inconsequential and all other instances of noncompliance that are material to the financial statements.

As required by OMB Circular A-133, we will determine and report on whether the organization complied in all material respects with the laws and regulations that apply to its major federal award programs. We will also perform tests of compliance with the general requirements that apply to all federal programs. With regard to transactions selected from nonmajor programs, our report on compliance will contain a statement of positive assurance on those items that were tested for compliance, and negative assurance on those items not tested.

If you intend to publish or otherwise reproduce the financial statements and make reference to our firm, you agree to provide us with printers' proofs or masters for our review and approval before printing. You also agree to provide us with a copy of the final reproduced material for our approval before it is distributed.

We understand that our reports on the internal control structure as part of the financial statement audit and on compliance with laws and regulations are intended for the information of the audit committee, management, and others within ________ [name of organization] and __________ [specify legislative or regulatory body].

We will review the Organization's federal and state [identify states] information and tax returns for the fiscal year ended ____________ [financial statement date].

Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Our fees for these services will be at our regular per diem rates, plus travel and other out-of-pocket costs. Invoices will be rendered every two weeks and are payable on presentation.

We are pleased to have this opportunity to serve you.

If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Very truly yours,

[Partner's Name]
[Firm's Name]

Acknowledged:

____
[Client Representative's Name]

____
[Title]

____
[Date]

Time Accumulation Sheet

Client: ______________________

Financial Statement Date: ______________________

		ACTUAL HOURS AND DATE																	
WORK AREAS	Budget						Sub-total						Sub-total						Total
Planning & administration																			
Internal control structure																			
Cash																			
Investments																			
Receivables																			
Inventories																			
Other assets																			
Property & equipment																			
Notes & loans payable																			
Payables & accruals																			
Taxes																			
Other liabilities																			
Fund balances																			
Revenues																			
Expenses																			
Tests of compliance with laws and regulations																			
Commitments, contingencies, & subsequent events																			
Related parties																			
Trial balance & adjustments																			
Supervision & review																			
Management letter																			
Report preparation																			
TOTAL																			

3.506

Time Summary Form

Client: ____________________

Financial Statement Date: ____________________

	Budgeted Hours					Actual Hours					Actual Hours Over
	Asst.	I/C	Mgr.	Ptr.	Total	Asst.	I/C	Mgr.	Ptr.	Total	(Under)*
Planning & administration											
Internal control structure											
Cash											
Investments											
Receivables											
Inventories											
Other assets											
Property & equipment											
Notes & loans payable											
Payables & accruals											
Taxes											
Other liabilities											
Fund balances											
Revenues											
Expenses											
Tests of compliance with laws and regulations											
Commitments, contingencies, & subsequent events											
Related parties											
Trial balance & adjustments											
Supervision & review											
Management letter											
Report preparation											
TOTAL											

* Attach memorandum explaining significant variances.

3.507

Summary of Time Savings for Next Year

Client: ____________________

Financial Statement Date: ____________________

SAVINGS SUGGESTIONS

3.508

Audit Planning Memorandum

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This memorandum should be completed for all audit engagements by the in-charge and reviewed by the engagement partner, before engagement personnel begin field work.

I. ENGAGEMENT ADMINISTRATION

A. Presentation of Engagement Letter

____
____
____
____
____

B. Use of Client Assistance or Paraprofessionals

____
____
____
____
____

C. Planning for Proper Work Space and Equipment

____
____
____
____
____

D. Assignment of Staff

____
____
____
____
____

E. Target Dates

Audit report ______
Management letter ______
Tax returns ______
Start of interim field work ______
Start of year-end field work ______
Other ______

F. Use of Specialists

G. Use of Audit Software

H. Audit Budget

I. Other Special Considerations

II. TECHNICAL AUDIT PLANNING DECISIONS

A. Overall Engagement Risk

B. Understanding of Internal Control Structure

C. Overall Materiality Limit

____

D. Sampling

____

E. Audit Approach

____

F. Key Engagement Area(s)

____

G. Planning Analytical Procedures

____

H. Other Special Considerations

____

Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Partner)

3.509

Materiality Computation Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed by the in-charge during planning and approved by the partner before field work is started. Separate materiality computations should be made for compliance tests of each major federal award program under OMB Circular A-133 (see section 3.510).

I. Overall Materiality Limit Computation:

Approximate balances at or near financial statement date:

A. Total Assets $__________ × __________% + __________ = $__________

B. Total Revenue and Support $__________ × __________% + __________ = $__________

Overall Materiality Limit $__________

Materiality Base — Greater of Total Assets or Total Revenues and Support		**Percentage of the Base**
Over	**But Not Over**	
$ 0	$ 30,000	6.00%
30,000	100,000	$ 1,800 + 5.00% in excess of $ 30,000
100,000	300,000	$ 5,300 + 3.00% in excess of $ 100,000
300,000	1,000,000	$ 11,300 + 2.00% in excess of $ 300,000
1,000,000	3,000,000	$ 25,300 + 1.50% in excess of $ 1,000,000
3,000,000	10,000,000	$ 55,300 + 1.00% in excess of $ 3,000,000
10,000,000	30,000,000	$ 125,300 + 0.50% in excess of $ 10,000,000
30,000,000	100,000,000	$ 225,300 + 0.25% in excess of $ 30,000,000
100,000,000	300,000,000	$ 400,300 + 0.20% in excess of $ 100,000,000
300,000,000	—	$ 800,300 + 0.15% in excess of $ 300,000,000

Rationale for overall materiality limit (if other than the larger of above computations):

____

____

____

____

____

II. Basic Allowance for Unknown Misstatement Computation:

For nonstatistical sampling applications, the basic allowance can be used in place of tolerable misstatement amount. If used in the table approach or model approach, it should also be considered when comparing total actual, projected and estimated misstatement to the final financial statement amounts.

Overall materiality limit from above	$ ________
Less estimated known misstatement from sampling and nonsampling tests (e.g., 1/3 of overall materiality)	$ ________
Basic allowance for unknown misstatement	$ ________

III. Individually Significant Items — Computation of Lower Limit:

The lower limit for individually significant items will usually be set at 1/3 of the basic allowance. Individually significant items may also be determined judgmentally for each sampling application. The rationale for such judgmentally determined limits should be explained at the bottom of the page.

Lower limit for individually significant items $ ________

Rationale for lower limit:

This uniform lower limit will normally be used for determining individually significant items to derive sampling populations and for determining sampling populations and account balances that are not material which can be excluded from testing.

If different lower limits are used for certain accounts, or for such procedures as sales and purchases cutoff tests and search for unrecorded liabilities, the reasons for their use should be documented below:

3.510

Materiality Computation Form — Major Programs

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS:

This form should be completed for audits under OMB Circular A-133 by the in-charge during planning and approved by the engagement partner before field work is started. The form is designed to establish the level of materiality for performing compliance auditing of major programs. It may be used to identify individually significant expenditures, and to determine sample sizes for tests of compliance.

I. Major Program Materiality Computation:

Major Program	Total Federal Support	Program Materiality
____________________	$__________	$__________
____________________	$__________	$__________
____________________	$__________	$__________
____________________	$__________	$__________

Total Federal Support: Over	Total Federal Support: But Not Over	Percentage
$ 0	$ 30,000	6.00%
30,000	100,000	$ 1,800 + 5.00% in excess of $ 30,000
100,000	300,000	$ 5,300 + 3.00% in excess of $ 100,000
300,000	1,000,000	$ 11,300 + 2.00% in excess of $ 300,000
1,000,000	3,000,000	$ 25,300 + 1.50% in excess of $ 1,000,000
3,000,000	10,000,000	$ 55,300 + 1.00% in excess of $ 3,000,000
10,000,000	30,000,000	$ 125,300 + 0.50% in excess of $ 10,000,000
30,000,000	100,000,000	$ 225,300 + 0.25% in excess of $ 30,000,000
100,000,000	300,000,000	$ 400,300 + 0.20% in excess of $ 100,000,000
300,000,000	—	$ 800,300 + 0.15% in excess of $ 300,000,000

Compliance Auditing

CHAPTER 4

COMPLIANCE AUDITING

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COMPLIANCE AUDITING

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COMPLIANCE AUDITING

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CHAPTER 4

COMPLIANCE AUDITING

4.000 WHAT IS COMPLIANCE AUDITING?

4.001 Compliance auditing is designed to determine whether an organization has violated laws, regulations, or contractual requirements. The objectives of performing compliance auditing procedures are to (1) determine whether there have been violations of laws, regulations, or contractual requirements that may have a material effect on the organization's financial statements, and (2) provide a basis for additional reports on compliance with laws, regulations, and contractual requirements. Compliance procedures are not tests of the organization's control policies and procedures. They are substantive tests, usually accomplished by examining supporting documents.

Compliance Auditing in GAAS Audits

4.002 The auditor's responsibilities for performing compliance auditing procedures in audits under generally accepted auditing standards (GAAS) are described in SAS No. 54, *Illegal Acts by Clients*, and SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, as elaborated in SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*. If SAS No. 74 has not yet been adopted, the auditor should follow the guidance in SAS No. 68, *Compliance Auditing Applicable to Governmental Entities and Recipients of Governmental Financial Assistance.*[1] The above standards require the auditor to design his or her audits to provide reasonable assurance of detecting material misstatements resulting from violations of laws, regulations, grants, and contractual requirements that have a direct and material effect on line-item amounts in the financial statements.

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[1] In February 1995 the AICPA Auditing Standards Board issued SAS 74, which supersedes SAS 68. SAS 74 does not include the specific guidance on the requirements of *Government Auditing Standards*, single audit, or OMB Circular A-133, found in SAS 68. Rather, SAS 74 makes only general reference to these requirements. As a result, revisions to a SAS are no longer needed each time changes are made to the above noted guidance. There are no other significant differences between SAS 74 and SAS 68.

The provisions of SAS 74 are effective for audits of financial statements and of compliance with laws and regulations for fiscal periods ending after December 31, 1994. Early application is encouraged. This 1995 edition of the manual incorporates the guidance of SAS 74 and references to SAS 68 have been removed. If you are performing an audit for a period ending on or before December 31, 1994, you may continue to follow the guidance set forth in SAS 68; however, the authors encourage you to apply SAS 74.

4.003 Not-for-profit organizations often are subject to a variety of laws, regulations, and contractual agreements with government funding sources that affect their financial statements. However, restrictions from government funding sources are not the only concern. Not-for-profit organizations are often subject to contractual restrictions from private funding sources. An important aspect of generally accepted accounting principles (GAAP) for not-for-profit organizations is the recognition of various legal and contractual requirements. These requirements are reflected in their bases of accounting, fund structure, and other accounting methods. Therefore, in performing an audit of a not-for-profit organization's financial statements in accordance with GAAS, the auditor is more likely to encounter laws, regulations, and contractual requirements that have a direct and material effect on the amounts in the financial statements than in performing an audit of a commercial entity.

Compliance Auditing for Audits in Accordance with *Government Auditing Standards*

> This chapter has been fully revised to reflect the new reporting requirements of the 1994 Yellow Book but maintains the reporting examples of the 1988 Yellow Book.

4.004 A not-for-profit organization must have an audit in accordance with *Generally Accepted Government Auditing Standards* (GAGAS) when it is required by law, regulation, agreement, contract, or policy. Generally, this type of audit is required when the not-for-profit organization receives governmental financial assistance. *Government Auditing Standards* are developed by the General Accounting Office (GAO) and are set forth in *Government Auditing Standards*.

4.005 In June 1994, the General Accounting Office (GAO) issued a revision of the 1988 *Government Auditing Standards*, (the Yellow Book). The provisions of the 1994 Yellow Book are effective for financial audits of periods ending on or after January 1, 1995, and for performance audits beginning on or after January 1, 1995. Some of the more important changes to the Yellow Book made in this revision are as follows:

- When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit performed in accordance with generally accepted government auditing standards (GAGAS), it should specifically cite GAGAS.

- GAGAS allows the issuance of reports for purposes other than to comply with the requirements called for in a GAGAS audit. In other words, if appropriate, the auditee may obtain an audit in conformity with GAAS in addition to that obtained in accordance with GAGAS, if that is what best suits its needs.

- Auditors will now be required to report the scope of testing on internal controls and compliance with laws and regulations, and disclose whether these tests were sufficient to support an opinion on internal controls and compliance with laws and regulations. This replaces the requirement to specify internal control categories tested, and to provide positive and negative assurance on compliance.

To obtain a copy of the 1994 Yellow Book call the Government Printing Office at (202) 512-1800 or fax them at (202) 512-2250. Ask for stock number 020-000-00-265-4.

4.006 Chapter 4, section 4.300 of this Manual describes performance and reporting requirements required for audits performed in accordance with GAGAS.

Practice Tip:

The Yellow Book also includes requirements related to direct reporting of irregularities and illegal acts, quality control, and continuing professional education.

Compliance Auditing in Organization-Wide Audits

4.007 OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*, contains the audit requirements for not-for-profit organizations receiving federal awards either directly or indirectly. With certain exceptions, not-for-profit organizations that receive over $25,000 per year in federal awards are subject to the requirements of OMB Circular A-133. In performing an audit in accordance with Circular A-133, the auditor is required to perform compliance procedures beyond those required by GAAS. Specifically the auditor is required to test and report on:

- Compliance with laws and regulations that may have a direct and material effect on the organization's financial statement amounts (i.e., tests are required by GAAS but the report is required by GAGAS).
- Compliance with the general requirements applicable to the federal awards programs.
- Compliance with the specific requirements that may have a direct and material effect on each major program.
- Compliance with certain laws and regulations applicable to nonmajor federal award programs.

4.008 Other requirements of OMB Circular A-133 are reports on the financial statements, on the supplementary schedule of federal awards, and on internal control structure policies and procedures relevant to federal award programs.

4.009 At the publication date of this Manual, the OMB was in the process of revising OMB Circular A-133. The proposed revisions, as published in the March 17, 1995 *Federal Register* are summarized in Illustration No. 4-1. The proposed circular is expected to apply to audits of not-for-profit organizations for fiscal years beginning on or after January 1, 1996 and is expected to be issued in late 1995.

ILLUSTRATION NO. 4-1

The significant provisions of the proposed revisions include the following:

- The threshold for when a not-for-profit organization is required to have an audit in accordance with OMB Circular A-133 is raised from $25,000 to $300,000 in federal financial assistance.
- Low risk organizations (as defined by the Circular) that receive more than $300,000 in federal financial assistance would be required to have an audit in accordance with Circular A-133 only on a triennial basis. In the off-years, the organization would be required to have an audit of its financial statements in accordance with GAGAS, along with additional tests of the organization's internal controls.
- Determining major programs would be based upon a risk assessment rather than the dollar amount of a federal program expenditures.
- A clarification that the auditor's required tests of internal controls over major programs should be based on the auditor's planning for a low assessed level of control risk.
- Guidance on the minimum requirements for the Schedule of Federal Awards.
- Raising the issue of whether there should be a management assertion or auditor attestation on internal controls or compliance.
- New guidance on reporting of audit findings and follow-up procedures.
- The definition of a not-for-profit organization is changed to include non-profit hospitals.

4.010 The 1994 revision of the Yellow Book deletes the requirement to describe categories of internal controls and the requirement to express positive and negative assurance on compliance with laws and regulations. These changes, however, have no effect on auditor reporting on internal controls and compliance relating to federal financial assistance under OMB Circular A-133. OMB Circular A-133 continues to require auditors to identify the categories of significant internal accounting controls, and those controls designed to provide reasonable assurance that federal programs are being managed in compliance with laws and regulations. Further, with respect to the auditor's report on compliance, OMB Circular A-133 continues to require positive assurance on those items tested and negative assurance on those items not tested. Therefore, auditors should continue to use the reports on internal controls and compliance relating to federal financial assistance included in the Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*, Appendix C, Examples D-8 through D-18.

Federal Government Pronouncements Applicable to Compliance Audits of Not-For-Profit Organizations

4.011 A number of pronouncements have been issued by the federal government to provide guidance applicable to compliance audits of not-for-profit organizations. Some of the major pronouncements and a brief description of their content are included below:

Pronouncements	Content
OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions* (currently being modified)	Establishes organization-wide audit requirements applicable to not-for-profit organizations that receive federal awards.
OMB *Compliance Supplement for Audits of Institutions of Higher Learning and Other Nonprofit Institutions*	Describes compliance requirements and procedures that should be considered in audits of not-for-profit organizations that receive federal awards.
President's Council on Integrity and Efficiency (PCIE) Position Statement No. 6, *Questions and Answers on OMB Circular A-133*	Provides additional guidance for audits performed under OMB Circular A-133.
OMB Circular A-110, *Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations—Uniform Administrative Requirements*	Prescribes uniform administrative requirements for federal awards with institutions of higher education, hospitals, and other not-for-profit organizations.
OMB *Common Rule for Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments*	Establishes uniform terms and conditions for federal grants to state and local governments.
OMB *Compliance Supplement for Single Audits of State and Local Governments*	Sets forth the general requirements for all federal financial assistance programs and the specific requirements for a number of programs.
OMB *Catalog of Federal Domestic Assistance*	Provides a list of federal assistance programs and provides their catalog numbers.
OMB Circular A-21, *Cost Principles for Educational Institutions* (currently being modified)	Establishes cost accounting principles for federal grants provided to educational institutions.
OMB Circular A-122, *Cost Principles for Nonprofit Organizations* (currently being modified)	Establishes cost accounting principles for federal awards provided to other not-for-profit organizations.

4.100 DETERMINING THE ORGANIZATION'S AUDIT REQUIREMENTS

4.101 Because a not-for-profit organization may be subject to a number of federal, state, or local audit requirements, the auditor should exercise due professional care in ensuring that management understands the type of engagement the organization needs to have performed—a GAAS audit, an audit in accordance with *Government Auditing Standards*, or an audit in accordance with OMB Circular A-133.

4.102 An audit in accordance with *Government Auditing Standards* may be required by law, regulation, or agreement with a funding agency. An audit in accordance with OMB Circular A-133 is required when the organization receives specified amounts of federal awards (see sections 4.402–4.404), or when a state or local funding agency requires such an audit.

4.103 Management is responsible for obtaining audits that satisfy the requirements of relevant legal, regulatory, or contractual requirements. However, if in the course of performing a GAAS audit, the auditor obtains information that indicates that a GAAS audit will not satisfy the organization's audit requirements, he or she should communicate this fact to management and the audit committee (or others with equivalent authority and responsibility, such as the board of trustees).

Practice Tip:

You should be alert for other compliance audit requirements, such as those required by state and local governments providing grants. These requirements may be contained in the terms of the grant or other guidance issued by the agency.

4.200 PERFORMING A GAAS AUDIT

4.201 When performing the audit of a not-for-profit organization, the auditor should consider federal, state, and local laws and regulations that are generally recognized to have a direct and material effect on the determination of financial statement amounts. Specifically, the auditor should:

- Assess whether management has identified laws and regulations that have a direct and material effect on the financial statements.
- Become familiar with those laws and regulations that could have a direct and material effect on the financial statements.
- Understand the characteristics of those laws and regulations that, if violated, could have a material effect on financial statement amounts.
- Assess the risk that a material misstatement has occurred because of such noncompliance.
- Design and conduct an audit to provide reasonable assurance of detecting such material noncompliance.

4.202 It is management's responsibility to identify the compliance requirements applicable to the not-for-profit organization. The auditor should discuss these requirements with operating and financial personnel of the organization and its legal staff. Other procedures that may be useful in assessing such compliance requirements and in obtaining an understanding of their effects on the financial statements include:

- Consider knowledge about such laws and regulations obtained from prior years' audits.
- Obtain written representation from management regarding the completeness of management's identification of such requirements.
- Review the organization's contracts and agreements, such as those related to grants and loans.
- Review the minutes of meetings of the board of directors or trustees.
- Review information about compliance requirements, such as information included in the Compliance Supplements issued by the OMB.

4.203 In assessing the risk of material misstatement that could result from noncompliance, the auditor should consider factors, such as the materiality of the effect on financial statement amounts, the level of management or employee involvement in the compliance assurance process, the opportunity for concealment of noncompliance, and the strength of the organization's internal controls over compliance.

4.204 When determining which laws, regulations, and requirements have a direct and material effect on the organization's financial statements, the auditor should consider the specific requirements of the programs, which include the following:

- *Types of services allowed or not allowed* — Specifies the types of goods or services that entities may purchase with financial assistance and the types of costs that may be claimed.
- *Eligibility* — Specifies the characteristics of individuals or groups to whom entities may give financial assistance.
- *Matching, level of effort, or earmarking* — Specifies amounts entities should contribute from their own resources toward projects for which financial assistance is provided.
- *Reporting* — Specifies reports that entities must file in addition to those required by the general requirements.
- *Special tests and provisions* — Identifies other provisions for which federal agencies have determined that noncompliance could materially affect the program.

4.205 Illustration No. 4-2 illustrates how the first four of these requirements might affect the financial statements and how the requirements might be tested. The effects of the fifth requirement, Special Tests and Provisions, depend on the nature of the specific provisions.

ILLUSTRATION NO. 4-2

Consideration of Specific Requirements in a GAAS Audit

Specific Requirement	Potential Financial Statement Effect	Nature of Typical Test
Types of services allowed or not allowed	Noncompliance can result in a disallowed cost (a questioned cost), resulting in revenues from the funding source being overstated.	Test of a sample transactions by reference to supporting documentation.
Eligibility	Noncompliance can result in disallowance of payments by the funding source for the assistance or services provided.	Test of a sample of program participants by reference to documentation supporting eligibility.
Matching, level of effort, or earmarking	Noncompliance can result in the organization being ineligible to obtain the funds from the funding source.	Inspection and review of records of funds spent on the project. (example of a matching test)
Reporting	Noncompliance can result in the organization being ineligible to obtain the funds from the funding source.	Inspection of reports filed.

4.206 With respect to detecting and reporting violations of laws and regulations that have an indirect effect on financial statement amounts, the auditor should be aware of the possibility that such violations may have occurred. If specific information comes to the auditor's attention that indicates that a material violation has occurred, he or she should apply audit procedures specifically designed to ascertain whether a violation has in fact occurred.

4.300 PERFORMING AN AUDIT IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* (GAGAS)

4.301 *Government Auditing Standards*, as set forth in the Yellow Book, include standards and guidance for performing two types of audits of entities receiving federal awards — performance audits and financial audits.

4.302 Performance audits involve audits of the economy and efficiency of organizations, i.e., whether the organization is using government resources economically and efficiently. They also include program audits that relate to whether the desired results are being achieved by the program. CPA firms are seldom engaged to perform performance audits of not-for-profit organizations. These types of audits are most often performed by government auditors. Therefore, performance audits are not considered in this Manual. The remainder of this section describes *Government Auditing Standards* based on the 1994 Yellow Book. If the 1994 version has not yet been adopted, the 1988 standards described in last year's version of this manual should be followed.

4.303 The performance requirements described above for GAAS audits are also applicable to financial audits in accordance with *Government Auditing Standards*. Specifically, the auditor's responsibility for testing for irregularities, illegal acts, and noncompliance is described in Chapter 4 of the Yellow Book. GAGAS does not prescribe additional standards on irregularities and illegal acts above those required for audits in accordance with GAAS, but offers guidance on:

a. The auditor's understanding of possible irregularities and violations of laws and regulations,

b. Due care concerning possible irregularities and illegal acts, and

c. Noncompliance other than illegal acts.

In addition, GAGAS provides guidance on materiality and internal controls.

4.304 **Irregularities and Violations.** In describing the auditor's responsibilities for understanding irregularities, the Yellow Book states that the auditor is responsible for being aware of the characteristics and types of potential material irregularities. This understanding is necessary to adequately plan the audit. Regarding laws and regulations, the Yellow Book restates the obligation in SAS No. 54 to be aware of those laws and regulations that are generally recognized to have a direct and material effect on the organization's financial statements. Occasionally, it may be necessary to use the work of legal counsel in (1) determining which laws and regulations might have a direct and material effect on the financial statements, (2) designing tests of compliance, and (3) evaluating the results of the tests. Information also might be obtained from others, such as investigative staff, audit officials of government entities that provide assistance to the organization, and the applicable law enforcement agency.

4.305 **Due Professional Care.** The Yellow Book states that the auditor should exercise due professional care in pursuing indications of possible irregularities and illegal acts so as not to interfere with potential future investigations or legal proceedings. Under some circumstances, this might require the auditor to promptly report indications of illegal acts to appropriate parties before extending audit procedures. The auditor may also be required to withdraw from or defer further work on a portion of the audit in order not to interfere with an investigation.

4.306 **Noncompliance.** The term noncompliance in the Yellow Book has a broader meaning than illegal acts. Noncompliance also includes violations of requirements of contracts, grants, or agency policies and procedures. The Yellow Book concludes that an audit in accordance with GAGAS should provide reasonable assurance of detecting instances of noncompliance that have a direct and material effect on the organization's financial statements.

4.307 In performing an audit in accordance with GAGAS, the auditor has the same responsibilities for considering internal controls as under GAAS. However, Chapter 4 of the Yellow Book contains some additional observations about the relation of internal controls to audit risk. These observations are summarized below:

a. **Control Environment.** The auditor's judgment about the control environment may influence either negatively or positively his or her judgments about the effectiveness of other control procedures. Therefore, if the auditor's tests of controls reveal that certain controls are ineffective, this may indicate that the auditor's orginal assessment of the control environment should be reevaluated.

b. **Safeguarding Controls.** Safeguarding controls are designed to prevent or detect unauthorized transactions and unauthorized access to assets that could have a material effect on the financial statements. Understanding safeguarding controls can help the auditor assess the risk that financial statements could be materially misstated. For example, an understanding of safeguarding controls can help the auditor recognize risk factors such as:

- failure to adequately monitor decentralized operations;
- lack of controls over certain activities;
- lack of controls over computer processing;
- failure to secure data or assets; and
- failure to investigate significant unreconciled differences between control accounts and subsidiary records.

c. **Controls Over Compliance With Laws, Regulations, Contracts, and Grants.** The auditor is required to design the audit to provide reasonable assurance that financial statements are free from material misstatements resulting from violations of laws, regulations, contracts, and grants that have a direct and material effect on the financial statements. To meet this requirement, the auditor should have an understanding of internal controls related to financial statement assertions affected by those laws, regulations, contracts, and grants. The auditor uses this understanding to identify potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests.

d. **Control Risk Assessments.** When the auditor assesses control risk below the maximum for a particular financial statement assertion, he or she should:

- identify internal controls that are relevant to the particular assertion;
- perform tests that provide sufficient evidence that those controls are effective; and
- document the tests of controls.

e. **Tests of Controls.** The Yellow Book contains the following observations about the effectiveness of tests of controls:

- Inquiries alone generally will not support an assessment of control risk at less than the maximum.
- Observations provide evidence about a control's effectiveness only at the time observed.
- Evidence from tests of controls performed in prior audits can be considered, but the auditor still must obtain evidence about significant changes in internal control policies and procedures.

All of the above requirements are met by performing the audit in accordance with GAAS.

Supplemental Reporting Requirements

4.308 Although the performance requirements of an audit in accordance with *Government Auditing Standards* are the same as a GAAS audit, there are several additional reporting requirements, including:

- Communication of certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit.
- Inclusion in the auditor's report(s) that the audit was made in accordance with generally accepted government auditing standards.
- Reporting on compliance with laws and regulations and on internal controls. The report on the financial statements should either (1) describe the scope of the auditor's testing of compliance with laws and regulations and internal controls and present the results of those tests or (2) refer to a separate report on these matters.
- Standards on privileged and confidential information.
- Standards on report distribution.

These additional requirements are described below.

4.309 Communication with Audit Committees. This standard applies when the auditee has an audit committee or the audit is performed under contract. The information communicated should include (1) auditors' responsibilities in a financial statement audit (including those related to testing and reporting on internal controls and compliance with laws and regulations) and (2) the nature of any additional testing of internal controls and compliance required by laws and regulations.

4.310 Reference to Generally Accepted Government Auditing Standards. The 1994 revision of the Yellow Book requires the auditor to refer to *Government Auditing Standards* in the auditor's report on the organization's financial statements. The reference to generally accepted government auditing standards in the auditor's reports typically takes the following form:

> We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States.

Sample reports based on an audit of the financial statements performed in accordance with *Government Auditing Standards* are shown in sections 4.602a–b.

Practice Tip:

If your client wants an audit report on its financial statements for general purposes, you will need to prepare a separate standard audit report for that purpose.

4.311 The Auditor's Report on Compliance with Laws and Regulations. The Yellow Book requires a written report on the auditor's tests of compliance with laws and regulations which includes reporting on irregularities, illegal acts, and other material noncompliance. The report may be issued as a separate report or included in the report on the organization's financial statements. The report encompasses federal, state, and local laws and regulations that, if violated, could materially affect the basic financial statements. The 1988 version of the Yellow Book required an expression of positive assurance on items tested and negative assurance on items not tested. These assurances are no longer part of the report. The report now indicates the scope of the tests of compliance and discloses whether these tests were sufficient to support an opinion on compliance.

4.312 The AICPA has issued an illustrative unqualified report on compliance based on an audit of general-purpose financial statements, performed in accordance with GAGAS. This report updates Example A17(A) from the Audit and Accounting Guide, *Audits of State and Local Governmental Units* for the 1994 Yellow Book. This sample report is shown in section 4.604b. We have further modified it to reflect compliance for a not-for-profit organization instead of a state or local governmental unit. The sample reports on compliance with laws and regulations that are to be used if the 1994 version of the Yellow Book has not been adopted are shown in sections 4.604a, and 4.605–4.607.

4.313 The tests underlying the auditor's report on compliance with laws and regulations are those required by GAAS. The auditor is not required to perform any additional testing. Remember that in an audit in accordance with GAAS, the auditors are required to design tests of compliance with laws and regulations that have a direct and material effect on line-item financial statement amounts. If the auditor concludes that there are no laws or regulations that could have a direct and material effect on the amounts in the financial statements, no tests of compliance are required. In these situations, the auditor still must issue a report on compliance with laws and regulations, but the report must state that the auditor did not test for compliance with laws and regulations.

4.314 Paragraph 18 of Chapter 5 of the Yellow Book requires that the auditor's report on compliance include all instances of noncompliance that are material to the organization's financial statements or to the program, award, claim, fund, or group of accounts being audited. Irregularities and illegal acts not clearly inconsequential must also be included. Immaterial instances of noncompliance need not be included in the report, but should be reported to management of the organization, preferably in writing. In reporting irregularities, illegal acts, or other noncompliance, the auditor should place the findings in perspective by, for example, relating the instances to the population, etc. When the auditor communicates immaterial instances of noncompliance in a separate management letter, the auditor's report on compliance should be modified to include a statement such as the following:

> We noted certain immaterial instances of noncompliance that we have reported to the management of XYZ Organization in a separate letter dated August 15, 19X1.

Practice Tip:

The Yellow Book requires that all communications to management about instances of noncompliance be documented in the auditor's working papers.

4.315 The auditor's responsibility to communicate illegal acts in an audit in accordance with GAGAS is similar to those for GAAS audits under SAS No. 54. If the auditor becomes aware of illegal acts or indications of such acts, he or she should promptly report them to the top official of the organization arranging for the audit (including the audit committee or others with equivalent authority). The auditor should also consider reporting the matter to the appropriate oversight body. In all cases in which the top official is believed to be a party to, or implicated in, such acts, the auditor should report the matter to the oversight body.

4.316 The Auditor's Report on the Internal Control Structure.[2] Both GAGAS and SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit,* require the communication of reportable conditions noted during an audit. In a GAAS audit, this communication may be oral; however, GAGAS requires the communication to be in writing. Under GAAS, an auditor is precluded from issuing a report stating that no reportable conditions were noted. Under GAGAS, a report must be issued regardless of whether or not reportable conditions were noted.

4.317 There are also several differences in the nature of the required report. The Yellow Book requires the report on the organization's internal control structure at a minimum to include:

a. A description of the scope of the auditor's work in obtaining an understanding of the internal control structure and in assessing the control risk,

b. A description of the reportable conditions, including the identification of those that are considered to be individually or collectively material weaknesses.

When nonreportable conditions are communicated in a letter to top management, the letter should be referred to in the internal control structure report. The AICPA has issued an illustrative report on the internal control structure based on an audit of general-purpose financial statements, performed in accordance with GAGAS. This report updates Example A25(A) from the Audit and Accounting Guide, *Audits of State and Local Governmental Units* for the 1994 Yellow Book. This sample report is shown in section 4.603b. We have further modified it to reflect an internal control structure report for a not-for-

[2] In the past we have included a listing of internal control structure categories. Since the 1994 Yellow Book does not require a listing of such categories, they are no longer presented here. Please note that the report in section 4.603b entitled "*Report on the Internal Control Structure Based on an Audit of Financial Statements Performed in Accordance with Government Auditing Standards*" does not include identification of such categories whereas the report in section 4.608 entitled "*Report on the Internal Control Stucture Used in Administering Federal Awards*" does include them. The report in section 4.603b is a report updated for the 1994 Yellow Book whereas the report in section 4.608 is based on SOP 92-9 which still requires such disclosure.

profit organization instead of a state or local governmental unit. The sample report on the internal control structure that is to be used if the 1994 version of the Yellow Book has not been adopted is shown in section 4.603a.

4.318 Standards on Privileged and Confidential Information. If certain information is not in the audit since general disclosure is prohibited by federal, state, or local laws or regulations, the report should state the nature of the information omitted and the ruling that made the omission necessary.

4.319 Report Distribution. The auditor should submit the audit report to appropriate officials of the auditee as well as to the organization that arranged for the audit. In addition, copies should also be sent to other parties who have legal oversight authority or responsibility over the organization. The identification of who is to receive copies of the report should be identified in the engagement agreement. The audit report should be available for public inspection unless not allowed by law or regulation. Typically, the auditor distributes the report to the auditee. The auditee then submits the report to appropriate parties. If the auditee is requiring the auditor to distribute the report to parties other than the auditee, this should be indicated in the engagement letter.

4.320 Illustration No. 4-3 describes the differences between the requirements of the Yellow Book and SAS No. 60 with respect to the communication of reportable conditions.

ILLUSTRATION NO. 4-3

Comparison of Requirements to Communicate Reportable Conditions—
1994 *Government Auditing Standards* and GAAS

	Government Auditing Standards	GAAS (SAS No. 60)
1. When must the report be issued?	In all audits.	When reportable conditions are noted.
2. How are reportable conditions communicated?	Written report required.	Oral or written.
3. Should the auditor identify the reportable conditions that are significant enough to be material weaknesses?	Yes.	Optional.

4.321 Illustration No. 4-4 lists examples of matters that might be considered reportable conditions in an audit of a not-for-profit organization.

ILLUSTRATION NO. 4-4

Possible Reportable Conditions

a. absence of appropriate segregation of duties consistent with appropriate control objectives;

b. absence of appropriate reviews and approvals of transactions, accounting entries, or systems output;

c. inadequate provisions for the safeguarding of assets;

d. evidence of failure to safeguard assets from loss, damage, or misappropriation;

e. evidence that a system fails to provide complete and accurate output consistent with the auditee's control objectives because of the misapplication of control procedures;

f. evidence of intentional override of internal controls by those in authority to the detriment of the overall objectives of the system;

g. evidence of failure to perform tasks that are part of internal controls, such as reconciliations not prepared or not timely prepared;

h. absence of a sufficient level of control consciousness within the organization;

i. significant deficiencies in the design or operation of internal controls that could result in violations of laws and regulations having a direct and material effect on the financial statements; and

j. failure to follow up and correct previously identified deficiencies in internal controls.

4.322 The auditor's report on the internal control structure required by *Government Auditing Standards* is based on the auditor's consideration of the internal control structure as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.* The report does not express an opinion on the internal control structure. It merely describes the extent of work performed as required by SAS No. 55.

4.323 If the auditor issues a separate management letter describing nonreportable conditions, the auditor's report on the internal control structure should refer to that separate letter in order to comply with *Government Auditing Standards*.

Direct Reporting of Irregularities and Illegal Acts

4.324 The 1994 revision of the Yellow Book describes the auditor's responsibilities for reporting irregularities or illegal acts directly to parties outside the organization. The auditor is required to meet these obligations even if he or she has resigned or been dismissed from the audit.

4.325 The organization may be required by law or regulation to report certain irregularities or illegal acts to certain external parties (for example, to a federal inspector general or a state attorney general). If the auditor communicates such matters, and the organization fails to report them, the auditor should communicate the details to the organization's governing body. If the organization then does not make the required report as soon as practicable, the auditor should report the irregularities or illegal acts directly to the external party specified in the law or regulation.

4.326 The second situation that may require direct reporting is when management fails to take appropriate steps to remedy irregularities or illegal acts that involve assistance received from a government agency. If the auditor concludes that such failure is likely to cause him or her to depart from the standard report on the financial statements or resign from the audit, then he or she should communicate that conclusion to the organization's governing body. Then, if the organization does not report the irregularity or illegal act as soon as practicable to the entity that provided the government assistance, the auditor should do so.

Audit Follow-up Requirements of *Government Auditing Standards*

4.327 The Yellow Book requires that the auditor follow-up on any findings or recommendations from prior-years' audits, and determine whether corrective action has been taken. The auditor should consider whether any uncorrected findings and recommendations have an impact on the current year's audit objectives. The auditor should also report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

Working Paper Requirements of *Government Auditing Standards*

4.328 The 1994 revision of the Yellow Book states that the audit working papers should contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain the evidence that supports the auditors' significant conclusions and judgments. More specifically, the Yellow Book indicates that the working papers should contain:

a. The objectives, scope, and methodology, including any sampling criteria used,

b. Documentation of the work performed to support significant conclusions and judgments, including descriptions of transactions and records examined that would enable an experienced auditor to examine the same transactions and records, and

c. Evidence of supervisory reviews of the work performed.

> **Practice Tip:**
>
> Requirement b. may be met by listing identifying numbers of items, such as invoice, voucher or check numbers. There is no need for extensive copying of documents to be part of the workpapers.

Continuing Education Requirements of *Government Auditing Standards*

4.329 The Yellow Book also contains continuing education requirements that apply to audits in accordance with *Government Auditing Standards*. The requirements are summarized as follows:

- Auditors responsible for planning, directing, conducting, or reporting on government audits should complete, every two years, at least 80 hours of continuing education and training that contributes to the auditor's professional proficiency. At least 20 hours should be completed in any one year of the two-year period.
- Individuals responsible for planning, directing, conducting substantial portions of the field work, or reporting on the government audit should complete at least 24 of the 80 hours on continuing education and training in subjects directly related to the government environment and to government auditing. (For purposes of applying this requirement, an Interpretation of these requirements issued in April, 1991 states that "individuals are considered responsible for conducting substantial portions of the field work when, in a given CPE year, their time chargeable to Yellow Book audits is 20 percent or more of their total chargeable time").
- If the audited entity operates in a specific or unique environment, auditors should receive training that is related to that environment.

4.330 After the issuance of the Yellow Book, an obvious question arose from auditors of not-for-profit organizations about whether continuing education courses covering not-for-profit organizations qualified for the 24 hours directly related to the government environment and government auditing. Since the third bullet above indicates that the training should focus on the unique audit environment, the authors believe that continuing education about not-for-profit organizations would qualify. The Interpretation of these requirements, issued in April, 1991, states in Paragraph 47c that "subjects and topics directly related to a specific or unique environment may include relevant accounting principles; economic, operating, or regulatory developments in the specialized area in which the audited entity operates; and relevant laws and regulations."

Quality Control Requirements of *Government Auditing Standards*

4.331 The Yellow Book includes specific quality control requirements that parallel those of the AICPA's requirements that firms establish a quality control system and undergo peer reviews. In fact, the Yellow Book indicates that public accountants should participate in the AICPA practice-monitoring program or an equivalent program. CPA firms are required to have an external quality control review at least once every three years by a firm or organization not affiliated with the firm being reviewed. The Yellow Book also indicates that the reports of these quality control reviews (but not the letters of comment) should be made available to appropriate oversight bodies, and recommends making them available to the public.

4.400 PERFORMING AN ORGANIZATION-WIDE AUDIT (OMB CIRCULAR A-133)

4.401 OMB Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*, introduced significant new audit requirements for not-for-profit organizations. As discussed in Illustration No. 4-1, there are proposed revisions that are being exposed for public comment. The following discussion relates to provisions in OMB Circular A-133 that are currently in effect.

Applicability of Circular A-133

4.402 The requirements of Circular A-133 apply to any trust, association, or other organization that has the following characteristics:

- Operated primarily for scientific, education, service, charitable, or similar purposes in the public interest,
- Not organized primarily for profit, and
- Net proceeds used to maintain, improve, and/or expand its operations.

4.403 This definition includes colleges and universities, except those that are audited in accordance with OMB Circular A-128, *Audits of State and Local Governments*. For example, a private university that receives federal financial awards, such as research grants, would be covered by Circular A-133. This definition excludes hospitals that are not affiliated with a college or university. Circular A-133 does not cover state and local governments and other entities covered by Circular A-128.

4.404 Circular A-133 generally requires not-for-profit organizations receiving $100,000 or more in federal awards in a year to have an audit in accordance with Circular A-133. Not-for-profit organizations receiving $100,000 or more in federal awards in a year, but under only one program, have the option of having a program-specific audit or an audit in accordance with Circular A-133. Organizations receiving total awards of at least $25,000 but not more than $100,000 in a year have the option of having an audit in accordance with Circular A-133 or having an audit made of each award. Not-for-profit organizations receiving less than $25,000 in federal awards in a year are exempt from federal audit requirements. These requirements are summarized below:

Total Amount of Federal Awards Received in a Year	Audit Requirement
$100,000 or more	Circular A-133 audit or, if the awards are under only one program, an audit of the requirements of that program.
At least $25,000, but less than $100,000	Circular A-133 audit or an audit of the requirements of each program.
Less than $25,000	Circular A-133 audit not required.

Frequency of Audits

4.405 Circular A-133 indicates that audits should usually be performed annually, and certain programs are required to have annual audits, such as community health centers under Section 330 of the Public Health Act. In addition, as provided by PCIE Position Statement No. 6, Question 71, an annual audit in accordance with OMB Circular A-133 is required if the organization obtains annual financial audits. All other not-for-profit organizations may obtain audits biennially. However, in performing these biennial audits, both years must be audited and major programs must be determined based on the combined expenditures for both years.

Determining the Amounts of Awards Received

4.406 The term "federal award" is broadly defined in Circular A-133 to include federal financial assistance and federal cost-type contracts used to buy services or goods for the use of the federal government. Federal financial assistance includes assistance in the form of grants, contracts, loans, cooperative agreements, loan guarantees, property, interest subsidies, insurance, direct appropriations, and other noncash assistance.

> **Practice Tips:**
>
> Certain state and local funding agencies have established lower limits for requiring audits in accordance with OMB Circular A-133. Therefore, grantor agency requirements and agreements should be carefully reviewed to determine whether such requirements are present.
>
> ********************
>
> The sum of all research and development (R&D) expenditures is considered a single program for testing purposes. A not-for-profit organization generally must have a Circular A-133 audit if it has multiple R&D awards totaling $100,000 or more. However, a program-specific audit is permitted if (1) the not-for-profit organization receives only R&D awards from a single federal agency or from a single prime recipient, and (2) the federal agency or prime recipient approves a program audit in advance.

4.407 Because the audit requirements listed in section 4.404 are tied to the receipt of federal awards each year, it is important to understand how "federal awards received" are measured. Generally, the amount of awards received during a year is determined based on GAAP. A recipient has received awards when it has obtained cash or noncash assistance, or when it has incurred expenditures that will be reimbursed under a federal program. Receipt of federal awards occurs when revenues are recognized in the financial statements. For example, for programs involving the receipt of tangible assets, such as food stamps, receipts of awards should be based upon when the related revenues are earned.

4.408 For programs that do not involve the transfer of tangible assets (such as loan guarantee or insurance programs), receipts should be based on the transaction or event that gives rise to the award. For example, in a loan guarantee program, receipt occurs at the point in which the guarantee is made by the agency.

4.409 PCIE Position Statement No. 6, Question 29, states that noncash assistance such as free rent, interest subsidy, food stamps, food commodities, Women/Infant/Children (WIC) program vouchers, or donated property should be valued at fair market value at the time of receipt to determine the amount of the federal award. WIC program vouchers may be valued at either the maximum allowed redemption value or the average redeemed value. A copy of PCIE Position Statement No. 6 is included in Appendix C.

4.410 If a not-for-profit organization receives only free rent, it would not be considered a federal award to carry out a program and, therefore, the organization would not be required to have an audit in accordance with Circular A-133. However, the organization may be subject to other audit requirements imposed by the federal agency providing the free rent. In some cases, the free rent may be received as part of a federal award or other assistance to "carry out a program." In these cases, the free rent would be considered "other noncash assistance" and would be included in the total amount awarded for the program, under Circular A-133.

Practice Tip:

It is especially important to recognize awards in the appropriate year for a not-for-profit organization that is not required to have an organization-wide audit every year (i.e., because the amount of the awards received are less than $100,000 in some years). Recognizing the receipts in the appropriate period is essential to assuring that the proper years are audited in accordance with Circular A-133.

Basic Requirements of OMB Circular A-133

Practice Tip:

A difference exists in consideration of materiality and calculation of sample size for purposes of A-133 and program audits. See Chapter 3, sections 3.349 and 3.510 for further information.

4.411 The basic objectives of OMB Circular A-133 include the following:

- The financial statements of the not-for-profit organization present fairly its financial position and the results of its operations in conformity with generally accepted accounting principles.
- The not-for-profit organization has complied with laws and regulations that may have a direct and material effect on its financial statement amounts or on each major federal program.
- The not-for-profit organization has an internal control structure to: (a) provide reasonable assurance that it is managing federal awards in compliance with applicable laws and regulations, and (b) ensure compliance with laws and regulations that could have a material effect on the financial statements.

OMB Circular A-133 requires the auditor to obtain an understanding of, assess control risk for, and perform tests of controls on the policies and procedures designed to provide reasonable assurance that an organization is managing federal awards in compliance with applicable laws, regulations, and contract terms and that it safeguards federal funds. The auditor's internal control structure responsibility includes testing a recipient's system for monitoring subrecipients and the controls in effect to ensure that direct and indirect costs are properly computed and billed. The procedures that an auditor would perform would include:

- testing the effectiveness of the design and operation of the internal control structure policies and procedures for preventing or detecting material noncompliance.
- reviewing the recipient's system for monitoring subrecipients and obtaining and acting on subrecipients' audit reports.
- determining whether controls to ensure that direct and indirect costs were computed and billed in accordance with the general requirements are in place.
- documenting procedures employed to assess and test the internal control structure.

If Circular A-133 was literally interpreted, such tests of controls would be performed on each federal program but the Guide provides auditors with greater direction. For major programs, the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that he or she considers relevant to preventing or detecting material noncompliance with:

- specific requirements applicable to those programs.
- general requirements.
- requirements governing claims for advances and reimbursements, and amounts claimed for reimbursement or used for matching.
- cost allocation and subrecipient monitoring.

If nonmajor programs were used in order to test at least 50 percent of federal program expenditures, then for the purpose of testing internal controls, these nonmajor programs would be considered major programs. For all other nonmajor programs, the auditor should, at a minimum, obtain an understanding of each of the three elements of the organization's internal control structure that he or she considers relevant in preventing or detecting material noncompliance with the general requirements. See section 4.609 of the Manual which illustrates a report on the internal control structure used in administering federal awards. In addition, see section 6.400 which identifies the audit program steps used in testing internal controls.

The major additional compliance audit requirements under Circular A-133 relate to the major federal assistance programs.

The Cognizant Agency

4.412 The OMB will assign a federal agency to serve as the cognizant agency over large not-for-profit organizations. The cognizant agency is responsible for overseeing the audits of the not-for-profit organization and ensuring that any audit findings that affect different programs are resolved. Organizations that are not assigned a cognizant agency are under the oversight of the federal agency that provides them with the most funds, either directly or indirectly.

4.413 The not-for-profit organization's cognizant agency is responsible for:

- Ensuring that audits are made and reports are received in a timely manner and in accordance with the applicable Circular.

- Providing technical advice and liaison to not-for-profit organizations and independent auditors.
- Obtaining or making quality control reviews of selected audits made by non-federal auditors.
- Informing appropriate officials of any reported illegal acts or irregularities.
- Advising recipients of audits not meeting requirements of the applicable Circular.
- Coordinating audits that are in addition to the audits made in accordance with the applicable Circular.
- Ensuring resolution of audit findings that affect programs of more than one agency.
- Seeking views of interested agencies before completing coordinated audits.
- Helping to coordinate audit work among various auditors to achieve the most cost-effective audit.

Identification of Major Programs

4.414 An important aspect of performing an audit in accordance with Circular A-133 is identifying the major federal assistance programs. The auditor must determine and report whether the organization has complied with laws and regulations that have a direct and material effect on each major federal program.

4.415 Whether a program is considered major depends on the amount of awards received through that program for the year in relation to the total amount of the federal awards received. Major programs are those with amounts more than the larger of (a) three percent of total cash and noncash federal awards, except for loans and loan guarantees, or (b) $100,000.

4.416 If a not-for-profit organization has no awards that total $100,000 in the year, it has no major programs. However, the auditors are still required to test and report on the general requirements applicable to the programs.

4.417 The following guidelines should be used to calculate the value of noncash awards received for determining major programs:

Types of Noncash Assistance	Basis Used to Determine Major Programs
Loans (including guaranteed student loans made by a college or university and loan guarantees)	Value of new loans processed during the fiscal year, plus the balance of loans made in the prior years for which the federal government is at risk, plus any interest subsidy, cash, or administrative cost allowance received.
Commodities	Value of the commodities issued during the year.
Insurance	Value of the insurance contract.
Guaranteed student loans that were not made by a college or university	Value of the guaranteed loans made during the year.
Food stamps	Value of the foods stamps distributed during the year.

At colleges and universities, the value of guaranteed student loans processed during the year, if available, is combined with other student financial assistance for purposes of determining whether this category represents a major program.

4.418 PCIE Position Statement No. 6, Question 26, provides additional guidance about inclusion of loan and loan guarantee programs in the determination of major programs. It states that "when including a loan program significantly affects the number or size of other major programs, the loan program should be considered a major program, and the value attributed to the loan program should be excluded in determining other major programs."

> **Practice Tip:**
>
> For the purpose of determining major programs, the sum of expenditures from awards for research and development is considered to be a single program. Also, the sum of expenditures for student financial aid is considered to be a single program.

Tests of Compliance With the Specific Requirements Applicable to Major Programs

4.419 When performing an audit in accordance with Circular A-133, the auditor must test and report on the organization's compliance with laws and regulations that could have a direct and material effect on each major federal assistance program. These tests should cover:

- Types of services allowed or not allowed,
- Eligibility of program beneficiaries,
- Matching, federal financial reports, and
- Special tests and provisions.

4.420 The auditor should obtain an understanding of the laws and regulations related to these aspects of major programs that is sufficient to assess the risk on material misstatement of program financial results.

4.421 The OMB has issued the *Compliance Supplement For Audits of Institutions of Higher Learning and Other Non-Profit Institutions* (October 1991), which sets forth the primary compliance requirements that should be considered in an organization-wide audit of universities and other not-for-profit organizations that receive federal assistance. The compliance requirements in the Compliance Supplement are regarded by federal agencies as those having a potentially direct and material effect on major programs. The Compliance Supplement also suggests audit procedures for testing federal programs for compliance with various types of requirements. A copy of the Compliance Supplement is included in Appendix B.

4.422 The auditor assesses the risk of material noncompliance with laws and regulations applicable to each major program by considering various factors, such as the amount of program expenditures and any changes made in the program. The auditor then assesses the control risk related to noncompliance with these requirements. Based on these assessments the auditor designs sufficient substantive procedures to test each major program for compliance with applicable laws and regulations. The testing provides the basis for the auditor's report on compliance.

4.423 The auditor generally tests the compliance requirements using the following procedures:

a. Inquiry, observations, and testing at the organization level.

b. Tests of transactions.

c. Inspection of documents and reports.

4.424 Circular A-133 requires the auditor to select an adequate number of transactions from each major program so that the auditor obtains sufficient evidence to support an opinion about whether each major program was administered in compliance with applicable laws and regulations. The extent of the testing of a program is based on the auditor's judgment about factors such as:

- The amount of expenditures for the program.
- The diversity or homogeneity of expenditures for the program.
- The length of time that the program has operated, or changes in its conditions.
- Prior experience with the program, particularly as revealed in audits or other evaluations (for example, inspections, program reviews, or system reviews required by the federal acquisition regulations).
- The extent to which the program is carried out through subrecipients.
- The extent to which the program contracts for goods or services.
- The level to which the program is already subject to program reviews or other forms of independent oversight.
- The results of the tests of adequacy of the controls for ensuring compliance.
- The expectation of adherence or lack of adherence to the applicable laws and regulations.
- The potential impact of adverse findings.

4.425 The auditor is required to perform sufficient work to express an opinion on whether:

a. The amounts reported as expenditures were for allowable services.

b. The records show that those who received services or benefits were eligible to receive them.

c. Matching requirements, levels of effort, and earmarking limitations were met.

d. Federal financial reports and claims for (1) advances and (2) reimbursements contain information that is supported by the books and records from which the general-purpose or basic financial statements were prepared.

e. Amounts (1) claimed for reimbursement or (2) used for matching were determined in accordance with cost principles and matching or cost-sharing requirements set forth in (a) Circular A-21; (b) Circular A-110; (c) Circular A-122; (d) Federal Acquisition Regulations (FAR), subpart 31, cost principles; and (e) other applicable cost principles or regulations. It also may be necessary to refer to HHS OASC-3, Cost Principles for Hospitals.

f. Special tests and provisions where federal agencies have determined noncompliance could materially affect the program. For example, some agencies set a deadline for the expenditure of federal awards or require that all international travel be performed in accordance with the Fly America Act. Also, when auditing a major student financial aid program at an educational institution, an auditor would typically perform tests of compliance with the laws and regulations of the Department of Education as specified in the Compliance Supplement relating to the eligibility of participants, the calculation of awards, and exercise of due diligence in the collection of loans.

Practice Tip:

A state's audit requirements may require the auditor to test and report on the not-for-profit organization's compliance with applicable state and local laws and regulations. In these situations the auditor should consult with state or local government officials or other sources about the nature and scope of the required testing.

Tests of Allowable Costs and Cost Principles

4.426 Transactions selected for compliance testing should be tested to determine whether the costs meet the criteria of the cost principles that apply to each program. The cost principles contained in Circular A-21 and A-122, FAR subpart 31, and HHS OASC-3 establish standards for determining costs applicable to grants, contracts, and other agreements. Costs are allowable only to the extent of benefits received by the program. Both the direct and indirect costs should meet the reimbursement criteria generally contained in the Basic Considerations section of the applicable cost principles. To be eligible these costs must be:

- Necessary and reasonable for the performance and administration of the federal program and allocable thereto under the provisions of the cost principles.
- Authorized or not prohibited under state or local laws or regulations and approved by the awarding agency, if appropriate. Certain costs require specific approval by the grantor agency, while some are not allowed as set forth in the section of the applicable cost principles dealing with Selected Items of Costs.
- In conformance with any limitations or exclusions set forth in the applicable cost principles, or with any limitations in the program agreement or specific requirements in the program regulations.

- Afforded consistent treatment with policies, regulations, and procedures applied uniformly to federal and nonfederal activities of the recipient organizations.
- Afforded consistent accounting treatment within and between accounting periods and not allocable to, or included as a direct cost of, a federal program, if the same or similar costs are allocated to the federal program as an indirect cost.
- Determined in accordance with GAAP or an other comprehensive basis of accounting.
- Not included as a cost or used to meet cost-sharing requirements of another federally supported activity of the current or a prior period.
- Allocable to the federal awards. The charges should be allocable to a particular cost objective, such as a grant, project, or other activity, in accordance with the relative benefits received. A cost is allocable to a federal award if it (a) is incurred specifically to advance the work under the award; (b) benefits both an award and other work and can be distributed in an equitable manner in relation to benefits received; (c) is necessary to the overall operation of the organization; and (d) is otherwise allowable under the cost principles provided in HHS OASC-3, if applicable, and OMB Circulars A-21 and A-122. An allocable cost of an award or other cost objective may not be shifted to other federal awards to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms of the award.
- Net of all applicable credits, for example, volume or cash discounts, refunds, rental income, trade-ins, scrap sales, direct billings (in the case of indirect costs), etc.
- Supported by underlying documentation, for example, time and attendance payroll records, personnel activity reports or other time and effort records for employees charged to federal awards or to more than one activity, approved purchase orders, receiving reports, vendor invoices, canceled checks, etc., as appropriate, and correctly charged as to account, amount, and period.

4.427 Illustration Nos. 4-5 and 4-6 provide general guidance on the allowability of costs.

ILLUSTRATION NO. 4-5

Allowability of Selected Costs

Costs	Rules about Allowability
Advertising	Allowable only if solely for: (1) recruiting personnel when consider in relation to other recruiting costs; (2) the procurement of goods and services; (3) the disposal of surplus materials acquired in the performance of an award. (subparagraph 1)
Bonding	Allowable costs include bonding required by the terms of the award or obtain in accordance with sound business practice and at reasonable rates. (subparagraph 4)

Costs	Rules about Allowability
Compensation for wages and benefits	Allowable costs must represent reasonable compensation and fringe benefits for the work performed and be appropriately chargeable to the grant as a direct or indirect cost. Charges to awards must be supported by documented payrolls and personnel activity reports signed by the employee or a responsible supervisor. (subparagraph 6)
Depreciation	Allowable if determined by reasonable and consistent methods. (subparagraph 9)
Equipment and other capital expenditures	Purchases of general purpose equipment are allowable as direct costs only with prior approval of the awarding agency. Special purpose equipment purchases are allowable as direct costs, but items with a unit cost of $1,000 or more must have prior approval of the awarding agency. Purchases of land, buildings, and improvements are unallowable as direct costs except with prior approval of the awarding agency. (subparagraph 13)
Insurance	Allowable if required or approved by the awarding agency or for general conduct of the organization's activities and in accordance with sound business practices. (subparagraph 18)
Meeting and conferences	Allowable if they meet the general requirements about allowability. (subparagraph 25)
Preaward costs	Allowable to the extent that they would have been allowable if incurred after the date of the award. (subparagraph 34)
Public information service costs	Allowable as direct costs only with prior approval of awarding agency. Unallowable as indirect costs. (subparagraph 37)
Publication and printing costs	Allowable as direct costs only with prior approval of awarding agency. Allowable as indirect costs if allocated to all benefiting activities. (subparagraph 38)

Note: References are to subparagraphs of OMB Circular A-122, Attachment B.

ILLUSTRATION NO. 4-6

Unallowable Costs

1. Bad debts
2. Contributions to a contingency reserve
3. Contributions and donations by the organization
4. Donated goods and services (however, they may be considered in allocating indirect costs and for matching purposes)
5. Entertainment
6. Interest
7. Fines and penalties
8. Fund raising
9. Investment management costs
10. Lobbying costs (with a few exceptions; see OMB Circular A-122, Attachment B, subparagraph 21)
11. Losses on other awards
12. Organization costs (unless prior approval is obtained)
13. Overtime, extra-pay shift, and multishift premiums (with a few exceptions; see OMB Circular A-122, Attachment B, subparagraph 28)

Source: OMB Circular A-122.

Practice Tip:

A reasonable basis for allocation of certain costs may be difficult to determine. For these costs, the organization should get advanced approval of the method of allocation from the awarding or cognizant agency. From an audit standpoint, if the organization has not obtained advanced approval, these costs have a higher risk of disallowance.

Practice Tip:

Certain costs may require prior approval from the awarding or cognizant agency. For example, OMB Circulars A-21 and A-122 and HHS OASC-3 indicate that prior approval is required for certain expenditures, such as those for the purchase of equipment and for foreign travel.

Allocation of Indirect Costs

4.428 Not-for-profit organizations often are allowed to allocate indirect costs to programs as well as direct costs. However, to obtain the reimbursement, the not-for-profit organization generally should establish a basis for allocating such costs by preparing a cost allocation plan or an indirect-cost rate proposal. To assess the allowability of the indirect costs, the auditor should refer to procedures set forth for indirect costs in the general requirements section of the Compliance Supplements.

4.429 The indirect-cost proposals are usually prepared on a prospective basis using prior year data or budgeted data for the current year. When the actual costs are determined, the differences between the proposed costs and the actual costs for the year are either carried forward to a subsequent period's rate or adjusted with the granting federal agency on a retroactive basis. In situations in which predetermined rates are determined and approved by the cognizant federal agency, subsequent adjustments are not made, with the exception of eliminating any unallowable costs.

Tests of Compliance Applicable to Nonmajor Programs

4.430 The auditor is not required to select transactions from nonmajor programs for compliance testing. However, in connection with auditing the financial statements or testing the internal control structure, the auditor may select transactions from nonmajor programs for testing. These transactions must also be tested for compliance with laws and regulations that affect these transactions. For example, a payroll transaction related to a nonmajor program may be selected in conjunction with the auditor's tests of controls for payroll. That transaction should be tested for any requirements that specifically apply to that payroll transaction, such as determining that the salary can be reasonably charged to the program. The auditor is not required to test the transaction for compliance with general requirements, such as civil rights or cash management requirements.

Practice Tip:

The allocation basis will generally differ significantly based on the size of the organization. For example, a large organization with multiple missions may use a multiple allocation-base method using multiple cost pools. The use of these cost pools may obscure the details of the costs allocated to the program.

For small organizations the allocation method may be simpler. Often costs are simply classified as direct or indirect. The indirect costs are then allocated to programs or activities using some equitable basis. Therefore, it is much easier to determine the specific costs allocated to various programs.

4.431 As another example, assume that the auditor is testing controls over cash disbursements and selects a travel expense charged to a nonmajor program for testing. The auditor should examine evidence about whether the employee making the claim worked on the program, whether the purpose of the travel was related to the program, whether administrative travel was an allowable charge to the program, and whether the travel allowance was within administratively prescribed limits.

4.432 If the auditor selected a program-related payment made directly to an individual or organization, he or she should determine whether the payment was for the purpose intended by the program and for services allowed by the program, and whether the individual or organization was eligible for the program.

Tests of Compliance With General Requirements

4.433 The Compliance Supplement identifies general requirements for which the auditor should test compliance in all audits in accordance with Circular A-133. The auditor should test compliance with the general requirements regardless of whether the not-for-profit organization has any major programs. These general requirements include:

- *Political Activity*. Funds cannot be used for partisan political purposes of any kind.
- *Davis-Bacon Act*. When required by federal grant program legislation, all laborers and mechanics employed by contractors or subcontractors to work on construction projects financed by federal assistance must be paid wages not less than those established for the locality of the project by the Secretary of Labor.
- *Civil Rights*. No persons shall, based on race, color, national origin, age, or handicap, be excluded from participation or be subjected to discrimination in any program funded, in whole or in part, by federal funds.
- *Cash Management*. The not-for-profit organization's financial management system must include procedures to minimize the time elapsed between the transfer of funds from the U.S. government and the disbursement of funds by the recipient.
- *Relocation Assistance and Real Property Acquisition*. When federal programs require the acquisition of property by a public agency, such property must be appraised in the presence of the owner, the appraisal must be reviewed, prices must be set, and settlements negotiated. When displacements of households or businesses are involved, assistance must be provided in locating replacement housing that meets acceptable standards, and records must be maintained on all acquisitions and displacements.
- *Federal Financial Reports*. Most federal financial programs require the periodic submission of financial reports. The reports fall within the following three categories:

  a. The reports that are required by OMB Circular A-110 and that apply to most programs described in the OMB Compliance Supplements:

     — Financial Status Reports.

     — Request for Advance or Reimbursement.

     — Outlay Report and Request for Reimbursement for Construction Programs.

     — Federal Cash Transaction Report (FCTR).

b. Cash management reports required by Treasury Circular 1075 for programs financed through letters of credit:

— Request for Payment on Letter of Credit and Status of Funds Report.

— Payment Voucher on Letter of Credit.

c. Various adaptations of type a or b reports, or others for which certain federal agencies have received OMB approval.

- *Allowable Costs and Cost Principles*. These principles prescribe the direct and indirect costs allowable for federal reimbursement.
- *Drug-Free Workplace*. The not-for-profit organization must certify that it will provide a drug-free workplace. The certification includes assurances related to the publication of a policy statement giving notification to employees, an established on-going drug-free awareness program, and meeting specific time frames for personnel actions as required.
- *Administrative Requirements*. In addition to the administrative requirements of financial reporting, cost principles, and cash management principles (described above), the auditor needs to consider several other requirements, including:

— Interest earned on advances.

— Program income.

— Real property.

— Equipment.

— Supplies.

— Subaward to debarred or suspended parties.

— Procurement.

— Subgrants.

— Revolving fund payments.

OMB Circular A-133 Reporting Requirements

4.434 OMB Circular A-133 requires the auditor to issue the following reports on an organization's federal awards:

a. Reports required to be issued in an audit performed in accordance with *Government Auditing Standards*:

- An opinion on the organization's basic financial statements based on an audit in accordance with GAAS.

- A report on internal control structure policies and procedures based solely on an understanding of the internal control structure and an assessment of control risk obtained as a part of the audit on the basic financial statements.
- A report on compliance with laws and regulations that may have a direct and material effect on the financial statements.

These reports are discussed in section 4.300.

b. A report on a supplementary schedule of the organization's federal awards, showing total expenditures for each federal award program.

c. A report on the internal control structure policies and procedures used in administering federal awards.

d. A report on compliance with specific laws and regulations that may have a direct and material effect on each major program.

e. A report on compliance with certain laws and regulations applicable to nonmajor programs.

f. A report on compliance with the general requirements applicable to federal programs.

Practice Tip:

Certain state and local funding agencies that require audits in accordance with OMB Circular A-133 have established different forms of required reports. In performing these engagements, the auditor should obtain an understanding of the required form of the reports, and make sure that they do not contain language that is not consistent with the extent of the audit work performed.

4.435 Report on Schedule of Federal Awards. The Schedule of Federal Awards should:

- Identify major programs.
- Show total expenditures for each program.
- Identify program by "Catalog of Federal Domestic Assistance" number.
- Show expenditures for nonmajor programs under caption "Other Federal Assistance."
- Disclose value of noncash assistance such as loan guarantees and food commodities.

Sample reports on the Schedule of Federal Awards are illustrated in sections 4.601 and 4.602a–b.

4.436 Illustration No. 4-7 provides an example of a Schedule of Federal Awards.

4.437 Report on Internal Control Structure Used In Administering Federal Awards. Circular A-133 requires that the auditor determine and report whether the not-for-profit organization has an internal control structure to provide reasonable assurance that the organization is managing its federal awards in compliance with applicable laws and regulations.

4.438 The auditor's tests of controls should encompass the design and operation of the internal control policies and procedures relevant to ensuring compliance with both specific and general requirements. Specifically, the auditor should:

- Document the understanding of the internal control policies and procedures related to compliance with the requirements of each major program,
- Test each of the significant internal control policies and procedures, and
- Consider the evidence from the tests of controls in designing tests of compliance with each major program.

4.439 If the total amount of major program expenditures represents less than 50% of the total federal expenditures, the auditor should perform tests of controls relevant to nonmajor programs until such procedures encompass 50% of the total federal expenditures. In these situations, one approach is to include the largest nonmajor program, the next to largest nonmajor program, and so on until 50% of the total expenditures are tested. Another approach is where the auditor selects nonmajor programs on a rotating basis, so that over a three-year period all but clearly insignificant programs are covered.

4.440 For other nonmajor programs the auditor is only required to obtain an understanding of the internal control structure related to preventing or detecting material noncompliance with general requirements.

4.441 Circular A-133 indicates that tests of controls may be omitted for those areas where internal control structure policies and procedures are likely to be ineffective in preventing or detecting noncompliance, however, a reportable condition or material weakness should be reported.

4.442 A sample report on the internal control structure used in administering federal awards is shown in section 4.608.

ILLUSTRATION NO. 4-7

Community Action Agency
Schedule of Federal Awards
For the Year Ended June 30, 19XX

Federal Grantor/ Pass-through Grantor/Program Title	Federal CFDA Number	Agency or Pass-through Number	Federal Expenditures
U.S. Dept. of Health and Human Services			
Headstart	93.600	05CH5560/07	$ 237,861
	93.600	05CH5560/08	200,000
Subtotal			437,861*

Federal Grantor/ Pass-through Grantor/Program Title	Federal CFDA Number	Agency or Pass-through Number	Federal Expenditures
Pass-through from State Dept. of Human Services Community Services Block Grant	93.792	K1578	536,987*
Weatherization	93.818	K4599	-
Subtotal—U.S. Dept. of Health and Human Services			974,848
Other Federal Assistance ACTION: Pass-through from State Department on Aging Foster Grandparents	72.001	33924	80,987
Total			$1,055,835

* Denotes a major program

4.443 Report on Compliance With Laws and Regulations Related to Major Programs. Circular A-133 requires the auditor to test and report on whether the not-for-profit organization has complied with laws and regulations that may have a direct and material effect on any of its major programs. The report must contain a summary of material findings of noncompliance and an identification of the total amounts of questioned costs, if any, for each major federal award, and the auditor's recommendations for necessary corrective action. The report need not mention immaterial findings, but they should be communicated to the organization in a separate communication.

4.444 A questioned cost is (1) an alleged violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the expenditure of funds, (2) a finding that, at the time of the audit, such cost is not supported by adequate documentation, or (3) a finding that the expenditure of funds for the intended purpose is unnecessary or unreasonable. Findings of noncompliance may be listed in a schedule that also identifies the dollar amount of questioned costs. Sample reports on compliance with laws and regulations related to major programs are illustrated in sections 4.609–4.614.

4.445 Report on Nonmajor Program Compliance. Circular A-133 requires the auditor to issue a report on nonmajor programs that provides a statement of positive assurance on those items tested for compliance and negative assurance on those items not tested. A sample report on compliance with laws and regulations related to nonmajor programs is illustrated in section 4.618.

4.446 Report on Compliance with General Requirements. The auditor must test and report on the general requirements regardless of whether the organization has major federal programs. No opinion is required on the general requirements; the report expresses positive assurance and negative assurance. Sample reports on compliance with general requirements are shown in sections 4.615–4.617.

Combined Reporting

4.447 If feasible, the Circular A-133 reports may be combined. For example, three reports could be issued—financial, compliance, and internal control.

> **Practice Tip:**
>
> Auditors should exercise care in combining such reports to assure that the unique reporting requirements of Circular A-133 are preserved in the combined report.

Other Reporting Requirements

4.448 There are several other significant reporting requirements of Circular A-133, including:

- The auditor should disclose in his or her report the status of known but uncorrected significant and material findings and recommendations from prior audits.
- The not-for-profit organization is required to provide a report on its comments on findings and recommendations reported by the independent auditor, including corrective action taken or planned.
- If the not-for-profit organization is a sub-recipient of a federal award, it must submit copies of reports to the primary recipient that provided the pass-through award as well as to the federal agency providing the award.
- The reports on both the audit of the basic financial statements and all other not-for-profit organization reports required to be completed by OMB Circular A-133 are due within 30 days after completion of the audit, but must be submitted not later than 13 months after the end of the not-for-profit organization's fiscal year unless a longer period is agreed upon with the cognizant or oversight agency.

Working Paper Requirements

4.449 Circular A-133 requires the auditor to retain working papers and reports for a minimum of three years from the date of issuance, unless otherwise notified. Also, they must be made available upon request to the cognizant agency, its designee, or the U.S. General Accounting Office.

4.500 PROGRAM-SPECIFIC AUDITS

4.501 A program-specific audit is an audit of one federal program in accordance with the federal laws, regulations, or audit guides related to that particular program. Program-specific audits do not include an audit of the not-for-profit organization's financial statements. In performing a program-specific audit, the auditor should follow *Government Auditing Standards* and any specific requirements set forth in the applicable regulations and related audit guides issued by the grantor agency. When engaged to perform a program-specific audit, the auditor should obtain an understanding of the audit requirements for the program by referring to the agreement with the grantor agency or an applicable federal audit guide, or through contact with the grantor agency. If a federal audit guide is available, it will provide guidance on the required compliance tests, other audit procedures, and reports.

4.502 For audits of those programs for which no current federal audit guide exists, PCIE Position Statement No. 6, Question 22, requires the auditor to follow the standards for financial audits in the Yellow Book. The report should generally include an opinion on the financial statements of the specific program, a report on the internal control over the program, and a report on program compliance with laws and regulations. If applicable, a schedule of findings and questioned costs, a management letter, or a report on illegal acts also is required.

Practice Tip:

For purposes of a program-specific audit, the sum of expenditures from awards for research and development (as defined by Circular A-133) and the sum of the expenditures for student financial assistance are considered to be single programs.

4.600 GAAS, GAGAS, AND OMB A-133 REPORT EXAMPLES

[3] The 1994 revision of the Yellow Book deletes the requirement to describe categories of internal controls and the requirement to express positive and negative assurance on compliance with laws and regulations. These changes, however, have no effect on auditor reporting on internal controls and compliance relating to federal financial assistance under OMB Circular A-133. OMB Circular A-133 continues to require auditors to identify the categories of significant internal accounting controls, and those controls designed to provide reasonable assurance that federal programs are being managed in compliance with laws and regulations. Further, with respect to the auditor's report on compliance, OMB Circular A-133 continues to require positive assurance on those items tested and negative assurance on those items not tested. Therefore, auditors should continue to use the reports on internal controls and compliance relating to federal financial assistance included in the Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*, Appendix C, Examples D-8 through D-18.

4.601 REPORT ON SCHEDULE OF FEDERAL AWARDS[1]

[*Addressee*]

We have audited the financial statements of [*name of organization*] for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[2] These financial statements are the responsibility of [*name of organization*]'s management. Our responsibility is to express an opinion on these basic financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards,* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the basic financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the basic financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Our audit was made for the purpose of forming an opinion on the basic financial statements of [*name of organization*] taken as a whole. The accompanying Schedule of Federal Awards is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information in that Schedule has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly presented in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

Notes:

1. This report is intended to be issued when the auditor's report on the basic financial statements is issued separately. However, the auditor may consider combining the report on the basic financial statements with this report (see section 4.602).

2. Describe any departure from the standard report.

This is in conformity with the 1988 Yellow Book and has not been updated to reflect all current pronouncements. The AICPA has issued a **non**authoritative report on the basic financial statements only in conformity with the 1994 Yellow Book. See section 4.602b.

4.602a REPORT ON BASIC FINANCIAL STATEMENTS AND SCHEDULE OF FEDERAL AWARDS

[*Addressee*]

We have audited the accompanying statement of financial position of [*name of organization*] as of June 30, 19XX, and the related statements of activities and cash flows[1] for the year then ended. These financial statements are the responsibility of [*name of organization*]'s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [*name of organization*] as of June 30, 19XX, and the results of its activities and its cash flows for the years then ended, in conformity with generally accepted accounting principles.

Our audit was made for the purpose of forming an opinion on the basic financial statements of [*name of organization*] taken as a whole. The accompanying Schedule of Federal Awards for the year ended June 30, 19XX is presented for purposes of additional analysis and is not a required part of the basic financial statements. The information in that schedule has been subjected to the procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

Note:

1. The sample auditor's reports found in this section have been updated to reflect financial statements to be issued in accordance with Statement of Financial Accounting Standards No. 117. Auditors who are engaged to perform audits for not-for-profit organizations who have not yet adopted the provisions of this Statement should modify their reports accordingly.

This is a nonauthoritative report issued to be in conformity with the 1994 Yellow Book. As of the date that this Manual went to press, the authoritative report has yet to be issued.

4.602b REPORT ON BASIC FINANCIAL STATEMENTS

[Addressee]

We have audited the statement of financial position of [*name of organization*] as of and for the year ended June 30, 19XX, and the related statements of activities and cash flows for the year then ended. These financial statements are the responsibility of [*name of organization*]'s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards[1]. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of [*name of organization*] as of June 30, 19XX, and the results of its activities and its cash flows for the year then ended, in conformity with generally accepted accounting principles.[2]

[Signature]

[Date]

Note:

1. When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards*, insert the phrase "and *Government Auditing Standards* issued by the Comptroller General of the United States".

2. When the report on the financial statements is submitted to comply with a legal, regulatory, or contractual requirement for an audit in accordance with *Government Auditing Standards*, a paragraph similar to the following should be added after the opinion paragraph:

   In accordance with *Government Auditing Standards*, we have also issued a report dated [*date of report*] on our consideration of [*name of organization*]'s internal control structure and a report dated [*date of report*] on its compliance with laws and regulations.

This is in conformity with the 1988 Yellow Book and has not been updated to reflect all current pronouncements. The AICPA has issued a **non**authoritative report in conformity with the 1994 Yellow Book. See section 4.603b.

4.603a REPORT ON THE INTERNAL CONTROL STRUCTURE BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

[Addressee]

We have audited the financial statements of *[name of organization]* as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

In planning and performing our audit of the financial statements of *[name of organization]* for the year ended June 30, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure.

The management of *[name of organization]* is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures in the following categories *[identify internal control structure categories[2]]*. For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data in a manner that is consistent with the assertions of management in the financial statements.[3]

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX.[4]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[5]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.

2. See paragraph 7.7 of SOP 92-9, for a discussion of categories to be identified. Also, see paragraphs 6.36 and 6.53 through 6.61 for specific and general requirements, respectively.

3. Paragraph 17 of SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in a Financial Statement Audit*, prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. When the auditor notes no reportable conditions during an audit, he or she may issue a report, such as the following, to satisfy the requirements of *Government Auditing Standards*.

   [*The first through the fifth paragraphs of the report are the same as those illustrated above.*]

   Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

[*The last two paragraphs of the report are the same as that illustrated above.*]

4. If a separate letter has not been issued, this paragraph should be omitted.

5. If the report is not part of the public record, this sentence should not be included in the report.

This is a nonauthoritative report issued to be in conformity with the 1994 Yellow Book. As of the date that this Manual went to press, the authoritative report has yet to be issued.

4.603b REPORT ON THE INTERNAL CONTROL STRUCTURE BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS*

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

The management of [*name of organization*] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles. Because of inherent limitations in any internal control structure, errors or irregularities may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

In planning and performing our audit of the financial statements of [*name of organization*] for the year ended June 30, 19XX, we obtained an understanding of the internal control structure. With respect to the internal control structure, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide an opinion on the internal control structure. Accordingly, we do not express such an opinion.

We noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data in a manner that is consistent with the assertions of management in the financial statements.[3]

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.[4]

We also noted other matters involving the internal control structure and its operation that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX.[5]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record, and its distribution is not limited.[6]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.
2. If the financial statements are on a basis other than GAAP, the phrase "generally accepted accounting principles" should be modified.
3. Paragraph 17 of SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in a Financial Statement Audit*, prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. When the auditor notes no reportable conditions during an audit, he or she may issue a report, such as the following, to satisfy the requirements of *Government Auditing Standards*.

   [*The first through the fourth paragraphs of the report are the same as those illustrated above.*]

   Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above.

   [*The last two paragraphs of the report are the same as that illustrated on the following page.*]

4. If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be modified as follows:

   However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of [*name of organization*] for the year ended June 30, 19XX.

   [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

5. If a separate letter has not been issued, this paragraph should be omitted.
6. If the report is not part of the public record, this sentence should not be included in the report.

This is in conformity with the 1988 Yellow Book and has not been updated to reflect all current pronouncements. The AICPA has issued a **non**authoritative report in conformity with the 1994 Yellow Book. See section 4.604b.

4.604a REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANTS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* WHEN THE AUDITOR'S PROCEDURES DISCLOSE NO MATERIAL INSTANCES OF NONCOMPLIANCE

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the provisions referred to in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those provisions.[2]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.

2. If the auditor determines noncompliance is pervasive and he or she is not able to provide negative assurance, the auditor's report should consist of the following:

   [*First three paragraphs as illustrated above.*]

   The results of our tests indicate that, with respect to the items tested, the [*name of organization*] complied with those laws and regulations referred to above, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to items that were not tested by us, there is more than a relatively low risk that the [*name of organization*] may not have complied with the provisions referred to in the preceding paragraph. These matters were considered by us in evaluating whether the basic financial statements are presented fairly in conformity with generally accepted accounting principles.

   [*Last paragraph as illustrated above.*]

3. If the report is not part of the public record, this sentence should not be included in the report.

This is a nonauthoritative report issued to be in conformity with the 1994 Yellow Book. As of the date that this Manual went to press, the authoritative report has yet to be issued.

4.604b REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANTS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* WHEN THE AUDITOR'S PROCEDURES DISCLOSE NO MATERIAL INSTANCES OF NONCOMPLIANCE

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

The results of our tests disclosed no instances of noncompliance that are required to be reported herein under *Government Auditing Standards*.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[2]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.

2. If the report is not part of the public record, this sentence should not be included in the report.

This is in conformity with the 1988 Yellow Book and has not been updated to reflect all current pronouncements. The AICPA has issued a **non**authoritative report in conformity with the 1994 Yellow Book. See section 4.605b.

4.605a REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANTS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* WHEN MATERIAL INSTANCES OF NONCOMPLIANCE EXIST

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in [*name of organization*]'s 19XX financial statements.

[*Include paragraphs describing the material instances of noncompliance noted.*]

We considered these material instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX on those financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the provisions referred to in the third paragraph of this report; and, with respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those provisions.[2]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from standard report.

2. If there is pervasive noncompliance and negative assurance cannot be provided, the report should be modified as shown in section 4.604, footnote 2.

3. If the report is not part of the public record, this sentence should not be included in the report.

This is a nonauthoritative report issued to be in conformity with the 1994 Yellow Book. As of the date that this Manual went to press, the authoritative report has yet to be issued.

4.605b REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANTS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* WHEN MATERIAL INSTANCES OF NONCOMPLIANCE EXIST

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in [*name of organization*]'s 19XX financial statements.

[*Include paragraphs describing the material instances of noncompliance noted.*]

We considered these material instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX on those financial statements.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[2]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from standard report.

2. If the report is not part of the public record, this sentence should not be included in the report.

This is in conformity with the 1988 Yellow Book and has not been updated to reflect all current pronouncements. The AICPA has issued a **non**authoritative report in conformity with the 1994 Yellow Book. See section 4.606b.

4.606a REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANTS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* WHEN UNCERTAINTY ABOUT THE EFFECTS OF NONCOMPLIANCE EXISTS

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following instances of noncompliance, the effects of which may be material to the financial statements but for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in [*name of organization*]'s 19XX financial statements.[2]

[*Include paragraphs describing the instances of noncompliance note.*]

We considered these instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX on those financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the provisions referred to in the third paragraph of this report; and, with respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those provisions.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.

2. The effect of the instances of noncompliance is considered when reporting on the basic financial statements and, if material to the basic financial statements, an explanatory paragraph similar to the following should be inserted after the opinion paragraph in the auditor's report on the financial statements:

    As discussed in note X, [*name of organization*] failed to comply with certain requirements applicable to the federal awards programs in which it participates. The financial statements do not include an adjustment for any liability that may result from possible actions of federal agencies relative to these instances of noncompliance.

    Auditors should be aware that instances of noncompliance may be material, either individually or in the aggregate, warranting an adverse opinion on the financial statements.

3. If the report is not part of the public record, this sentence should not be included in the report.

This is a nonauthoritative report issued to be in conformity with the 1994 Yellow Book. As of the date that this Manual went to press, the authoritative report has yet to be issued.

4.606b REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANTS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* WHEN UNCERTAINTY ABOUT THE EFFECTS OF NONCOMPLIANCE EXISTS

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of obtaining reasonable assurance about whether the financial statements are free of material misstatement, we performed tests of [*name of organization*]'s compliance with certain provisions of laws, regulations, contracts, and grants. However, the objective of our audit of the financial statements was not to provide an opinion on overall compliance with such provisions. Accordingly, we do not express such an opinion.

Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following instances of noncompliance, the effects of which may be material to the financial statements but for which the ultimate resolution cannot presently be determined. Accordingly, no provision for any liability that may result has been recognized in [*name of organization*]'s 19XX financial statements.[2]

[*Include paragraphs describing the instances of noncompliance note.*]

We considered these instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX on those financial statements.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.

2. The effect of the instances of noncompliance is considered when reporting on the basic financial statements and, if material to the basic financial statements, an explanatory paragraph similar to the following should be inserted after the opinion paragraph in the auditor's report on the financial statements:

    As discussed in note X, [*name of organization*] failed to comply with certain requirements applicable to the federal awards programs in which it participates. The financial statements do not include an adjustment for any liability that may result from possible actions of federal agencies relative to these instances of noncompliance.

    Auditors should be aware that instances of noncompliance may be material, either individually or in the aggregate, warranting an adverse opinion on the financial statements.

3. If the report is not part of the public record, this sentence should not be included in the report.

This is in conformity with the 1988 Yellow Book and has not been updated to reflect all current pronouncements. The AICPA has issued a **non**authoritative report in conformity with the 1994 Yellow Book. See section 4.607b.

4.607a REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANTS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* WHEN THE AUDITOR DECIDES NOT TO PERFORM ANY TESTS OF COMPLIANCE[1]

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[2]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of [*name of organization*]'s compliance with such provisions of laws, regulations, contracts, and grants.

However, in connection with our audit, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with the laws, regulations, contracts, and grants referred to in the preceding paragraph.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

Notes:

1. This report is only appropriate in rare circumstances, based on assessments of materiality and audit risk, where the auditor may decide not to perform any tests of compliance with provisions of laws, regulations, contracts, and grants. (See paragraph 7.27 of SOP 92-9 for a discussion of dating of reports.)
2. Describe any departure from the standard report.
3. If the report is not part of the public record, this sentence should not be included in the report.

This is a nonauthoritative report issued to be in conformity with the 1994 Yellow Book. As of the date that this Manual went to press, the authoritative report has yet to be issued.

4.607b REPORT ON COMPLIANCE WITH LAWS, REGULATIONS, CONTRACTS, AND GRANTS BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH *GOVERNMENT AUDITING STANDARDS* WHEN THE AUDITOR DECIDES NOT TO PERFORM ANY TESTS OF COMPLIANCE[1]

[*Addressee*]

We have audited the financial statements of [*name of organization*], as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[2]

We conducted our audit in accordance with generally accepted auditing standards and *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

Compliance with laws, regulations, contracts, and grants applicable to [*name of organization*] is the responsibility of [*name of organization*]'s management. As part of our audit, we assessed the risk that noncompliance with certain provisions of laws, regulations, contracts, and grants could cause the financial statements to be materially misstated. We concluded that the risk of such material misstatement was sufficiently low that it was not necessary to perform tests of [*name of organization*]'s compliance with such provisions of laws, regulations, contracts, and grants.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

Notes:

1. This report is only appropriate in rare circumstances, based on assessments of materiality and audit risk, where the auditor may decide not to perform any tests of compliance with provisions of laws, regulations, contracts, and grants.

2. Describe any departure from the standard report.

3. If the report is not part of the public record, this sentence should not be included in the report.

4.608 REPORT ON THE INTERNAL CONTROL STRUCTURE USED IN ADMINISTERING FEDERAL AWARDS

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1] We have also audited [*name of organization*]'s compliance with requirements applicable to major federal awards programs, and have issued our report thereon dated August 15, 19XX.

We conducted our audits in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and about whether [*name of organization*] complied with laws and regulations, noncompliance with which would be material to a major federal awards program.

In planning and performing our audits for the year ended June 30, 19XX, we considered [*name of organization*]'s internal control structure in order to determine our auditing procedures for the purpose of expressing our opinions on [*name of organization*]'s financial statements and on its compliance with requirements applicable to major programs and to report on the internal control structure in accordance with OMB Circular A-133. This report addresses our consideration of internal control structure policies and procedures relevant to compliance with requirements applicable to federal awards programs. We have addressed policies and procedures relevant to our audit of the financial statements in a separate report dated August 15, 19XX.

The management of [*name of organization*] is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. The objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition, that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in accordance with generally accepted accounting principles, and that federal awards programs are managed in compliance with applicable laws and regulations. Because of inherent limitations in any internal control structure, errors, irregularities, or instances of noncompliance may nevertheless occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that procedures may become inadequate because of changes in conditions or that the effectiveness of the design and operation of policies and procedures may deteriorate.

For the purpose of this report, we have classified the significant internal control structure policies and procedures used in administering federal financial assistance programs in the following categories: [*identify internal control structure categories.*[2]] For all of the internal control structure categories listed above, we obtained an understanding of the design of relevant policies and procedures and whether they have been placed in operation, and we assessed control risk.[3]

During the year ended June 30, 19XX, [*name of organization*] expended X percent of its total federal awards under major programs.[4,5]

We performed tests of controls,[6] as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements; general requirements; and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the organization's major programs, which are identified in the accompanying schedule of federal awards. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

We noted certain matters[7] involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgement, could adversely affect the organization's ability to administer federal awards programs in accordance with applicable laws and regulations.

[*Include paragraphs describing the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal awards program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that none of the reportable conditions described above is a material weakness.[8]

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[9]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.

2. See paragraph 7.7 of SOP 92-9 for a discussion of categories to be identified. Also see paragraphs 6.36 and 6.53 through 6.61 for specific and general requirements, respectively.

3. If a cyclical approach is used, the last sentence of this paragraph should be modified and the following paragraph added:

   Because of the large number of nonmajor programs and the decentralized administration of these programs, we performed procedures to obtain an understanding of the internal control structure policies and procedures relevant to nonmajor programs on a cyclical basis. Our procedures during the current year covered X percent of the nonmajor program expenditures administered by the organization as a whole. The nonmajor program expenditures not covered during the current year have been or are expected to be subject to such procedures at least once during the X-year cycle.

4. If the total amount expended under major programs is less than 50 percent of total federal awards expended during the year under audit, the auditor should follow the guidance in paragraph 5.23 of SOP 92-9 to satisfy the objectives of OMB Circular A-133. When such guidance is followed, the sixth and seventh paragraphs of this report should be modified as follows:

   During the year ended June 30, 19XX, [*name of organization*] expended X percent of its total federal awards under major programs and the following nonmajor programs [*list appropriate nonmajor programs*]:

   We performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the organization's major programs, which are identified in the accompanying schedule of federal awards, and the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

5. If the organization had no major programs during the year under audit, the auditor should follow the guidance in paragraph 5.25 of SOP 92-9 to satisfy the objectives of OMB Circular A-133. When such guidance is followed, the second sentence of the first paragraph of the report, which refers to an audit of compliance with requirements applicable to major programs, would be omitted and the phrase "and about whether [*name of organization*] complied with laws and regulations, noncompliance with which would be material to a major federal program" should be omitted. Also, the phrase "and on its compliance with requirements applicable to major programs" should be omitted from the third paragraph. The sixth and seventh paragraphs of this report should be modified as follows:

During the year ended June 30, 19XX, [*name of organization*] had no major programs and expended X percent of its total federal awards under the following nonmajor programs [*list appropriate nonmajor programs*]:

We performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to the aforementioned nonmajor programs. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

6. When no tests of controls are performed for certain compliance requirements, this paragraph and those that follow should be replaced with the following:

Except as discussed in the following paragraph, we performed tests of controls, as required by OMB Circular A-133, to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that we considered relevant to preventing or detecting material noncompliance with specific requirements, general requirements, and requirements governing claims for advances and reimbursements and amounts claimed or used for matching that are applicable to each of the [*name of organization*]'s major federal awards programs, which are identified in the accompanying schedule of federal awards. Our procedures were less in scope than would be necessary to render an opinion on these internal control structure policies and procedures. Accordingly, we do not express such an opinion.

For [*identify relevant federal awards programs*], we performed no tests of controls to evaluate the effectiveness of the design and operation of internal control structure policies and procedures that could be relevant to preventing or detecting material noncompliance with [*identify relevant compliance requirements*]. We did not perform such tests because the results of procedures and whether they have been placed in operation indicated that [*describe the absence of relevant policies and procedures or the circumstances that cause the auditor to conclude that policies and procedures are unlikely to be effective*]. We consider this condition to be a reportable condition under standards established by the American Institute of Certified Public Accountants.

Reportable conditions involve matters coming to our attention concerning significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect [*name of organization*]'s ability to administer federal awards programs in accordance with applicable laws and regulations. In addition to the reportable conditions identified in the preceding paragraph, we noted other matters involving the internal control structure and its operation that we consider to be reportable conditions.

[*Include paragraphs to describe the reportable conditions noted.*]

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level of risk that noncompliance with laws and regulations that would be material to a federal awards program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe none of the reportable conditions described above is a material weakness.

We also noted other matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.

[*Signature*]

[*Date*]

7. When there are no material weaknesses and no reportable conditions noted, this paragraph and those that follow should be replaced with the following paragraphs:

    Our consideration of the internal control structure policies and procedures used in administering federal awards would not necessarily disclose all matters in the internal control structure that might constitute material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that noncompliance with laws and regulations that would be material to a federal awards program may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

    However, we noted certain matters involving the internal control structure and its operation that we have reported to the management of [*name of organization*] in a separate letter dated August 15, 19XX.

    This report is intended for the information of the audit committee, management, and [*name of organization*]. However, this report is also a matter of public record and its distribution is not limited.

    [*Signature*]

    [*Date*]

8. If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the audit of compliance with requirements applicable to major programs. The last sentence of this paragraph of the report should be modified as follows:

    However, we noted the following matters involving the internal control structure and its operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of [*name of organization*]'s compliance with requirements applicable to its major programs for the year ended June 30, 19XX, and this report does not affect our report thereon dated August 15, 19XX. [*A description of the material weaknesses that have come to the auditor's attention would follow.*]

9. If the report is not part of the public record, this sentence should not be included in the report.

4.609 UNQUALIFIED OPINION ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO MAJOR PROGRAMS

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We have also audited [*name of organization*]'s compliance with the requirements governing [*list requirements tested*][2] that are applicable to each of its major federal awards programs, which are identified in the accompanying schedule of federal awards[3] for the year ended June 30, 19XX. The management of [*name of organization*] is responsible for [*name of organization*]'s compliance with those requirements. Our responsibility is to express an opinion on compliance with those requirements based on our audit.

We conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*name of organization*]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.[4]

In our opinion, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*][1] that are applicable to each of its major federal awards programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[5]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.

2. Specific requirements generally pertain to the following matters:

   - Types of services allowed or not allowed
   - Eligibility
   - Matching, level of effort, or earmarking
   - Reporting
   - Special tests and provisions
   - Financial reports and claims for advances and reimbursements
   - Amounts claimed or used for matching

3. Major programs should be clearly identified in the schedule of federal awards.

4. If there are no instances of noncompliance, this paragraph should be omitted. Immaterial instances of noncompliance may be communicated to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the first sentence of this paragraph should be replaced with a sentence similar to the following: "The results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to above that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."

5. If the report is not part of the public record, this sentence should not be included in the report.

4.610 QUALIFIED OPINION ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO MAJOR PROGRAMS—SCOPE LIMITATION

[Addressee]

[The first and second paragraphs are the same as those of the standard report on major program compliance illustrated in Section 4.609.]

Except as discussed in the following paragraph, we conducted our audit of compliance with those requirements in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether material noncompliance with the requirements referred to above occurred. An audit includes examining, on a test basis, evidence about [*name of organization*]'s compliance with those requirements. We believe that our audit provides a reasonable basis for our opinion.

We were unable to obtain sufficient documentation supporting [*name of organization*]'s compliance with the requirements of [*identify the major program*] governing types of services allowed or unallowed; nor were we able to satisfy ourselves as to [*name of organization*]'s compliance with those requirements by performing other auditing procedures.

[The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in Section 4.609.]

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding [*name of organization*]'s compliance with the requirements of [*identify the major program*] governing types of services allowed or unallowed, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal awards programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[Signature]

[Date]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

4.611 QUALIFIED OPINION ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO MAJOR PROGRAMS—NONCOMPLIANCE

[*Addressee*]

[*The first three paragraphs are the same as those in the standard report on major program compliance illustrated in Section 4.609.*]

The results of our audit procedures for [*identify the major program*] disclosed that [*name of organization*] did not comply with the requirement that [*name of organization*] match the funds received from [*identify the major program*]. In our opinion, [*name of organization*]'s matching of funds received from [*identify the major program*] is necessary for [*name of organization*] to comply with the requirements applicable to [*identify the major program*].

[*The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in Section 4.609.*]

In our opinion, except for those instances of noncompliance with the requirements applicable to [*identify the major program*] referred to in the fourth paragraph of this report and identified in the accompanying schedule of findings and questioned costs, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]

[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

4.612 ADVERSE OPINION ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO MAJOR PROGRAMS

[*Addressee*]

[*The first three paragraphs of the report are the same as those in the standard report on major program compliance illustrated in Section 4.609.*]

[*Add a paragraph describing the reasons for the adverse opinion.*]

[*The fifth paragraph is the same as the fourth paragraph of the standard report on major program compliance illustrated in Section 4.609.*]

In our opinion, because of the noncompliance referred to in the fourth paragraph, [*name of organization*] did not comply, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal awards programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]

[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

4.613 DISCLAIMER OF OPINION ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO MAJOR PROGRAMS

[Addressee]

[The first paragraph of the report is the same as the first paragraph in the report illustrated in Section 4.609.]

We were also engaged to audit [*name of organization*]'s compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal awards programs, which are identified in the accompanying schedule of federal awards for the year ended June 30, 19XX. The management of [*name of organization*] is responsible for [*name of organization*]'s compliance with those requirements.

The management of [*name of organization*] has refused to provide us with written representations that generally accepted auditing standards require us to obtain.

Because of the matter described in the preceding paragraph, the scope of our audit work was not sufficient to enable us to express, and we do not express, an opinion on [*name of organization*]'s compliance with the requirements governing [*list requirements tested*] that are applicable to each of its major federal awards programs for the year ended June 30, 19XX.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[Signature]

[Date]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

4.614 QUALIFIED OPINION ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO MAJOR PROGRAMS—UNCERTAINTIES

[*Addressee*]

[*The first three paragraphs are the same as those of the standard report on major program compliance illustrated in Section 4.609.*]

The results of our audit procedures for the [*name*] program disclosed that [*name of organization*] did not comply with the requirements that [*identify the requirements*]. In our opinion, [*name of organization*]'s compliance with this requirement is necessary for [*name of organization*] to comply with the requirements applicable to the [*name*] program.

In addition, the results of our audit procedures disclosed immaterial instances of noncompliance with the requirements referred to in the second paragraph of this report, which are described in the accompanying Schedule of Findings and Questioned Costs. We considered these instances of noncompliance in forming our opinion on compliance, which is expressed in the following paragraph.

In our opinion, except for those instances of noncompliance with requirements applicable to the [*name*] program referred to in the fourth paragraph of this report and identified in the accompanying Schedule of Findings and Questioned Costs, [*name of organization*] complied, in all material respects, with the requirements governing [*list requirements tested*] that are applicable to each of its major federal awards programs for the year ended June 30, 19XX.

Resolving instances of noncompliance identified in the fourth paragraph of this report is the responsibility of [*name of organization and federal officials*]. The determination of whether the identified instances of noncompliance will ultimately result in a disallowance of costs cannot be presently determined. Accordingly, no adjustment for any disallowances that may result has been made to the federal program amounts listed in the accompanying schedule of federal awards and no provision for any liability that may result has been recognized in [*name of organization*]'s 19XX financial statements.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[1]

[*Signature*]

[*Date*]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

4.615 REPORT ON COMPLIANCE WITH GENERAL REQUIREMENTS— NO MATERIAL NONCOMPLIANCE IDENTIFIED

[*Addressee*]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

We have applied procedures to test [*name of organization*]'s compliance with the following requirements applicable to its federal awards programs, which are identified in the accompanying schedule of federal awards for the year ended June 30, 19XX: [*List the general requirements tested.*[2]]

Our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of our procedures disclosed no material instances of noncompliance with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] has not complied, in all material respects, with those requirements. However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.[3]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[4]

[*Signature*]

[*Date*]

Notes:

1. Describe any departure from the standard report.

2. General requirements deal with the following matters:

   - Political activity
   - Davis-Bacon Act
   - Civil rights
   - Cash management
   - Federal financial reports
   - Allowable costs/cost principles

- Drug-free workplace
- Administrative requirements

The auditor should refer to the Compliance Supplement for additional information on the general requirements.

3. If there are no immaterial instances of noncompliance, this sentence should be omitted. Immaterial instances of noncompliance may be communicated to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the last sentence of this paragraph should be replaced with a sentence similar to the following: "The results of our procedures disclosed immaterial instances of noncompliance with the requirements referred to above that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."

4. If the report is not part of the public record, this sentence should not be included in the report.

4.616 REPORT ON COMPLIANCE WITH GENERAL REQUIREMENTS WHEN MATERIAL NONCOMPLIANCE IS IDENTIFIED

[*Addressee*]

[*The first three paragraphs are the same as those of the standard report on compliance with general requirements illustrated in Section 4.615.*]

Material instances of noncompliance consist of failures to follow the general requirements that caused us to conclude that the misstatements resulting from those failures are material to [*indicate program(s) or financial statements*]. The results of our tests of compliance disclosed the material instances of noncompliance that are described in the accompanying Schedule of Findings and Questioned Costs.[1]

We considered these material instances of noncompliance in forming our opinion on whether [*name of organization*]'s 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.[2]

Except as described above, the results of our procedures to determine compliance indicate that, with respect to the items tested, [*name of organization*] complied, in all material respects, with the requirements listed in the second paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements. However, the results of our procedures also disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

Notes:

1. If, individually or collectively, the instances of noncompliance are also material to the general-purpose financial statements, the report on compliance required by *Government Auditing Standards* (Section 4.604) is modified as follows:

   [*First three paragraphs are the same as in the report illustrated in Section 4.604.*]

   Material instances of noncompliance are failures to follow requirements, or violations of prohibitions, contained in laws, regulations, contracts, or grants, that cause us to conclude that the aggregation of the misstatements resulting from those failures or violations is material to the financial statements. The results of our tests of compliance disclosed the following material instances of noncompliance, the effects of which have been corrected in the 19XY financial statements of [*name of organization*].

[*Include paragraphs describing the material instances of noncompliance noted.*]

We considered these material instances of noncompliance in forming our opinion on whether the 19XX financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles, and this report does not affect our report dated August 15, 19XX, on those financial statements.

Except as described above, the results of our tests of compliance indicate that, with respect to the items tested, [*name of organization*], complied, in all material respects, with the provisions referred to in the third paragraph of this report, and with respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*], had not complied, in all material respects, with those provisions.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[3]

[*Signature*]

[*Date*]

2. The following is an illustration of the auditor's report when the auditor determines noncompliance is pervasive and the auditor is not able to provide negative assurance on general requirements.

   [*First three paragraphs and last paragraph are the same as in the report illustrated above.*]

   With respect to the items tested, [*name of organization*], complied with the requirements listed in the second paragraph, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to items that were not tested by us, there is more than a relatively low risk that [*name of organization*], may not have complied with the requirements referred to in the second paragraph. These matters were considered by us in evaluating whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

3. If the report is not part of public record, this sentence should not be included in the report.

4.617 REPORT ON COMPLIANCE WITH GENERAL REQUIREMENTS WHEN A SCOPE LIMITATION EXISTS

[Addressee]

[The first two paragraphs are the same as those of the standard report on compliance with general requirements illustrated in Section 4.615.]

Except as described in the following paragraph, our procedures were limited to the applicable procedures described in the Office of Management and Budget's *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions* [*or describe alternative procedures performed*]. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with the requirements listed in the preceding paragraph. Accordingly, we do not express such an opinion.

We were unable to obtain sufficient documentation of [*name of organization*]'s compliance with [*identify the requirement*] of [*name*] program, nor were we able to satisfy ourselves by alternative procedures as to [*name of organization*]'s compliance with those requirements of [*name*] program.

With respect to the items tested, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding [*name of organization*]'s compliance with the [*identify the requirement*] of [*name*] program, [*name of organization*] complied, in all material respects, with the requirements listed in the first paragraph of this report. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements. The results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying Schedule of Findings and Questioned Costs.

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is also a matter of public record and its distribution is not limited.[1]

[Signature]

[Date]

Note:

1. If the report is not part of the public record, this sentence should not be included in the report.

4.618 REPORT ON COMPLIANCE WITH SPECIFIC REQUIREMENTS APPLICABLE TO NONMAJOR PROGRAM TRANSACTIONS

[Addressee]

We have audited the financial statements of [*name of organization*] as of and for the year ended June 30, 19XX, and have issued our report thereon dated August 15, 19XX.[1]

In connection with our audit of the financial statements of [*name of organization*] and with our consideration of [*name of organization*]'s internal control structure used to administer federal awards programs, as required by Office of Management and Budget (OMB) Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*, we selected certain transactions applicable to certain nonmajor federal awards programs for the year ended June 30, 19XX. As required by OMB Circular A-133, we performed auditing procedures to test compliance with the requirements governing [*list requirements tested*[2]] that are applicable to those transactions. Our procedures were substantially less in scope than an audit, the objective of which is the expression of an opinion on [*name of organization*]'s compliance with these requirements. Accordingly, we do not express such an opinion.

With respect to the items tested, the results of our procedures disclosed no material instances of noncompliance with the requirements listed in the preceding paragraph. With respect to items not tested, nothing came to our attention that caused us to believe that [*name of organization*] had not complied, in all material respects, with those requirements.[3] However, the results of our procedures disclosed immaterial instances of noncompliance with those requirements, which are described in the accompanying schedule of findings and questioned costs.[4]

This report is intended for the information of the audit committee, management, and [*specify legislative or regulatory body*]. However, this report is a matter of public record and its distribution is not limited.[5]

[Signature]

[Date]

Notes:

1. Describe any departure from the standard report.

2. See note 2 to section 4.609.

3. The following is an illustration of the auditor's report when the auditor determines noncompliance for nonmajor program transactions is pervasive and the auditor is not able to provide assurance.

   [*First two paragraphs and last paragraph are the same as in the report illustrated above.*]

The results of our tests indicate that, with respect to the items tested, [*name of organization*], complied with those requirements, except as described in the attached schedule. However, the extent of noncompliance noted in our testing indicates that, with respect to nonmajor program transactions not tested by us, there is more than a relatively low risk that [*name of organization*] may not have complied with the requirements referred to in the preceding paragraph. These matters were considered by us in evaluating whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

4. If there are no instances of noncompliance, this sentence should be omitted. Immaterial instances of noncompliance may be reported to the organization in a separate letter or in the report. If the auditor has issued a separate letter describing immaterial instances of noncompliance, the last sentence of this paragraph should be replaced with a sentence similar to the following: "However, we noted certain immaterial instances of noncompliance that we have communicated to the management of [*name of organization*] in a separate letter dated August 15, 19XX."

5. If the report is not part of the public record, this sentence should not be included in the report.

Audit Approach

CHAPTER 5

THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL SUBSTANTIVE APPROACH

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CHAPTER 5

THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL SUBSTANTIVE APPROACH

5.000 INTRODUCTION

5.001 Chapters 1 through 4 of this Manual present practical assistance to all auditors of not-for-profit organizations, whether the auditors develop their own forms, questionnaires, programs, and workpapers, or whether they use those provided throughout this Manual.

5.002 This chapter, however, presents a unique approach to audit planning and performance—an approach designed specifically to minimize substantive testing and thereby maximize engagement profits. This Manual provides all the forms, questionnaires, programs, and workpapers needed to meet all planning and documentation requirements, as well as to determine the most cost effective way to conduct the engagement.

5.003 Also included in this chapter is sampling guidance for the basic audit and for testing compliance with laws and regulations.

5.100 OVERVIEW OF AUDIT APPROACHES

Overview of ABC System

5.101 The ABC System is a unique approach to planning and performing the audit, in that it is designed to allow the auditor to assess the control risk for each of the major audit areas of a not-for-profit organization, and to provide the auditor with the tests of controls, tests of balances, and analytical procedures most likely to be relevant to each major audit area.

5.102 The ABC System is based on the assumption that the auditor will desire to place as much reliance on the client's internal control structure as possible in order to minimize substantive testing while maintaining high audit quality and complying fully with all generally accepted (and governmental, when applicable) audit standards.

5.103 The ABC System's Internal Controls Questionnaire (Chapter 6, section 6.100) is organized into three levels of priorities (for each major audit area):

- those controls necessary to provide the client with an effective basic accounting system (level C),
- those controls necessary to provide the client with both an effective accounting system and good primary controls (levels B and C acting together), and

- those controls necessary to provide the client with good secondary controls, as well as good primary controls and an effective accounting system (levels A, B, and C acting together).

5.104 By completing the entire Internal Controls Questionnaire for an audit engagement, the auditor can assess the controls for each major audit area. The auditor can then exercise judgment to determine that:

- a major audit area for which all (or substantially all) controls in the A, B, and C levels are present would qualify as an "A System," for which the auditor could assess control risk as low or moderate (which would justify minimizing substantive tests once the controls themselves are tested),
- a major audit area for which all (or substantially all) controls in the B and C (but not the A) levels are present would qualify as a "B System," for which the auditor could assess control risk as moderate to slightly below the maximum (which would justify reducing some substantive tests once the controls are tested), or
- a major audit area for which all (or substantially all) controls in the C level (but not the A and B levels) are present would qualify as a "C System," for which the auditor could assess control risk as maximum to slightly below maximum (which would cause the auditor to perform primarily substantive tests in most cases, even after the controls are tested).

5.105 Illustration 5-1 portrays the interrelationship of control risk and degree of reliance on controls for systems classified as A, B, or C.

5.106 The Manual's programs for tests of controls (Chapter 6, section 6.300) and tests of balances (Chapter 7, section 7.200) are organized according to whether controls over a major audit area are determined to constitute an A System, a B System, or a C System. Each major audit area must be assessed and classified independently from other major audit areas; thus, the payroll cycle may be classified as an A system, the payments and acquisitions cycle may be classified as a B System, and the receipts, support and revenue cycle may be a C System. Of course, an auditor must use his or her understanding of the client and the client's industry to customize the precise audit program for an engagement, but the ABC System gives the auditor assistance with determining appropriate and justifiable levels of substantive testing without "overauditing" or "underauditing."

5.107 The ABC System incorporates analytical procedures to the maximum extent possible, whether a system is rated as A, B, or C, in order to obtain the optimal mix of audit evidence for quality and efficiency. The ABC System is discussed further in section 5.300.

Overview of the All Substantive Approach

5.108 **The Approach.** This Manual's All Substantive Approach presumes that the auditor obtains an understanding of the internal control structure sufficient to plan the audit (see section 3.307, Chapter 3) and assesses control risk at the maximum. The approach is designed to place no reliance on the control system, and to use analytical procedures and substantive tests extensively. If an engagement is subject to the requirements of OMB Circular A-133, the ABC System, rather than the All Substantive Approach, should be used to include the appropriate tests of compliance.

ILLUSTRATION NO. 5-1

RELIANCE MATRIX

Reliance on Types of Tests Based on Control Risk Assessment

Audit Approach	Control Risk	Tests of Controls	Analytical Procedures	Tests of Balances
ABC System:				
System A: Good Internal Control Procedures	Low to Moderate	High Reliance	Maximum Extent Possible	Low Reliance
System B: Good Accounting System and Primary Controls	Moderate to Slightly Below the Maximum	Moderate Reliance	Maximum Extent Possible	Medium Reliance
System C: Good Accounting System or More Efficient Tests of Balances Approach	Slightly Below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance
All Substantive Approach:				
Weak Accounting System or More Efficient Substantive Tests of Balances Approach (System C Tests Of Controls)	Slightly Below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance

Note: For audits in accordance with OMB Circular A-133, auditors should use the ABC System.

5.109 There are two ways in which an auditor may come to the decision to assess control risk at the maximum for all major audit areas: elective and forced.

5.110 Elective Use of the Approach. If the client's operations and financial statements are noncomplex, an auditor may decide that substantive testing can easily provide all the evidential matter needed for him or her to express an opinion on the financial statements. An example might be a foundation whose only assets are investments that can readily be confirmed with a third party, whose only revenue is investment income, and whose only expenses are salaries and grants awarded.

5.111 For this type of client, the auditor may decide to "artificially" assess control risk at the maximum for all major audit areas in order to avoid the inefficient use of audit time to make a detailed evaluation of and to test the internal control structure on which the auditor does not intend to rely.

5.112 This Manual provides an All Substantive Approach Questionnaire (section 5.703) for the auditor to document his or her understanding of the client's internal control structure. By using this questionnaire, an auditor may bypass the two ABC System steps of completing the entire Internal Control Questionnaire and performing extensive Tests of Controls. However, performing limited tests of controls is recommended in order to enhance the auditor's understanding of the internal control structure and the flow of transactions through the accounting system. Completing some or all of the System C Test of Controls Programs can satisfy these objectives.

5.113 Forced Use of the Approach. The auditor does consider controls over each major audit area and determines that control risk in fact should be assessed at maximum, due to absent or faulty controls or due to inadequate compliance with the controls that ostensibly are in place. Such situations would call for the forced use of the All Substantive Approach, unless or until the auditor determines that the client records are not auditable, which would require a scope limitation or withdrawal from the engagement.

5.114 The All Substantive Approach is discussed further in section 5.400.

5.200 TYPES OF TESTS

5.201 In developing an audit strategy, the auditor must consider, among other things, the relative efficiency and effectiveness of the three types of audit procedures—tests of controls, tests of balances, and analytical procedures. To help in this determination (which influences the auditor's selection of the ABC System or the All Substantive Approach), the following sections briefly describe these three types of tests.

Tests of Controls

5.202 When the auditor assesses control risk below the maximum (such as in a System A or B approach), he or she must perform tests of controls to support the lower assessed level of control risk. Appendix B of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319.67), defines tests of controls as:

> Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

Examples of tests of controls include inquiries of client personnel, inspection of documents and reports, and observation of the application of a control policy or procedure. Performing tests of controls to support a lower assessed level of control risk allows the auditor to reduce substantive tests. As a result, before performing tests of controls, the auditor should weigh the relative effort needed to perform the tests of controls against the effort saved by reducing substantive tests. Tests of Controls Programs are included in Chapter 6, section 6.300.

Substantive Tests

5.203 Paragraph 4.11 of the AICPA's Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states:

> The auditor makes judgments about the nature of substantive tests based on an assessment of the effectiveness and efficiency of the available alternative procedures in detecting material misstatements. The procedures may include substantive analytical procedures, substantive tests of details, or a combination of both. Judgments about the nature, timing, and extent of audit procedures are influenced by the—
>
> - Assessment of the inherent risk of material misstatement.
> - Materiality of transactions and balances.
> - Assessed level of control risk.
> - Amount, volume, and variability of transactions and balances.
> - The effectiveness of other available audit procedures.

5.204 As a result, the assurance an auditor needs from substantive tests (which is based on the assessed level of control risk and tests of controls) is obtained by performing substantive tests of balances procedures, substantive analytical procedures, or a combination of both.

5.205 Depending on the nature and extent of the analytical procedures, it may be possible to *substantially* reduce the related tests of balances. For example, a reasonableness test of depreciation expense may eliminate detail tests of a client's depreciation schedule. As another example, calculation of units sold times average sales price to predict sales revenues may eliminate the need for further analysis of that account. In both of these cases, a simple analytical procedure can be used to adequately verify all the financial statement assertions for a general ledger account balance. Further tests of those balances may not be necessary.

5.206 **Substantive Tests of Balances.** Whenever control risk is assessed at the maximum level (a substantive audit approach), the auditor will place high reliance on substantive testing. Characteristics of highly reliable substantive tests are that they are performed at year end rather than at interim dates, the evidence provided by the tests is highly reliable (such as examining supporting documents prepared by a third party rather than internally-prepared documents), and maximum sample sizes are selected.

5.207 When the auditor relies on tests of controls, the nature, timing, and extent of substantive tests may be changed. The Evidence Matrix in Illustration No. 5-2 shows the impact of a client's internal control structure on the substantive tests of balances evidence.

5.208 The Tests of Balances Programs for not-for-profit organizations are included in Chapter 7.

5.209 **Analytical Procedures.** In most cases, analytical procedures should be performed to the maximum extent possible, because they are often more efficient to perform than tests of balances. The Analytical Procedures Program—Not-for-Profit Organizations is included in Chapter 7, section 7.100. The standard program should be modified for the addition or deletion of procedures required by the results of the tests of controls procedures and on the planned reliance on tests of balances. The results of the analytical procedures should be documented on supporting working papers.

5.210 Analytical procedures should be performed by the in-charge, or a supervised assistant, as early in the engagement as possible. If the client prepares year-end adjustments prior to beginning year-end field work, analytical procedures should be performed immediately upon beginning field work. In fact, in these cases, it may be appropriate for the in-charge to arrive several hours, even days on larger jobs, before the staff. The in-charge should use this lead time to complete the analytical procedures, to follow up on their results, and to reflect the conclusions in the modifications of the Tests of Balances Programs.

5.211 If the client does not prepare year-end adjustments, analytical procedures should at least be performed as work is completed and adjustments are prepared for each audit area. Performing analytical procedures as work is completed will provide corroborating evidence that will help achieve the desired level of assurance. In such cases, the results of the analytical procedures are high-reliance evidence. When modifying the tests of balances procedures, the contribution of analytical procedures to verification of the financial statement assertions should be considered.

ILLUSTRATION NO. 5-2

EVIDENCE MATRIX

Audit Approach	Control Risk for Most Financial Statement Assertions	Substantive Tests of Balances Evidence: Amount	Nature	Extent	Timing
ABC Approach					
System A: Good Internal Control Procedures	Low	Small Amounts	Least Reliable	Small Samples	Most Precede Year End
System B: Good Accounting System and Primary Controls	Moderate	Medium Amounts	More Reliable	Medium Samples	Some Precede Year End
System C: Good Accounting System	Slightly Below the Maximum to Maximum	Large Amounts	Most Reliable	Large Samples	Most at Year End
All Substantive Approach					
Weak Accounting System or More Efficient Tests Of Balances	Slightly Below the Maximum to Maximum	Large Amounts	Most Reliable	Large Samples	Most at Year End

5.300 THE ABC SYSTEM

5.301 As mentioned in section 5.102, the ABC System should be used for engagements in which the auditor plans to rely on the client's internal control structure in order to minimize substantive tests. The ABC System should also be used on all engagements in which the auditor must perform compliance tests under OMB Circular A-133. The following are the basic steps involved in designing an audit approach using the ABC System, and the forms and documents contained in this Manual related to those steps:

Procedure	Documentation
1. Understand the organization's operations and industry.	1. Client Acceptance and Continuance Form
2. Perform audit planning procedures.	2. Audit Planning Memorandum
3. Perform analytical procedures sufficient to plan the audit.	3. Audit Planning Memorandum
4. Obtain an understanding of the organization's internal control structure.	4. Internal Controls Questionnaire and EDP Controls Questionnaires
5. Assess the risk that misstatements in the financial statements could occur.	5. Risk of Potential Misstatements Evaluation Form
6. Assess control risk for each financial statement assertion and determine the tests of controls and the level of substantive tests to be performed.	6. Internal Controls Questionnaire and Planning Matrix

5.302 Procedures 1, 2, and 3 are discussed in Chapter 3 of this Manual. The following sections discuss procedures 4, 5, and 6 and the related documentation.

Internal Control Structure

5.303 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), requires the auditor to obtain a sufficient understanding of an entity's control structure (control environment, control policies and procedures, and accounting system) to adequately plan the audit and to determine the nature, timing, and extent of audit procedures. The description of the three elements of the control structure contained in SAS No. 55 is shown in Illustration No. 5-3.

ILLUSTRATION NO. 5-3

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

For a financial statement audit, an entity's internal control structure comprises the following:

Control Environment: The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies or procedures. The control environment includes such factors as—

- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance, including internal auditing.
- Personnel policies and practices.
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies.

The control environment reflects the overall attitude, awareness, and action of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity.

Accounting System: The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system will give appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

Control Procedures: Those policies and procedures, in addition to the control environment and the accounting system, that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures pertain to—

ILLUSTRATION NO. 5-3 (Continued)

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparisons of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

5.304 Completion of the Internal Controls Questionnaire (Chapter 6) satisfies the SAS No. 55 requirement to obtain and document the understanding of the three elements of the control structure. Additional narratives and flowcharts may be useful on larger, more complex engagements, however, they should supplement rather than replace the Internal Controls Questionnaire.

5.305 The Questionnaire contains the following six sections, representing 12 major audit areas for not-for-profit organizations:

I. Accounts and pledges receivable confirmations, compliance auditing, and completeness of private support.
II. Vouching and inspecting fixed assets, search for unrecorded liabilities, purchases cutoff, expense account analysis and vouching, and compliance auditing.
III. Vouching of purchases and sales of investments.
IV. Payroll tests and compliance auditing.
V. Physical inventory observation and pricing and clerical tests.
VI. Compliance auditing.

5.306 The Internal Controls Questionnaire, Tests of Controls Programs, and Tests of Balances Programs are designed by audit areas and are based on transaction cycles. Strengths and weaknesses in the internal control structure for each transaction cycle must, therefore, be reflected in the auditor's planned assessed level of control risk. The relationship is illustrated in Illustration No. 5-4, "Relationship of Major Audit Areas to Transaction Cycles."

ILLUSTRATION NO. 5-4

RELATIONSHIP OF MAJOR AUDIT AREAS TO TRANSACTION CYCLES

Major Audit Area	Related Transaction Cycles
1. Accounts and pledges receivable confirmations	1. Receipts, support and revenue.
	Restrictions and their fulfillment.
Compliance auditing	
Completeness of private support	
2. Vouching and inspecting fixed assets	2. Acquisitions and payments.
	Restrictions and their fulfillment.
Search for unrecorded liabilities	
Purchases cutoff	
Expense account analysis and vouching	
Compliance auditing	
3. Vouching of purchases and sales of investments	3. Investments.
4. Payroll tests	4. Payroll and personnel.
Compliance auditing	
5. Physical inventory observation	5. Perpetual inventory records.
Pricing and clerical tests of inventory	Maintained — inventory and warehousing.
6. Compliance auditing	6. Government programs.

5.307 Within each of the six sections of the Internal Controls Questionnaire listed in section 5.305 are three categories of controls: the accounting system controls, primary controls, and secondary controls. As described below, the "yes" and "no" responses within the three categories will help the auditor select the proper system for that section. System C is the weakest system and is characterized by good accounting system controls, but weak primary and secondary controls; System A is the strongest and is characterized by good accounting system and good primary and secondary controls. Even if the auditor anticipates that some major audit areas will be C Systems, all questions should be answered so that the auditor's requirement to understand the control structure is met. The following describes how to select the appropriate system (A, B, or C) after completing the Internal Controls Questionnaire.

1. Within each of the six sections of the Questionnaire, identify the most advanced system classification, A, B, or C, with a majority of "yes" answers in each section of the Questionnaire. Because tests of controls often require less time than tests of balances, the objective should be to perform tests of controls to the maximum extent practical.

2. Consult with the engagement partner to determine if tests of controls for the system classification selected are practical in light of past experience with the client. Prior years' unacceptable results from tests of controls, and the resulting high reliance on tests of balances, may cause the selection of a lower system classification, i.e., B or C, and minimize controls testing. In other words, this decision may prevent overauditing. For audits under OMB Circular A-133, see section 6.400 of Chapter 6 for the required compliance tests.

3. For all "no" answers, i.e., potential weaknesses, up to and including the system selected in each section, complete the following process:

   a. Determine if the "no" answer is, in fact, a weakness.

   b. For the potential weakness, review any "yes" answers to other controls for possible offsetting strengths. Such strengths could be included within the system classification selected or in a more advanced systems. For example, a weakness in a System B (a "no" answer) could be offset by another control within System B (a "yes" answer) or by a control in System A.

   c. The Tests of Controls Programs have been designed to test the controls that exist in each system, as evidenced by the Internal Controls Questionnaire. For example, the control in a System A that may offset a weakness in System B would not be tested when the System B Tests of Controls program is used. To rely on the offsetting System A control, a modifying test of that control must be added to the System B program.

   d. Select the Tests of Controls Programs for each section of the Questionnaire that corresponds with the selected system classification, A, B, or C.

5.308 The in-charge's selection of the type of internal control system should be recorded on the Planning Matrix, section 5.702, and reviewed by the engagement executive before the in-charge selects the corresponding Tests of Controls Programs. The complete Internal Controls Questionnaire is included in Chapter 6, section 6.100.

5.309 Illustration No. 5-5 is a sample completed section of the Internal Controls Questionnaire.

5.310 EDP Controls. SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements,* amended SAS No. 22, *Planning and Supervision,* by adding to the list of required planning considerations the methods used to process significant accounting information,

ILLUSTRATION NO. 5-5

Internal Controls Questionnaire	**Section IV**
Client: Clean-Up Your Act Environmental Fund	
Financial Statement Date: December 31, 1994	

MAJOR AUDIT AREA: 1. Valuation of payroll expenses.
2. Compliance auditing.

TRANSACTION CYCLES: Payroll and personnel.

ACCOUNTING CONTROLS (SYSTEM C)	Personnel	Yes	No	N/A
1. A payroll journal is prepared and balanced.	Pat	✓		
2. Payroll disbursements are made by check.	Barbara	✓		
3. Labor is functionally classified.	Marc	✓		
4. Employees' time records are maintained.	Doris	✓		
5. W-4 forms are maintained.	Doris	✓		
6. Employees' earnings records are maintained.	John	✓		
7. A payroll bank account reconciliation is prepared.	John	✓		
8. Wage rates are authorized by the owner or manager (at least verbally).	Marc	✓		
9. Adequate records are maintained to allow allocation of payroll costs to functions (including lobbying activities), specific grants and contracts.	Barbara	✓		
10. Procedures exist for appropriate allocation of expenses to those related to the organization's purpose and those that are used to generate unrelated business income.	—		✓	

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION IV (Continued)

	Personnel	Yes	No	N/A
PRIMARY CONTROLS (SYSTEM B)				
1. Time sheets or cards are prepared by employees.	—	✓		
2. The director or manager approves:				
a. Rates of pay.	Marc	✓		
b. Withholdings.	Marc	✓		
c. Changes in above.	Marc	✓		
3. The payroll bank account reconciliation is prepared by someone independent of payroll preparation and check signing or by the owner or manager.	Barbara		✓	
4. Payroll checks are prenumbered and accounted for.	Pat	✓		
5. Checks are recorded in the payroll journal as prepared.	Barbara	✓		
6. Payroll journals are posted at least monthly to employees' earnings records.	Pat	✓		
7. Payroll checks are signed by the owner or manager.	Marc	✓		
8. Time cards are approved by a director or manager.	Marc	✓		
SECONDARY CONTROLS (SYSTEM A)				
1. A time clock is used to record time or time is logged by someone independent of payroll preparation, check-signing or distribution functions.	—		✓	
2. An imprest payroll bank account is used.	—	✓		
3. All payroll calculations are checked by an independent person.	—		✓	

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION IV (Continued)

	Personnel	Yes	No	N/A
4. Employees' earnings records are periodically reconciled to the general ledger by persons independent of payroll preparation and distribution.	Marc	✓		
5. Account codings are reviewed by someone other than preparer.	—		✓	
6. Adequate personnel files are maintained.	Pat	✓		
7. Payroll checks are accounted for by a person independent of the preparation function.	—		✓	
8. Payroll is prepared by persons independent of time card approval, check signing and check distribution.	—		✓	
9. Payroll bank account reconciliation is reviewed by the director or manager.	Marc	✓		
10. Unclaimed payroll checks are followed up on by the director or manager.	Marc	✓		

Other comments:

INTERNAL CONTROLS QUESTIONNAIRE— NOT-FOR-PROFIT ORGANIZATIONS SECTION IV (Continued)

	Personnel	Yes	No	N/A

System selection (circle one):

System A(1) System B(2) System C(3)

Modification of standard tests:

	1994	19__	19__	19__	19__
Prepared by:					
Client	MD				
In-Charge	SP				
Reviewed by:					
Engagement Partner	JH				

(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

e.g., computer processing, because such methods influence the design of the accounting system and the nature of the internal control procedures. SAS No. 48 also added a new paragraph summarizing the aspects of computer processing that may have an effect on planning an audit of financial statements. The auditor should complete the Microcomputer Questionnaire or the General Computer Controls along with the Application Computer Controls Questionnaire, depending on the sophistication of the client's system. These forms are included in Chapter 6, sections 6.215–6.217.

5.311 If the organization uses a service organization to process a significant application (e.g., payroll), the auditor may be required to obtain an understanding of the controls at the service organization in accordance with SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*. Refer to Chapter 6, section 6.222 for further details. Also, the auditor may wish to complete the Service Organization Application Controls Documentation Form or the Service Auditor Report Evaluation Form in Chapter 6, sections 6.233–6.234.

5.312 The Questionnaires should be used primarily to identify major weaknesses and strengths that could affect the auditor's planned tests of controls and tests of balances procedures. Weaknesses that represent reportable conditions (see Chapter 8, section 8.607) must be communicated to the client. The auditor may also wish to communicate less significant weaknesses to management along with recommendations for improvement.

Risk of Potential Misstatements Evaluation

5.313 As discussed in sections 3.322–3.340 of Chapter 3, an important consideration in designing an audit strategy is considering the risk that errors, irregularities, and illegal acts that have a material effect on the financial statements could occur. The assessment of this risk, combined with information obtained in completing the Client Acceptance and Continuance Form, the Audit Planning Memorandum, and the Internal Controls Questionnaire affects the nature, timing, and extent of tests required to reduce that risk to an acceptable level. For example, if the auditor determines that there is a high risk that a material error could occur in a particular area (such as an asset subject to misappropriation or an account that involves very complex accounting methods), he or she would increase the amount of evidence required from tests of controls, analytical procedures, and/or tests of balances for that area. The purpose of the risk evaluation is to direct the auditor's efforts toward the audit areas that are most likely to contain misstatements. Most importantly, this assessment occurs before the evidence collection process begins.

5.314 This early assessment allows the auditor to modify the design of tests before the engagement is completed and overauditing has occurred. For example, the auditor may have planned to test a client's inventories by relying heavily on tests of controls, in order to reduce year-end inventory count observations, pricing, and clerical tests. A review of the client's prior year's error history, however, revealed that significant counting, pricing, and clerical testing errors had occurred, resulting in a significant extension of the year-end tests. In this case, both extensive tests of controls and tests of balances were required. Had the prior year's errors been identified at the beginning of the engagement, the auditor would have planned to rely primarily on substantive tests, rather than waste time and effort on tests of controls that produced unsatisfactory results.

5.315 The Risk of Potential Misstatements Evaluation Form in section 5.701 is designed to help the auditor assess the likelihood that material misstatements in the financial statements could occur, and if so, to develop an appropriate audit strategy. It should be completed during the pre-engagement audit planning by the in-charge and reviewed by the partner.

5.316 The Form is comprised of two parts. Part I, "Special Considerations," is a series of questions about the client and the audit engagement circumstances that could indicate a high risk of potential misstatements. "Yes" answers to the questions in Part I should be explained. Part II, "Potential Misstatements Matrix," involves assessing the risk of misstatements for each audit area. This assessment is made by considering: (1) the responses to Part I, "Special Considerations," (2) whether the accounts are unusual and material or high risk due to the client's industry and operations, and (3) information from prior years' engagements about high exposure areas and any significant adjustments, made or passed. After considering these three risk categories, the auditor arrives at a conclusion, based on his or her professional judgment as to whether risk is high or low for each area. This conclusion is transferred to the Planning Matrix, section 5.702, where it will be considered in developing an audit strategy. Any situations that indicate a high risk of potential misstatement should be described, along with the planned modification to the tests of controls and substantive tests.

The Planning Matrix

5.317 Completion of the Client Acceptance and Continuance Form, the Audit Planning Memorandum, the Internal Controls Questionnaire, and the Risk of Potential Misstatements Evaluation Form provides the auditor with the information needed to plan the nature, timing, and extent of tests. The Planning Matrix in section 5.702 is designed to bring this information into one form.

5.318 The Planning Matrix contains the following audit areas:

- Cash, including receipts and disbursements
- Accounts receivable and revenue
- Contributions receivable and support
- Inventories

5.319 These are the areas most likely to be tested under a System A or B in a not-for-profit organization. In other words, they are areas in which tests of controls is an efficient and effective means of reducing substantive tests. The Matrix should be modified on each engagement to include any other accounts or audit areas for which the System A or B would be more efficient and effective.

5.320 Completion of the Planning Matrix involves the following steps for each audit area:

1. Indicate the preliminary System classification (A, B, or C) from the Internal Controls Questionnaire.

2. Based on the system classification in step 1, select the planned assessed level of control risk. Because a System C lacks good primary and secondary controls, control risk should be assessed at the maximum or slightly below the maximum for these classifications. Control risk for System B classifications can be assessed at a moderate level, and for System A, at a low level. Also, the auditor may elect to use the System C even though the system is evaluated as an A or B, if he or she believes it will be more efficient and effective to test those assertions under System C (a primarily substantive approach).

3. From the Risk of Potential Misstatements Matrix, indicate whether the risk of potential misstatements is high or low.

4. Determine whether analytical procedures can be relied on to detect material misstatements and indicate whether the risk that they will **not** detect a material misstatement is maximum, moderate, or low.

5. Indicate briefly, the planned reliance on tests of balances, including the nature, timing, and extent of these tests.

5.321 Illustration No. 5-6 shows some ways that substantive tests of balances may be reduced in a not-for-profit organization when the ABC System is used.

5.400 THE ALL SUBSTANTIVE APPROACH

5.401 The All Substantive Approach should be used on engagements that have some or all of the following characteristics:

1. Concentration of operational control in the hands of one or a few individuals.

2. Management personnel or employees have limited accounting knowledge.

3. Management believes that it cannot or need not hire employees having accounting knowledge.

4. The potential for management override of internal accounting controls is high.

5. Internal control deficiencies result from:

   a. Limited segregation of functions within the accounting system because of the small number of employees.

   b. Easy access to physical assets by clerical and administrative personnel.

   c. Informally designed procedures for planning, budgeting, accounting, and reporting depend on management style.

6. The organization has an inactive or ineffective governing board.

5.402 The majority of small- and medium-size not-for-profit organizations possess some or all of these characteristics, making it necessary for the auditor to perform extensive tests of balances to compensate for unacceptable results of tests of controls.

5.403 As mentioned in section 5.110, an auditor may elect to use the All Substantive Approach on an engagement, if he or she decides that a substantive audit approach would be the most efficient approach. In other words, the nature of the organization's control structure may make performing tests of balances more cost effective than tests of controls. For example, for an organization

ILLUSTRATION NO. 5-6

REDUCTIONS IN SUBSTANTIVE TESTS OF BALANCES

Audit Areas	Possible TOBs Reductions
1. Cash	1. Prove fewer bank reconciliations. Prove some reconciliations at dates other than balance-sheet date. Trace fewer reconciling items to support. Use client's subsequent bank statement instead of cutoff statement.
2. Accounts receivable confirmation and alternative procedures for nonreplies and exceptions	2. Send fewer confirmations. Confirm at dates other than balance-sheet date. Alternative procedures for nonreplies to positive requests should consist of reviews of subsequent collections. Absent subsequent collections, and in the event of numerous nonreplies, sales and shipping documents should be examined.
3. Investments	3. Limit the extent of vouching of investment transactions.
4. Physical inventory observation[1]	4. Fewer test counts taken and recorded. More time spent determining client is following instructions. Less time spent on observation. Observe cycle counts for perpetual systems.
5. Tests of balances inventory pricing and clerical tests[1]	5. Limit the extent of the tests.

[1] When client's inventory system is nonperpetual, controls testing of inventory cannot be performed. Observation procedures, pricing and clerical tests are primarily substantive tests of balances, the extent of which depends on how well client personnel follow written instructions and on the extent of the client's double-checking procedures.

ILLUSTRATION NO. 5-6 (Continued)

REDUCTIONS IN SUBSTANTIVE TESTS OF BALANCES

Audit Areas	Possible TOBs Reductions
6. Vouching and inspecting fixed assets	6. Less physical inspection of assets. Limit the extent of vouching tests for additions, repairs, supplies, etc., especially when numerous, low value assets have been capitalized.
7. Search for unrecorded liabilities	7. Higher dollar limits for review of journals, open invoices, receiving reports, and purchase order files. Few, if any, vendor confirmations would be sent.
8. Revenue and federal assistance	8. Limit the extent of tests of amounts and compliance with applicable requirements.
9. Support	9. Limit the extent of tests of completeness.
10. Payroll tests	10. Eliminate monthly or periodic comparison of payroll. Eliminate reconciliation of payroll-to-payroll tax returns.
11. Expense account analysis and vouching	11. Limit extent of account analysis and vouching.
12. Compliance auditing	12. Limit the extent of compliance tests.

receiving most of its revenue as large grants (as opposed to thousands of small contributions from individuals), it may be more cost effective to confirm a substantial portion of the grants (a substantive approach) than to perform tests of controls in order to limit the confirmations.

5.404 In such circumstances, the engagement partner may approve the All Substantive Approach discussed below. This approach involves assessing control risk at the maximum or slightly below the maximum for all major audit areas. Under this approach, little or no reliance is placed on tests of controls and high reliance is placed on tests of balances and analytical procedures. Even though tests of controls are not required whenever control risk is assessed at the maximum, this approach provides for minimum controls tests through completion of the System C Tests of Controls Programs. Performing these minimum tests of controls is recommended because they can enhance the auditor's understanding of the control structure and flow of transactions through the accounting system, and also allow the auditor to slightly reduce substantive tests.

5.405 Illustration No. 5-7 shows the primary planning and procedural forms that should be completed when using the All Substantive Approach, along with the corresponding forms used in the ABC System approach.

ILLUSTRATION NO. 5-7

DOCUMENTATION REQUIREMENTS FOR THE ALL SUBSTANTIVE APPROACH AND THE ABC SYSTEM

All Substantive Approach	ABC System
Client Acceptance and Continuance Form	Same.
Audit Planning Memorandum	Same.
All Substantive Approach Questionnaire	Replaces Internal Controls Questionnaire, Risk of Potential Misstatements Evaluation Form, and Planning Matrix.
Materiality Computation Schedule and Summary of Possible Journal Entries Form	Same.
System C Test of Controls Programs (optional)	System A, B, and C Tests of Controls Programs, as evaluated for each audit area.
Internal Control Structure Reportable Conditions Form, based on completion of All Substantive Approach Questionnaire	Same, but based on Internal Controls Questionnaire.
Analytical Procedures Program, maximum reliance.	Same, with less reliance if related audit areas are evaluated as Systems A or B.
Tests of Balances Program, highly reliable procedures and maximum sample sizes.	Same, with less reliance if related audit areas are evaluated as Systems A or B.

All Substantive Approach Questionnaire

5.406 The All Substantive Approach Questionnaire—Not-for-Profit Organizations, included in section 5.703, should be completed on small, noncomplex engagements if it is the most cost-beneficial approach. Section I of the Questionnaire is designed to provide the auditor with an understanding of the organization's internal control structure as required by SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*. It also helps the auditor identify material control environment and accounting system weaknesses that might impact the design of the audit. "No" answers should be recorded on the Internal Control Structure Reportable Conditions Form in Chapter 6, Section 6.500.

5.407 Section II should be used to evaluate the risk of potential misstatements on the engagement. Areas containing high risk should be described and considered when designing analytical and tests of balances procedures and selecting sample sizes. A high risk of potential misstatements may increase the evidence requirements in certain audit areas.

5.408 Completion of the Internal Controls Questionnaire, the Planning Matrix, and the Risk of Potential Misstatements Evaluation Form is not necessary for small, noncomplex engagements.

Tests of Controls

5.409 Even though tests of controls are not required whenever control risk is assessed at the maximum, the All Substantive Approach requires minimum controls testing, using the System C Tests of Controls Programs, to enhance the auditor's understanding of the control structure and flow of transactions. Performing the System C tests of controls may also support an assessment of control risk at slightly below the maximum, allowing the auditor to achieve a slight reduction in tests of balances. The System C Tests of Controls Programs should be selected for all audit areas. Minimum sample sizes may be selected, since minimum reliance is being placed on the tests of controls.

Analytical Procedures

5.410 As for all audit engagements, analytical procedures should be performed on small, noncomplex audit engagements to the maximum extent practical and should be performed as early in the engagement as possible. On engagements where significant adjustments are required, analytical procedures should be performed after all significant adjustments have been recorded. In each circumstance, the planned reliance on analytical procedures should be reflected in the modification of the Tests of Balances Program.

Tests of Balances

5.411 Because minimum or no reliance is placed on tests of controls in a System C, substantive tests of balances become the primary source of evidence. The nature, timing, and extent of the tests of balances and analytical procedures selected should be those that are the most reliable, e.g., positive vs. negative confirmations, larger sample sizes, and tests should be performed at year end rather than at interim dates. Illustration No. 5-8 presents some suggestions that should be considered in designing high-reliance tests of balances for major audit areas.

ILLUSTRATION NO. 5-8

ALL SUBSTANTIVE APPROACH-SUGGESTED TESTS OF BALANCES

Major Audit Area	Program Design Consideration
1. Cash	1. Prove all major bank reconciliations at the balance-sheet date. Trace most reconciling items to cutoff statements. Search extensively for unrecorded bank transfers.
2. Accounts receivable confirmation and alternative procedures	2. Send positive confirmations for representative accounts comprising a substantial portion of the account balances at year end in accordance with SAS No. 39. Support nonreplies and exceptions by reference to sales and cash receipts documents. Compare sales by month, by product, to preceding years. Follow up on significant fluctuations by inspecting underlying records.
3. Sales cutoff	3. Perform extensive cutoff tests by reference to sales and shipping documents for a large period before and after the balance-sheet date.

ILLUSTRATION NO. 5-8 (Continued)

ALL SUBSTANTIVE APPROACH–SUGGESTED TESTS OF BALANCES

Major Audit Area	Program Design Consideration
4. Physical inventory observation	4. Consider observing inventory from start to finish. Make extensive test counts at all locations.
5. Inventory pricing and clerical tests	5. Perform extensive, representative tests in accordance with SAS No. 39. A significant portion of the inventory items should be subjected to tests.
6. Vouching and inspecting fixed assets	6. Perform extensive vouching and inspections. A significant portion of the fixed assets, repairs, supplies, etc., accounts balances should be subjected to tests.
7. Search for unrecorded liabilities	7. Perform an extensive search for unrecorded liabilities including subsequently recorded transactions, open invoices, receiving report, and purchase order files. Low dollar limits should be used. Consider confirming major suppliers, including zero balances.
8. Purchases cutoff	8. Perform extensive cutoff tests by reference to vendor invoices for a large period before and after the balance-sheet date.
9. Payroll tests	9. Compare monthly payroll by labor category and follow up on transactions by reference to underlying records. Consider predictive analytical procedure or reconciling gross wages to payroll tax returns. Consider observation or payroll distribution.
10. Expense account analysis and vouching	10. Perform extensive vouching tests for all significant account balances by examining canceled checks and supporting documents.

5.500 SAMPLING DECISIONS

Audit Procedure Study and Changes to "Sampling Decisions"

As this Manual goes to print, the Auditing Standards Division of the AICPA is developing an Audit Procedure Study (APS) to replace the AICPA Audit and Accounting Guide, *Audit Sampling*. The APS is expected to be issued by the fourth quarter of 1995.[2]

The guidance contained in this section is consistent with the guidance in the Audit and Accounting Guide except that the "assurance factors" used in the Model Approach (see section 5.533) conform with those used in the draft APS. The authors believe that these factors better reflect current practice.

This section has been revised to make it easier to comply with the requirements of SAS No. 39, *Audit Sampling*. To simplify our coverage of audit sampling for substantive tests, the Table Approach to nonstatistical sampling has been removed from this edition of the Manual because the approach is in substance equivalent to the Model Approach. Practitioners who wish to use the Table Approach should refer to the AICPA Audit Sampling Guide. In this regard, the following forms have been deleted:

- Sampling Decision Working Paper
- Sample Size Selection and Evaluation Form
- Attributes Sampling Summary Form
- Nonstatistical Sample Size Selection Matrix — Tests of Controls

5.501 The requirements for audit sampling are included in SAS No. 39, *Audit Sampling* (AU 350), and the AICPA Audit and Accounting Guide, *Audit Sampling* (AAG-SAM).

5.502 According to SAS No. 39, *Audit Sampling* (AU 350), sampling occurs when the auditor tests less than 100% of a population to make some conclusion about the population. SAS No. 39 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client's internal control structure. If the All Substantive Approach is being used, the auditor will not perform tests of controls using audit sampling. Also, if the sampling populations are small, it is usually more efficient to audit individually significant items and obtain audit assurance about the remaining balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control structure increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

Audit Sampling for Tests of Controls

5.503 SAS No. 39 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This Manual provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

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[2] When the APS is issued, it may be obtained by calling the AICPA's Order Department at 1-800-862-4272.

1. **Determine the objective of the test** — The objective of a test of control is to determine whether a particular internal control policy or procedure is being applied as prescribed. Audit sampling for tests of controls is generally appropriate when application of the internal control policy procedure leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant internal control policy or procedure was applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling.

2. **Define the deviation conditions** — A deviation condition is a situation that indicates that the policy or procedure was not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (e.g., the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Adequate performance of a policy or procedure consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed procedure requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the procedure for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as " a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"

3. **Define the population** — The population selected must be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of an internal control procedure designed to determine if all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.

   For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. However, sometimes the results of tests performed at an interim date may be sufficient to generalize about the population for the entire period. In determining whether interim tests are sufficient, the auditor should consider the results of the tests, responses to inquiries concerning the remaining period, the length of the remaining period, the nature and amounts of the transactions or balances involved, and related evidence obtained from the tests of balances. If a control policy or procedure has been changed during the year, the auditor will often decide that it is efficient to only test the new policy or procedure.

   For sample results to be reliable, the sample must be selected from the complete population. Completeness of the population can be determined by either physical or numerical control. Normally, the auditor can establish the completeness of the population by inspecting the documents to see that it appears that they have all been accounted for.

4. **Determine the method of selecting the sample** — Any sample that is selected should be representative of the population and all items should have an opportunity to be selected. Random-number selection should generally be used when statistical sampling is being applied. When nonstatistical sampling is applied, random-number sampling, systematic sampling, and haphazard sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at section 5.540.

5. **Determine the sample size** — Sample sizes for tests of controls are affected by (1) the risk of assessing control risk too low, (2) the tolerable deviation rate, (3) the expected population deviation rate, and (4) any effects of small population sizes.

Guidance for determining sample size when performing nonstatistical sampling begins with section 5.506. A description of statistical sampling begins with section 5.509.

6. **Perform the sampling plan** — Once the sample has been selected, the auditor should examine each item for evidence of performance of the internal control policy or procedure. If the auditor selects an item that is unused (e.g., a voided document), the auditor should select another item, at random. However, the auditor should make sure that the item really represents an unused item. If the document is valid, but cannot be found, the item should be treated as a deviation in evaluating the sample results.

7. **Evaluate the sample results** — Guidance for evaluating nonstatistical sampling results begins with section 5.507 and guidance for evaluating statistical sampling results begins with section 5.510.

8. **Document the sampling procedure** — The audit working papers should document the following matters:

   - The objectives of the test.
   - A description of the deviation conditions.
   - The acceptable risk of assessing control risk too low.
   - The tolerable deviation rate.
   - The expected deviation rate.
   - The sample results, including the disposition of any deviations found.
   - The effect of the results on the auditors assessed level of control risk.

5.504 Factors Affecting Sample Sizes for Tests of Controls. Sample sizes for tests of controls are affected by the following factors:

1. *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk that the sample supports a lower level of control risk than is in fact the case. Decreasing the risk of assessing control risk too low will increase the sample size.

2. *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. As the expected population deviation rate increases, the sample size will increase.

3. *Tolerable deviation rate.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure that the auditor is willing to accept without increasing the assessed level of control risk. Higher tolerable deviation rates will permit smaller sample sizes.

4. *Population size.* Populations over 500 items have little or no effect on sample size. For populations under 500 in size, the auditor may slightly reduce the size of the sample.

5.505 The effects of these factors may be summarized as follows:

Factor	Effect on Sample Size
Acceptable risk of assessing control risk too low — increase (decrease)	Smaller (larger)
Tolerable deviation rate — increase (decrease)	Smaller (larger)
Expected population deviation rate — increase (decrease)	Larger (smaller)
Population size	Populations less than 500 items should be adjusted to slightly smaller sample sizes

5.506 Sample Sizes Using Nonstatistical Sampling. Nonstatistical sample sizes for tests of controls may be determined using the sample size selection tables in section 5.507, or they may be selected on a purely judgmental basis. Sample sizes should be entered directly on the appropriate Tests of Controls Program. For each method of selection, the auditor should document consideration of the relevant factors. For example, the rationale for selecting tests of controls sample sizes of 30 from the first table in section 5.507 for an internal control system that is classified as a System B may be:

1. Control risk will be assessed at a moderate level, and
2. The expected population deviation rate is at or near zero.

5.507 The following tables should be used for a nonstatistical approach to determine sample sizes for tests of controls:

CONTROLS TESTING NONSTATISTICAL
SAMPLE SIZE SELECTION TABLE

Assessed Level of Control Risk	Sample Size
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

The numbers in the table were determined using a risk of assessing control risk too low of 10% and an expected population deviation rate of 0%. When deviations are expected or found in a sample, the following table may be used to determine the sample size or evaluate the sample results:

Deviations (Expected or Actual)	Assessment of Control Risk		
	Slightly Below Maximum	Moderate	Low
0	15	30	40
1	25	50	65
2	34	67	90
3	43	85	115

5.508 In evaluating the results of the sample, the auditor should consider the number of deviations found and the nature of the deviations. If the auditor uses the first table in section 5.507 to determine sample size, the discovery of one or more deviations will require the auditor to reassess the planned level of control risk. In these cases, the second table in section 5.507 may be used to evaluate the assessed level of control risk that is supported by the sample results. When looking at the nature of the deviations, the auditor is concerned with the following questions:

- Was the cause of the deviation an error or does it indicate an intentional violation of the control?
- Are there implications for other audit areas?

5.509 **Sample Sizes Using Statistical Sampling.** The appropriate statistical method for tests of controls is attributes sampling, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling results may be used to estimate the frequency of deviations from performance of an internal control policy or procedure.

5.510 Applying attributes sampling involves performing the following steps:

1. **Decide on the attributes to test.** The Tests of Controls Program may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.
2. **Define the population from which the sample items should be selected.** The auditor should make sure that the population is appropriate for the audit objective as described in 5.503.
3. **Specify the following factors:**

   - *Acceptable Risk of assessing control risk too low.* The risk of assessing control risk too low is the risk the sample supports a lower level of control risk than is the case. Since sample evidence represents the only evidence typically obtained about the operating effectiveness of a particular control, the risk of assessing control risk too low is usually set at 5% or 10%.
   - *Tolerable deviation risk.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure the auditor is willing to accept without increasing the assessed level of control risk. Higher assessments of control risk will permit higher tolerable deviation rates as shown in the following table:

Planned Assessed Level of Control Risk	Tolerable Rate
Low	2% - 7%
Moderate	6% - 12%
Slightly below the maximum	11% - 20%
Maximum	Omit test

- *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. The auditor's expectations may be based on prior years' experience with the client, or experience with similar clients. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.

4. **Determine the appropriate sample size.** Sample sizes are found in the tables in sections 5.511 through 5.512. The table in section 5.511 is designed for a risk of assessing control risk too low of 5%, and the table in section 5.512 is designed for a 10% risk of assessing control risk too low. With the tolerable deviation rate and the expected deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.
5. **Randomly select the sample from the population.** The section beginning at 5.540 describes the methods that may be used to select a random sample.
6. **Perform the audit procedures to identify deviations in the sample.**
7. **Calculate the statistical results.** Using the tables in sections 5.513–5.514 for the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.
8. **Reassess the level of control risk.** If the actual deviation rate in the sample is higher than that specified in determining the sample, the sample results will not support the auditor's planned assessed level of control risk. In these situations, the auditor should increase the assessed level of control risk. The auditor should also consider the causes of the deviations found, and whether they have implications for other audit areas.
9. **Document the Sampling Procedures.** The audit working papers should document the matters set forth in 5.503 (item No. 8).

5.511

Statistical Sample Sizes for Testing Controls
Five Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Tolerable Rate

Expected Population Deviation Rate	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

* Sample Size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table assumes a large population.

5.512

Statistical Sample Sizes for Testing Controls
Ten Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Expected Population Deviation Rate	Tolerable Rate 2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	144(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
.25	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.50	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.75	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00	*	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25	*	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50	*	*	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75	*	*	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00	*	*	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25	*	*	*	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75	*	*	*	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00	*	*	*	*	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25	*	*	*	*	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50	*	*	*	*	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75	*	*	*	*	*	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00	*	*	*	*	*	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00	*	*	*	*	*	*	160(8)	115(6)	78(4)	34(2)	18(1)
6.00	*	*	*	*	*	*	*	182(11)	116(7)	43(3)	25(2)
7.00	*	*	*	*	*	*	*	*	199(14)	52(4)	25(2)

* Sample Size is too large to be cost effective for most audit applications.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table assumes a large population.

5.513

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Five Percent Risk of Assessing Control Risk Too Low

	Actual Number of Deviations Found										
Sample Size	0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.8	*	*	*	*	*	*	*
45	6.5	10.2	5.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	5.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	5.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	5.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	5.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

* Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

5.514

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Ten Percent Risk of Assessing Control Risk Too Low

Actual Number of Deviations Found

Sample Size	0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	*	*	*	*	*	*	*	*	*
25	8.8	14.7	19.9	*	*	*	*	*	*	*	*
30	7.4	12.4	16.8	*	*	*	*	*	*	*	*
35	6.4	10.7	14.5	18.1	*	*	*	*	*	*	*
40	5.6	9.4	12.8	16.0	19.0	*	*	*	*	*	*
45	5.0	8.4	11.4	14.3	17.0	19.7	*	*	*	*	*
50	4.6	7.6	10.3	12.9	15.4	17.8	*	*	*	*	*
55	4.1	6.9	9.4	11.8	14.1	16.3	18.4	*	*	*	*
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	*	*	*
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	17.9	19.6	*
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.6
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.6
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	5.9	15.0
120	2.0	3.3	4.4	5.5	6.6	7.6	8.7	9.7	10.7	11.6	12.6
160	1.5	2.5	3.3	4.2	5.0	5.8	6.5	7.3	8.0	8.8	9.5
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6

* Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

Audit Sampling for Tests of Balances

5.515 In planning tests of balances, the auditor should decide on the most efficient approach to performing the tests. For some recorded populations, instead of sampling, it may be more efficient to examine individually significant items comprising a majority, or near majority, of the recorded population. Audit assurance about the remaining balance may then be obtained by (1) performing analytical procedures, or (2) concluding that the risk of material misstatement of the remaining balance is low. For example, confirmation of 50% to 80% of the dollar amount of accounts receivable may be necessary when risk is high; 40% to 60% may be sufficient when risk is low.

5.516 Obviously, when the remaining balance, after auditing the individually significantly items, is immaterial, no testing of the remaining balance is necessary.

5.517 The decision to sample, or not to sample, should be documented in the Audit Planning Memorandum (Chapter 3, section 3.508).

5.518 Selecting all individually significant items is not considered a sampling application. Items such as large receivables are usually examined individually. Procedures used for examining such items should ordinarily be the most reliable under the circumstances, such as positive confirmation requests.

5.519 When planning a sampling application for tests of balances, the in-charge should consider the financial statement assertions and audit objectives and their relationship to populations selected. For example, understatements cannot be detected by sampling recorded amounts; instead, units from populations of all existing transactions must be selected. The populations, and the appropriate sampling units, are described in the Tests of Balances Program — Not-for-Profit Organizations (Chapter 7, section 7.500).

5.520 The following is an approach to nonstatistical sampling for tests of balances.

1. Determine the sampling population by identifying and deducting the individually significant items.
2. Determine the sample size by considering the following factors:
   - The amount of tolerable misstatement.
   - The assessed level of inherent and control risk for the assertions being tested.
   - The risk that other substantive procedures (e.g., analytical procedures) will fail to detect a material misstatement.
   - Variations within the population.
3. Select the sample.
4. Perform the test procedure.
5. Evaluate the results.
   - Project the misstatement.

- Consider sampling risk.
- Consider qualitative aspects of the test results.

6. Document the sample procedure when using the Model Approach described in sections 5.528–5.539, the Model Approach Working Paper — Tests of Balances Sampling (see section 5.706) and the Audit Sampling Evaluation Form — Tests of Balances Sampling (see section 5.707) may be used for this purpose.

5.521 Sample selection methods should produce representative samples and may include random selection, systematic selection, or haphazard selection methods. Care should be taken to avoid bias, however, when a haphazard selection method is used. Section 5.540 describes these sample selection methods.

5.522 Determine the sample size for tests of balances. Sample sizes for tests of balances are affected by the following factors:

- *Tolerable misstatement.* As the amount of tolerable misstatement increases, the sample size decreases. Conversely, larger sample sizes are required to compensate for a smaller amount of tolerable misstatement. The tolerable misstatement for a sampling application may be taken from the Materiality Computation Form in Chapter 3, section 3.509.
- *Assessed level of inherent and control risk.* As the combined level of inherent and control risk increases, the sample size increases. Assessments of inherent and control risk may be obtained by reviewing the Planning Matrix (see section 5.702).
- *The risk that other substantive procedures will fail to detect a material misstatement.* As the risk that other substantive procedures will fail to detect a material misstatement increases, the sample size increases. This risk is determined by considering the effectiveness of these procedures.
- *Variations within the population.* Sample sizes are smaller when the sampling population is stratified into homogeneous groups. Larger sample sizes are usually required to obtain a representative sample from sampling populations with high variations.

5.523 Illustration No. 5-9 summarizes the impact of the factors above on sample size planning.

ILLUSTRATION NO. 5-9

FACTORS INFLUENCING SAMPLE SIZES FOR SUBSTANTIVE TESTS OF BALANCES

	Conditions Leading to:	
Factor	Smaller Sample Size	Larger Sample Size
a. Tolerable misstatement.	Larger amount	Smaller amount.
b. Assessed level of inherent and control risk.	Lower.	Higher.
c. Risk that other procedures will fail to detect a material misstatement.	Lower.	Higher.
d. Variation within the population.	Less variation.	More variation.

5.524 Nonstatistical Sampling Approaches. At the direction of the engagement partner, either of the following nonstatistical approaches can be used for selecting tests of balances sample sizes:

1. Judgmental method.
2. Model approach.

5.525 Judgmental Method. Sample sizes can be selected judgmentally after considering the influence of the factors described above. The in-charge should describe, in the Audit Planning Memorandum, the factors that influence the sample sizes selected for substantive tests of balances. The engagement partner should approve the planned sample sizes before the substantive tests of balances work is begun. See Chapter 3, section 3.508 for an illustrative Audit Planning Memorandum.

5.526 Judgmentally selected samples are considered in terms of audit coverage of a total population. Large dollar coverage generally includes individually significant items, and units from the sampling population that cover more than 50% of the dollar amount of the total population.

5.527 The coverage of the total population will also be affected by the nature of the population and the degree of the engagement risks. For example, a large coverage of accounts receivable for confirmation in high-risk circumstances may be from 50% to 80% of the total dollar population. A large coverage for an inventory price test in the same circumstances may only be 30% to 40% of total inventory because the risk of inventory price misstatement is generally less. In low-risk circumstances, a large coverage of accounts receivable may be 40% to 60%, a large inventory coverage may be 20% to 30%. These percentages are not presented as specific guidelines for decision making, but as illustrations of the factors influencing nonsampling decisions. Since the auditor's opinion is expressed on the financial statements taken as a whole, evidence should be designed to include tests of a majority of the dollars in the financial statements, but should also be, overall, the most efficient in the circumstances.

5.528 The Model Approach. The model approach is a nonstatistical sampling method that is based on Probability Proportional To-Size (PPS) Sampling. Because the approach is based on PPS theory, the overall materiality limit does not have to be allocated to each account to determine tolerable misstatements. Instead, the basic allowance for unknown misstatement, i.e., overall materiality limit minus estimates for unadjusted misstatement from nonsampling tests, expected projected misstatement from sampling tests and related allowances for imprecision, may be used in place of tolerable misstatement for each sampling application. An acceptable approach would be to use 66⅔%, or a smaller percentage, of the overall materiality limit for the basic allowance. (See the Materiality Computation Form in Chapter 3, section 3.509). Under PPS theory, the overall materiality limit does not have to be allocated to accounts because the financial statements may be viewed as one population and the basic allowance for unknown error applies to the financial statements taken as a whole. The basic allowance must also be considered, however, when measuring misstatements on the Summary of Possible Journal Entries Form.

5.529 It is important to recognize that when sample sizes are selected nonstatistically based on some statistical theory such as PPS, it is assumed that the population will be stratified. A simple method of stratification is as follows:

- Determine the mean of the population to be sampled.
- Select 2/3 of the sample items from those items equal to or greater than the mean.
- Select 1/3 of the sample items from those items less than the mean.

5.530 If it is not practical to stratify the sampling population, the sample size should be increased by a factor of 20%, or multiplied by 1.2.

5.531 A more time consuming, yet more accurate method would, of course, be a PPS statistical selection method. For the sake of time, however, this statistical method ordinarily is not used. When populations are unusually large and engagement risks are high, however, a PPS statistical method may be appropriate. Guidance for PPS statistical sampling may be found in the AICPA Audit and Accounting Guide, *Audit Sampling*.

5.532 Developed from the model in the AICPA Audit Sampling Guide (paragraphs 4.57 to 4.60), the Model Approach follows:

Sampling Population Tolerable Misstatement	×	Assurance Factor	=	Preliminary Sample Size (units)
Preliminary Sample Size (Units)	×	Marginal Risk Factors (1.2 to 1.5)	=	Adjusted Sample Size (units)

5.533 The assurance factors, also based on PPS statistical theory, are as follows:

Assessment of inherent and control risk	Risk that other substantive procedures (e.g. analytical procedures) will fail to detect a material misstatement		
	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

5.534 The steps to be taken in determining the sample size using the Model Approach Working Paper — Tests of Balances Sampling Form (see section 5.706) are as follows:

A. Assess the combination of inherent and control risk:

1. Maximum — Control and inherent risk are assessed at the maximum for the particular assertions. No tests of controls are required to support this assessment.

2. Slightly below the maximum — Control and inherent risk are assessed at slightly below the maximum for the particular assertions. Minimal tests of controls are required for this assessment.

3. Moderate — Control and inherent risk are assessed at a moderate level for this particular assertion. Moderately effective tests of controls are required for this assessment.

4. Low — Control and inherent risk are assessed at a low level for the particular assertions. Very effective tests of controls are required for this assessment.

B. Determine the basic allowance for unknown misstatements (tolerable misstatement). This is related to preliminary estimates of materiality for the engagement.

C. Assess the risk that other substantive procedures (such as analytical procedures) designed to test the same assertions will fail to detect a material misstatement in a particular assertion as follows:

1. Maximum — No other substantive procedures are performed that are designed to test the same assertions.

2. Moderate — Other substantive procedures to test the assertions are expected to be moderately effective in detecting material misstatements.

3. Low — Other substantive procedures to test the assertions are expected to be highly effective in detecting material misstatements.

D. Determine the population's recorded amount after deducting any items that will be audited 100% (all items that are more than 1/3 of tolerable misstatement).

E. Use the appropriate assurance factor and the formula to determine the initial sample size.

5.535 Depending on the amount of the basic allowance for unknown misstatements, sample sizes computed with this model may approximate those sizes selected judgmentally. Because the model is based on a highly stratified approach, and this approach usually will include minimal or no stratification, the sample should be somewhat larger than the preliminary size if there are significant variations in the population. If stratification is necessary and is not practical, an acceptable approach would be to multiply the preliminary sample size by a marginal risk factor of 1.2 to compensate for the sampling risk associated with not stratifying. The marginal risk factor should *not* be used when the population is stratified or when stratification is not necessary.

5.536 **Evaluating the Sample Results.** The misstatement in the sample must be projected to the population. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement by the fraction of total dollars in the population to total dollars included in the sample. For example, if a $1,000 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $10,000 ($1,000/.10).

5.537 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if $200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is $2 ($200/100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 25,000 items) by the average difference of $2 for each sample item. The estimate of misstatement in the population is $50,000 (25,000 × $2).

5.538 If the projected misstatement is less than tolerable misstatement for the account balance, consideration must be given to the risk that actual misstatement exceeds the amount of tolerable misstatement. If the projected misstatement is less than 1/3 of tolerable misstatement, it is generally safe to conclude that sampling risk is sufficiently low. If it is greater than 1/3, consideration should be given to performing additional tests of the account.

5.539 The Audit Sample Evaluation Form — Tests of Balances (section 5.707) is designed to project the misstatement in the sample to the population, and to evaluate sampling risk. The form should be completed by the in-charge and reviewed by the engagement partner. Remember that any projected misstatement should be posted to the Summary of Possible Journal Entries Form.

Selecting Samples

5.540 SAS No. 39 permits random number selection, systematic selection with or without random starts and haphazard selection methods for nonstatistical sampling. Block sampling is not acceptable. A random number selection method should be used for statistical sampling.

5.541 Random-based selection methods can be applied using random number tables or computer or calculator programs. The Random Selection With a Random Table Form (see section 5.708) may be used to document sample size selections using a random number table.

5.542 To use a random number table:

1. Assign each element in the population a unique address that corresponds to the random number table.
2. Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
3. Place a pencil on a page to determine a random starting point.
4. Modify the population numbers to the smallest possible number of digits to reduce discards.

5.543 The procedure for using a program or calculator to generate random numbers varies with the programs. However, these techniques generally require the auditor to provide the smallest and largest item numbers, and the number of sample items needed.

5.544 Systematic sampling requires the calculation of an interval. An interval is determined by dividing the population size by the number of sample units desired. For example:

N	=	Sample Size	=	4,000
n	=	Desired Units	=	50
I	=	Interval		

$$I = \frac{N}{n} = \frac{4{,}000}{50} = 80$$

5.545 After selecting a random number within the interval as a starting point, each 80th unit would be selected. A Random Selection With a Systematic Sample Form in section 5.709 may be used to document systematic selection methods with random starts.

5.546 Haphazard sampling involves selecting items on a purely judgmental basis, without any bias towards the selection of particular items.

5.600 USING AUDIT SAMPLING FOR TESTING COMPLIANCE WITH LAWS AND REGULATIONS

5.601 As discussed in Chapter 4, compliance auditing involves performing procedures to determine whether the organization has violated laws and regulations that may have a material effect on the organization's financial statements or a specific federal assistance program. In performing audits that involve compliance auditing, the auditor may use sampling in one of two ways: (1) to perform tests of the organization's internal controls over compliance with laws and regulations, or (2) to perform substantive tests of compliance with laws and regulations.

Sampling in Tests of Controls Over Compliance With Laws and Regulations

5.602 The auditor uses audit sampling to perform tests of controls over compliance with laws and regulations in much the same manner that audit sampling is used to perform tests of other types of controls (see sections 5.503–5.514).

5.603 **Determining the Objectives of the Test.** Tests of controls over compliance with laws and regulations may be performed for a number of audit objectives. When the auditor is performing an audit in accordance with generally accepted auditing standards, the tests may provide evidence for the auditor's opinion on the organization's financial statements. Generally accepted auditing standards require the auditor to obtain reasonable assurance of detecting violations of laws and regulations that have a direct and material effect on the not-for-profit organization's financial statements. Tests of controls, including those that involve audit sampling, provide a basis for the auditor's assessment of control risk that such violations exist. This process of testing internal controls and assessing control risk provides evidential matter that may reduce the auditor's substantive tests of compliance.

5.604 If the auditor is performing an organization-wide audit in accordance with OMB Circular A-133, he or she must report on a number of matters. Two of these reports rely, at least in part, on evidence obtained from tests of controls over compliance with laws and regulations:

1. The report on internal control structure policies and procedures relevant to federal financial assistance, and

2. The report on compliance with laws and regulations.

5.605 In reporting on internal control, the auditor is required to determine and report whether the organization has internal control policies and procedures in place to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. Specifically, the auditor is required to perform tests of controls to evaluate the effectiveness of the design and operation of the policies and procedures in preventing or detecting material noncompliance. Some of these tests may involve the use of audit sampling.

5.606 To provide a basis for the second report, the auditor is required to perform tests to determine whether the organization has complied with laws and regulations that may have a material effect upon each major federal assistance program. The process of assessing control risk, based on tests of controls, provides evidential matter about the risk that material noncompliance exists in a major federal financial assistance program. This evidential matter may be used to reduce the auditor's substantive tests of compliance for major federal financial assistance programs.

5.607 **Defining the Population.** The manner in which the auditor defines the population for a test of controls over compliance with laws and regulations also depends on the objective of the test.

5.608 *Tests to obtain evidence for the report on the internal control structure.* If the objective is to obtain evidence to report on the internal control policies and procedures used in administering federal financial assistance, the population generally will consist of the items to which the control was applicable during the period under audit. This would normally include only those items from major federal financial programs. However, if the total amount of major federal financial assistance program expenditures is less than 50 percent of the organization's total federal financial assistance expenditures, the population of items tested should be increased to include items from nonmajor programs until at least 50 percent of federal financial assistance expenditures are subject to testing.

5.609 *Tests to obtain evidence to assess control risk for compliance with requirements that have a direct effect on the organization's financial statements or specific programs.* If the objective of the test is to obtain evidence to assess control risk of compliance with requirements that have a direct and material effect on the organization's financial statements or specific programs, the auditor may define the population in one of two ways. Because a particular internal control procedure often is applicable to the items of more than one program, the auditor may (1) define the items from each program as a separate population, or (2) define all items to which the control is applicable as a single population. Since the size of the population has little or no effect on sample size, it usually will be more efficient to select one sample from all the items to which the control is applicable.

5.610 For example, assume that you are performing an audit of XYZ Organization in accordance with OMB Circular A-133. XYZ has three major federal financial assistance programs and four nonmajor programs. One of XYZ's control procedures consists of a transaction review that is designed to ensure that only allowable costs are charged to each program. You could decide to test the transaction review control procedure for each of the three major programs separately. However, it would be more efficient to select one sample from the population of all transactions that are subject to the control procedure. Assume that based on the planned assessed level of control risk, you have specified the risk of assessing control risk too low at 5 percent and the tolerable rate at 9 percent, and you expect the population deviation rate to be 1 percent. As indicated in the Table in section 5.511, the required sample size from the entire population would be 51 transactions. If no more than 1 deviation from performance of the procedure is found in the sample, you would be able to assess control risk at the planned level for all three major programs and the four nonmajor programs.

5.611 Determining the Sample Size. The considerations involved in determining the sample size for a test of controls over compliance with laws and regulations also depends on the objective of the test. In determining the sample size for tests of controls to achieve any of the objectives, the auditor may use statistical sampling or nonstatistical sampling. The table in section 5.507 for determining sample sizes for tests of controls may also be used for these tests.

5.612 *Tests to obtain evidence for the report on the internal control structure.* If the test of controls is designed to provide evidence to support the auditor's report on the internal control structure used to administer federal financial assistance programs, the auditor should determine the sample size based on that objective. Since tests of controls provide the only evidence to support the auditors' report on the internal control structure used to administer federal financial assistance programs, the sample sizes for this purpose will often be larger than those required for the audit the organization's financial statements. The auditor uses professional judgment to combine the evidence obtained from tests of controls that involve audit sampling with the evidence from other tests of controls that do not involve audit sampling (e.g., those that involve observation and inquiry). The extent of this combined evidence must be sufficient to determine whether the organization has internal control policies and procedures in place to provide reasonable assurance that it is managing federal financial assistance programs in compliance with applicable laws and regulations. The evidential matter that is sufficient is a matter of professional judgment. However, in making this judgment, the auditor should consider matters such as the following:

- The nature of the internal control structure policy or procedure.
- The significance of the internal control structure policy or procedure in ensuring compliance with laws and regulations.
- The nature and extent of tests of the effectiveness of the internal control policy or procedure performed by the organization, if any.

5.613 *Tests to obtain evidence to assess control risk for compliance with requirements that have a direct effect on the organization's financial statements or specific programs.* If the auditor is performing the test of controls for the purpose of providing an opinion on the organization's financial statements or providing a report on the organization's compliance with requirements related to specific federal financial assistance programs, the auditor should consider the factors described in section 5.606 in determining the sample size.

Sampling for Substantive Tests of Compliance

5.614 Tests of compliance with laws and regulations are substantive tests, usually accomplished by examining supporting documents. The auditor uses audit sampling to perform tests of compliance with laws and regulations in much the same manner that audit sampling is used to perform other types of substantive tests (see sections 5.515 through 5.539). This section will describe the unique aspects of using audit sampling in performing tests of compliance with laws and regulations.

5.615 **When is Audit Sampling Appropriate?** Some compliance requirements because of their nature lend themselves to sampling. Such requirements leave documentary evidence of compliance and do not involve small populations. Others, because of the small population involved or the type of evidence of compliance available, do not lend themselves to sampling. Illustration No. 5-10 identifies requirements that typically are not tested using audit sampling (i.e., nonsampling requirements). Nonsampling requirements are usually tested by inquiry, observation, and inspection.

ILLUSTRATION NO. 5-10

NONSAMPLING REQUIREMENTS

Specific Requirements

Matching, level of effort, or earmarking

General Requirements

Civil rights

Cash management

Davis-Bacon Act

Relocation assistance and real property acquisition

Federal financial reports

Drug-free workplace

5.616 Requirements that lend themselves to testing by audit sampling (i.e., sampling requirements) typically include those that relate to activities or transactions that can be quantified in terms of dollars. An example of a requirement that may be tested by sampling is the general requirement governing the allowable cost principle that prescribes the direct and indirect costs allowable for federal reimbursement. Other requirements that may be tested using audit sampling are described in Illustration No. 5-11.

ILLUSTRATION NO. 5-11

SAMPLING REQUIREMENTS

Specific Requirements

- Types of services allowed or not allowed
- Eligibility
- Special tests and provisions

General Requirements

- Allowable costs/cost principles
- Administrative requirements
- Federal financial reports
- Political activity

5.617 Defining the Population. The population for a test of compliance will normally consist of a class of transactions that are subject to the requirements of a particular law or regulation. Compliance with the law or regulation is necessary for the organization to recognize the transaction amount as revenue earned or to submit the expense for reimbursement from the applicable federal agency. Therefore, compliance with the law or regulation has a direct effect on the line-item amounts in the organization's financial statements or a specific financial assistance program. In audits in accordance with GAAS and Government Auditing Standards, tests of compliance are required only for those requirements that have a direct and material effect on line-item amounts in the financial statements.

5.618 When the auditor is performing an audit in accordance with OMB Circular A-133, he or she is required to select a representative number of transactions from each major program, but it is not required that separate samples be used for each major program. Experience has shown, however, that it is generally preferable to select separate samples for each major program. Separate samples clearly provide evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor decides to select one sample from the entire population of major program transactions, the sample should be selected so that (a) a representative number of transactions will be selected from each major program, and (b) the results of tests of the sample, together with other audit evidence, will be sufficient to support the opinion on each major program's compliance with the applicable requirements.

5.619 OMB Circular A-133 also requires the auditor to perform tests of compliance with general requirements that do not have a direct and material effect on line-item amounts in the financial statements or a particular financial assistance program. Performing these tests of compliance may or may not involve the use of audit sampling. When audit sampling is involved, the auditor should use judgment in determining the appropriate audit population.

5.620 **Determining Sample Size.** When performing an audit in accordance with OMB Circular A-133, the objectives of auditing procedures for federal financial assistance are to provide sufficient, competent evidential matter to reasonably assure the detection of noncompliance with specific requirements applicable to major federal financial assistance programs. Based on the auditor's assessment of control risk, the auditor should select sample sizes that will provide sufficient evidence for this purpose. The auditor's professional judgment should be used when selecting sample sizes.

5.621 Circular A-133 requires that a representative sample be selected from major programs for compliance testing. Specifically, OMB Circular A-133 states that the auditor must select "an adequate number of transactions" from each major program to support the auditor's opinion on compliance. In addition, the auditor should assess audit risk and materiality in relation to the individual major program being tested. Materiality should not be measured in relation to major programs taken as a whole or in relation to the organization's financial statements.

5.622 The OMB has stated that sample sizes in audits of federal financial assistance should be based on professional judgment considering the following factors:

- the amount of expenditures for the program
- the newness of the program or changes in its conditions
- prior experience with the programs particularly as revealed in audits and other evaluations (e.g., inspections program reviews, or system reviews required by Federal Acquisition Regulations)
- the extent to which the program contracts for goods or services
- the level to which the program is already subject to program review or other forms of independent oversight
- the assessed level of control risk of material misstatement due to noncompliance
- the potential impact of adverse findings
- results of any tests of compliance with the general requirements

Practice Tip:

If the dollar amounts of the items in the population for a substantive test of compliance vary significantly, it will be more efficient to stratify the population into groups and select more items from the groups with the larger dollar amounts.

Evaluating the Sample Results

5.623 SAS No. 39 states, "The auditor should project the error results of the sample to the items from which the sample was selected. . . ." When performing samples for tests of compliance, this requirement is met by projecting the amount of questioned costs found in the sample. When evaluating samples for an audit in accordance with GAAS, the auditor compares the total projected questioned costs to tolerable misstatement for the account or class of transactions, and considers the risk that the amount of questioned costs exceeds the tolerable amount. When evaluating the results in an OMB Circular A-133 audit, the auditor compares the total projected costs questioned for each major federal financial assistance program to the amount of questioned costs that is considered to be material for that program, and considers the risk that such result might be obtained even though the amount of questioned costs exceeds the amount considered to be material.

Dual-Purpose Tests

5.624 When performing engagements that involve compliance auditing, it is often efficient to perform dual-purpose tests. These tests will have the dual purpose of testing controls used in administering federal financial assistance, and directly testing compliance with laws and regulations. The size of the sample designed for a dual-purpose test should be the larger of the samples that would otherwise have been designed for the two separate purposes. Deviations from performance of controls and amounts of questioned costs resulting from noncompliance should be evaluated separately, using the risk level applicable for the respective purposes when evaluating the dual-purpose samples.

A Nonstatistical Sampling Approach for Tests of Compliance

5.625 An approach to performing substantive tests of compliance using nonstatistical sampling is described below. This approach may be used to perform and evaluate dual-purpose samples to test controls over compliance with laws and regulations and substantive tests of compliance.

1. Define the population based on the objective of the test.

2. Determine the required sample size:

   a. Consider the amount of questioned costs that is material to the federal financial assistance program.

   b. Assess the risk of a material amount of questioned costs of the federal financial assistance program based on the factors contained in section 5.622.

   c. Use the following table to determine sample size:

Risk of Material Amount of Questioned Costs	Sample Size
High	60
Moderate	45
Low	25

3. Select the sample in such a way that the sample can be expected to be representative of the population. Before selecting the sample, identify individually significant items for testing. If necessary, stratify the remaining population and allocate the sample size to the specific groups.

4. Evaluate the sample results:

   a. Project the amount of questioned costs found in the sample to the items from which the sample was selected.

   b. Compare the amount of projected questioned costs with the amount of questioned costs considered to be material to the federal financial assistance program and consider the risk that the actual amount of questioned costs exceeds the amount considered to be material.

   c. Consider the qualitative aspects of the questioned costs, including (1) the nature and cause, such as whether they are (a) errors or irregularities or (b) due to misunderstanding of instructions or to carelessness, and (2) the possible relationship of questioned costs to other phases of the audit.

5.626 Working papers for documenting a sample for a substantive test of compliance with laws and regulations are presented in section 5.704, 5.705, and 5.710.

5.700 DOCUMENTATION ASSISTANCE

5.701

Risk of Potential Misstatements Evaluation Form — Not-for-Profit Organizations

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used on audit engagements under the ABC approach to evaluate and document the risk of potential errors and irregularities. Answers should be based on inquiries of client personnel, an understanding of the client's business and industry, experience from prior years' engagements, the current year's internal control structure assessment and other special considerations. The impact of the risk of potential misstatements should be documented in the Planning Matrix.

	Yes	No
I. Special Considerations. ("yes" answers, i.e., high risk, should be checked on accompanying Potential Misstatements Matrix)		
1. Are there client-imposed limitations on the scope of the engagement? (Describe below.)	____	____
2. Is this an initial engagement?	____	____
3. Do discussions with prior engagement personnel or predecessor accountants indicate a high risk of potential misstatements? (Describe below.)	____	____
4. Are the client's accounting policies, methods or estimates unusual or difficult to apply, or have they been changed recently? (Describe below.)	____	____
5. Are there significant related-party or other unusual transactions? (Describe below.)	____	____
6. Is the overall engagement risk evaluation high?	____	____

Describe the circumstances surrounding "yes" answers and record effects on Potential Misstatements Matrix:

II. Potential Misstatements Matrix:

Complete the accompanying Potential Misstatements Matrix and transfer the summary of risk by audit area to the Planning Matrix. In addition to classifying the risk of potential misstatements from special considerations above by engagement area, the Potential Misstatements Matrix includes similar classifications for:

1. High Risk or Material *and* Unusual Account Balances:

   The nature of the client's industry or operations may typically cause certain account balances and the relative risk of misstatements to be high. Material account balances must also be unusual in the client's circumstances to be considered high risk. Sales of fixed assets, for example, would not be considered high risk unless increases or decreases were unusual in nature or account.

2. Significant Prior-Year Adjustments and Exposure Areas:

   Significant prior-year adjustments, made or passed, and exposure areas that may recur and affect the current period should also be noted on the Potential Misstatements Matrix.

POTENTIAL MISSTATEMENTS MATRIX

Engagement Area	Special Considerations	High Risk/Unusual and Material Account Balances	Prior-Year Adjustments or Exposure Areas	Risk Summary (Low or High)
Cash				
Trade accounts receivable				
Grants receivable				
Pledges receivable				
Inventories				
Fixed assets				
Accounts payable				
Contributions and grants				
Sales				
Payroll tests				
Expense account analysis and vouching				

The risk categories on the Potential Misstatements Matrix for each engagement area should contain a check mark (✓) where the risk of potential misstatements is high. Low risk is otherwise assumed. After considering the number and significance of misstatements in each engagement area, the in-charge should use professional judgment to summarize the risk of potential misstatements as low or high. The summary should be transferred to the Planning Matrix. Describe below the modifications to the Tests of Balances Audit Program that will be made to compensate for the high risks of potential misstatements (low risks require no modification).

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

EXPLANATION OF HIGH RISK POTENTIAL ERRORS

Engagement Area	Explanation

5.702

Planning Matrix — Not-for-Profit Organizations

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS:

The Planning Matrix should be prepared by the in-charge accountant for audit engagements under the ABC approach. The matrix coordinates the evaluation of the risk of potential misstatements and the internal control structure to guide the selection of tests of controls, and tests of balances, and analytical procedures and sample sizes. The matrix should be completed after the following documents have been finalized:

1. Client Acceptance and Continuance Form.

2. Audit Planning Memorandum.

3. Internal Controls Questionnaire and any supplementary narrative and flowcharts.

4. Risk of Potential Misstatements Evaluation Form.

The Matrix and related documentation should be reviewed by the engagement executive before the tests of controls are started.

PLANNING MATRIX

Audit Area	(1) System Classification (Circle One)	(2) Assessed Level of Control Risk* (Circle One)	(3) Risk of Potential Misstatement (High or Low)	(4) Risk That Analytical Procedures Will Not Detect Material Misstatement* (Circle One)	(5) Resulting Evidence Required from Detailed TOBs
Cash, including Receipts & Disbursements	A B C				
a. Existence & Rights		M S Md L	______	M Md L	______
b. Completeness		M S Md L	______	M Md L	______
Accounts Receivable and Revenue	A B C				
a. Existence & Rights		M S Md L	______	M Md L	______
b. Completeness		M S Md L	______	M Md L	______
c. Valuation (i.e., Allowance for Uncollectible Acct.)		M S Md L	______	M Md L	______
Contributions Receivable and Support	A B C				
a. Existence & Rights		M S Md L	______	M Md L	______
b. Completeness		M S Md L	______	M Md L	______
c. Valuation (i,e., Allowance for Uncollectible Acct.)		M S Md L	______	M Md L	______

* M - Maximum
S - Slightly below the maximum
Md - Moderate
L - Low

PLANNING MATRIX (Continued)

Audit Area	(1) System Classification (Circle One)	(2) Assessed Level of Control Risk* (Circle One)	(3) Risk of Potential Misstatement	(4) Risk That Analytical Procedures Will Not Detect Material Misstatement* (Circle One)	(5) Resulting Evidence Required from Detailed TOBs
Inventories:	A B C				
a. Existence & Rights		M S Md L	______	M Md L	______
b. Completeness		M S Md L	______	M Md L	______
c. Valuation (i.e., Allowance for Uncollectible Acct.)		M S Md L	______	M Md L	______
Other Accounts:	A B C	M S Md L	______	M Md L	______
	A B C	M S Md L	______	M Md L	______
	A B C	M S Md L	______	M Md L	______
	A B C	M S Md L	______	M Md L	______
	A B C	M S Md L	______	M Md L	______
	A B C	M S Md L	______	M Md L	______

Note: For any assertions not contained on the form, it is assumed that control risk is assessed at the maximum.

Prepared by: ______________ Approved by: ______________ Date: ________

Planning Matrix Legend

(1) The system classification is obtained from the Internal Controls Questionnaire. It may vary by financial statement assertion.

(2) Assessing control risk at less than the maximum will decrease the amount of evidence required from substantive tests. Control risk may be assessed at the Maximum (M), Slightly below the Maximum (S), Moderate (Md), or Low (L). Tests of controls must be performed in situations where control risk is assessed at slightly below the maximum or at a moderate or low level.

(3) From the Risk of Potential Misstatements Evaluation Form, the risk of potential misstatements (low or high) may vary for different financial statement assertions. These risk factors may increase or decrease the needed evidence from substantive tests. The risk may be assessed as high or low.

(4) Evidence from analytical procedures can reduce the extent of the evidence required from other substantive tests (i.e., detailed tests of balances). The Planning Matrix rates this evidence in terms of the risk that the analytical procedures will fail to detect a material misstatement in the account or the assertions about the account. For example, maximum risk means no evidence is obtained from analytical procedures.

(5) The required evidence from detailed tests of balances (TOBs) is a product of the assessed level of control risk, the risk of potential misstatements and the evidence obtained from analytical procedures. The examples below illustrate this relationship.

System Classification	Control Risk	Risk of Potential Misstatements	Risk That Analytical Procedures Will Not Detect a Material Misstatement	Resulting Required Evidence from Detailed Tests of Balances
A	M S Md L	Low	M Md L	None
A	M S Md L	High	M Md L	Low
A	M S Md L	Low	M Md L	Low
A	M S Md L	Low	M Md L	Moderate
B	M S Md L	Low	M Md L	None
B	M S Md L	High	M Md L	Moderate
B	M S Md L	Low	M Md L	Moderate
C	M S Md L	Low	M Md L	Low
C	M S Md L	High	M Md L	Moderate
C	M S Md L	Low	M Md L	Slightly Below High
C	M S Md L	Low	M Md L	Moderate
C	M S Md L	Low	M Md L	High

Page 2 of 2

The Planning Matrix contains assessments for assertions about those accounts where audit efficiencies are usually obtained. Assertions about other accounts not contained on the form can be added when control risk for those assertions is assessed at below the maximum. For assertions about accounts not included or added to the Planning Matrix, control risk is assessed at the maximum and maximum reliance is placed on analytical procedures and detailed tests of balances.

These guidelines presume account balances are material. If balances are immaterial, so state in the Final Resulting Evidence Required from Detailed TOBs column. No evidence is required for immaterial account balances.

High degree of evidence from detailed tests of balances will require procedures with high reliability, e.g., large sample sizes with tests performed primarily at the balance-sheet date. Low degree of evidence from detailed tests of balances will allow less reliable tests, e.g., small sample sizes and performing tests at interim dates.

The ABC approach presumes high reliance on analytical procedures for all engagements to the maximum extent practical.

Final modification of the Tests of Balances Audit Program will be made based on the results of performing the tests of controls on the internal control structure policies and procedures.

(6) Nonstatistical sample size ranges for tests of controls may be determined using the following table unless otherwise directed by the engagement partner. Sample sizes so selected should be entered directly on the appropriate Tests of Controls Program. The in-charge should document in the Planning Memorandum consideration of the factors that affect the sample sizes selected. The partner should approve the Planning Memorandum *before* the tests of controls are begun.

TESTS OF CONTROLS
SAMPLE SIZE SELECTION TABLE

Assessed Level of Control Risk	Sample Size*
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

* The numbers in the table were determined using a risk of assessing control risk too low of 10% and an expected population deviation rate of 0%. If one or more deviations are found in the sample, the sample size should be increased or the assessed level of control risk should be increased.

(7) When deviations are expected or found in a sample the following table may be used to determine the sample size or evaluate the sample results:

Deviations (Expected or Actual)	Assessment of Control Risk		
	Slightly Below Maximum	Moderate	Low
0	15	30	40
1	25	50	65
2	34	67	90
3	43	85	115

Tests of controls consisting of observation of performance and inquiries are not normally subject to audit sampling.

5.703 ALL SUBSTANTIVE APPROACH QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS

Use of the Questionnaire

This Questionnaire is designed to be used on small, noncomplex audit engagements. It consists of two sections: Section I contains questions about the organization's control structure and Section II deals with the risk of potential misstatements. Completion of Section I provides the auditor with the basic understanding of the control structure. It requires the auditor to document any special internal control matters that would affect substantive testing. Section II requires the auditor to consider the risk of potential misstatements in the financial statements, and consider their impact on the design of the audit.

This Questionnaire replaces the Internal Controls Questionnaire, the Planning Matrix, and the Risk of Potential Misstatements Evaluation Form, required under the ABC System. The decision to use this Questionnaire should be made during planning and should be based on engagement circumstances and economic considerations. For example, tests of controls may have produced unacceptable results in prior years, or the nature of the client's operations may cause tests of balances to be the most efficient evidence collection method. Use of this Questionnaire presumes minimum tests of controls and maximum substantive tests will be performed, and that tests of balances will be performed as of the balance-sheet date.

INSTRUCTIONS:

When appropriate, client personnel should complete the Questionnaire for review by the in-charge. In the "Personnel" column, insert the name and title of the individual that performs the control procedure. "No" answers to the control environment and accounting systems questions (Section I) represent potential weaknesses. Material weaknesses and reportable conditions should be posted to the Internal Control Structure Reportable Conditions Form. Most organizations' control environments include board or manager controls. The term "manager," as used in this Questionnaire, describes a person performing internal verification functions. That person may be the executive director, controller, bookkeeper, program director or other employee.

The risks of potential misstatements, and the resulting program modification, should be summarized in Section II by the in-charge. Both sections should be reviewed by the engagement partner before field work is started.

All Substantive Approach Questionnaire— Not-for-Profit Organizations — Section I

Client: ____________________

Financial Statement Date: ____________________

General Control Environment and Accounting System	Personnel	Yes	No	N/A
1. A general ledger is posted and balanced.				
2. A general journal is prepared and balanced.				
3. Journal entries have adequate support.				
4. An adequate chart of accounts is in use.				
5. The manager participates in the day-to-day activities of the business.				
6. All employees in a position of trust are bonded.				
7. All employees in a position of trust are required to take vacations.				
8. Hazard insurance coverage is periodically reviewed to determine adequacy.				
9. Management receives financial statements on a regular basis.				
10. The board/manager's attitudes about budget projections and business/fund-raising uncertainties are conservative.				
11. The board/manager understands the importance of control procedures.				
12. The board/manager understands and uses financial statements and reports prepared by accounting personnel.				

ALL SUBSTANTIVE APPROACH QUESTIONNAIRE— NOT-FOR-PROFIT ORGANIZATIONS
Section I (Continued)

	Personnel	Yes	No	N/A
13. Accounting personnel have experience and training appropriate for their jobs and understand their responsibilities.	______	___	___	___
14. The board/manager and accounting personnel are competent, possess high integrity, and are concerned about the quality of their work.	______	___	___	___
15. Documents, records, and assets are physically controlled to prevent their destruction or unauthorized use.	______	___	___	___
16. The financial condition of the entity is sound.	______	___	___	___

17. Describe the following features of the control environment:

a. Describe the personnel structure of management, accounting, and operations personnel below, or attach an organization chart.

____

____

____

____

b. Describe the board's attitudes and practices that may affect the risk of errors or irregularities in the financial statements. Consider such factors as deteriorating operations or funding creating a need for working capital, financial statement ratios influencing lenders' decisions, motivation of board/manager to attract funding, and board/manager's history of taking unnecessary business risks.

____

____

____

____

____

ALL SUBSTANTIVE APPROACH QUESTIONNAIRE— NOT-FOR-PROFIT ORGANIZATIONS

Section I (Continued)

c. Describe the board's awareness of the importance of a good accounting system, performing board/manager controls, and understanding and use of related financial information.

d. List the accounting personnel, their positions and length of employment, describe briefly their education and experience, and evaluate their job performance based on firm experience with the client.

e. How does the client achieve an adequate cut-off of transactions when the financial statements are prepared?

f. Describe how the client's financial statements are prepared, including the way in which major accounting estimates are made.

ALL SUBSTANTIVE APPROACH QUESTIONNAIRE— NOT-FOR-PROFIT ORGANIZATIONS
Section I (Continued)

	Personnel	Yes	No	N/A
Receipts, Support, and Revenue				
1. A cash receipts journal is prepared and balanced.				
2. A sales journal is prepared and balanced.				
3. Cash receipts are recorded as received.				
4. Sales are recorded in the period the sale was made or the merchandise was shipped.				
5. Records of customer payments on pledges or accounts receivable are maintained (remittance advice or duplicate deposit slip).				
6. Collections are deposited intact.				
7. Over-the-counter receipts are controlled, such as by a cash register or prenumbered receipts tickets.				
8. Prenumbered sales invoices and/or shipping reports evidencing shipping date are prepared.				
9. Copies of sales invoices or customers' statements are mailed periodically.				
10. The board or manager reviews copies of sales invoices or customers' statements and resolves customer disputes.				
11. Receivables are aged regularly and reviewed by the board or manager.				
12. The person who opens the mail maintains a log of mail receipts.				
13. Direct solicitors document the amounts they turn in for recording and deposit.				

ALL SUBSTANTIVE APPROACH QUESTIONNAIRE— NOT-FOR-PROFIT ORGANIZATIONS

Section I (Continued)

	Personnel	Yes	No	N/A
Acquisitions and Payments Transaction Cycle				
1. A cash disbursements journal is prepared and balanced.				
2. A detailed disbursements schedule is prepared and balanced to the general ledger.				
3. All checks are signed by a board member or manager.				
4. Checks are signed only when disbursement is made (not in advance).				
5. The check signer compares data on supporting documents to checks.				
6. Vendor invoices are canceled when checks are signed.				
7. Checks are recorded in the disbursements journal as prepared.				
8. Checks are prenumbered.				
9. Vendor invoices support purchases.				
10. Vendor invoices or receiving reports contain the date goods were received.				
11. Unpaid vendor invoices are filed separately from paid invoices.				
12. Purchases are approved by the board/manager.				
13. The bank reconciliation is reviewed by the board/manager.				
14. Expense assignments to functions are made based on specific identification of the function benefited or based on a reasonable allocation method.				

ALL SUBSTANTIVE APPROACH QUESTIONNAIRE— NOT-FOR-PROFIT ORGANIZATIONS
Section I (Continued)

	Personnel	Yes	No	N/A
Payroll and Personnel Transaction Cycle				
1. A cash disbursements journal is prepared and balanced.				
2. Payroll disbursements are made by check.				
3. Checks are prenumbered.				
4. Payroll checks are recorded in the payroll journal as prepared.				
5. Employees' time records are maintained.				
6. W-4 forms are maintained.				
7. Employees' earnings records are maintained.				
8. The payroll bank reconciliation is reviewed by the board/manager.				
9. Wage rates are authorized by the board/manager.				
10. Payroll checks are signed by the board/manager.				
11. Payroll checks are distributed by the board/manager.				
Inventory and Warehousing Transaction Cycle				
1. An annual physical inventory is taken and adequate count records (tags or sheets) are maintained.				
2. Adequate records of inventory pricing and summary are maintained.				
3. The inventory count is taken, checked, or supervised by the board/manager.				
4. Obsolete and consigned goods are excluded from the count.				
5. Good physical cutoff procedures are utilized to insure an accurate count and recording of inventory.				

ALL SUBSTANTIVE APPROACH QUESTIONNAIRE—NOT-FOR-PROFIT ORGANIZATIONS

Section I (Continued)

Modification of standard tests for special internal control risks:

Unless indicated otherwise, control risk is assessed at the maximum level for all financial statement assertions.

	19___	19___	19___	19___	19___
Prepared by:					
Client					
In-Charge					
Reviewed by:					
Engagement Partner					

All Substantive Approach Questionnaire—Not-for-Profit Organizations—Risk of Potential Misstatements and Impact on Tests of Balances Section II

Client: ____________________

Financial Statement Date: ____________________

I. Describe any special considerations such as scope limitations, first engagement circumstances, unusual or difficult accounting principles, methods or estimates, related parties or other unusual circumstances causing risk. Identify engagement areas affected.

II. Describe high risk or unusual and material account balances.

III. Describe prior-year adjustments or exposure areas with potential impact on this year's engagement.

ALL SUBSTANTIVE APPROACH QUESTIONNAIRE—NOT-FOR-PROFIT ORGANIZATIONS—RISK OF POTENTIAL MISSTATEMENTS AND IMPACT ON TESTS OF BALANCES

Section II (Continued)

IV. Describe the impact of the risks of potential misstatements on the tests of balances, i.e., the resulting program modifications.

Prepared by: ______________________ Date: ____________
(In-Charge)

Reviewed by: ______________________ Date: ____________
(Partner)

5.704

Audit Sampling Form — Dual Purpose Test of Compliance

Client: ______________________________

Financial Statement Date: ______________________________

1. Identify the program or programs being tested: ______________________________
____
____
____

2. Identify what will be considered deviations from performance of the control procedures:
____
____
____

3. Identify the requirements to be tested: ______________________________
____
____
____

4. Total recorded population: $ ______________

5. Determine the sample size using the following criteria:

Risk of Material Amount of Questioned Costs	Sample Size
High	60
Moderate	45
Low	25

6. Identify the sample size: __________.

7. Identify the method of sample selection:

Random __________
Haphazard __________
Systematic __________

5.705

Audit Sample Evaluation Form — Dual Purpose Tests of Compliance

Client: ______________________________

Financial Statement Date: ______________________________

1. Project the amount of questioned costs:

   Based on Dollars:

   a. Misstatement in the sample $ ________
   b. Dollar value of the sample $ ________
   c. Dollar value of the population $ ________
   d. Projected misstatement in the population (c. ÷ b. × a.) $ ________

   Based on Number of Items:

   a. Number of exceptions ________
   b. Number of items sampled ________
   c. Number of items in the population ________
   d. Number of dollars expended ________
   e. Projected misstatement in the population [(a. ÷ b.) × c. × d.] $ ________

   Note: The purpose of projecting the amount of questioned costs is to determine whether this amount indicates that there is a material misstatement of a major program. If so, additional tests of compliance should be performed. Only the actual amount of questioned cost should be reported in the schedule of questioned cost.

2. Amount that is considered material to the major program $ ________
3. Identify the number of control deviations found: ______________________________
4. Describe the cause of the control deviations found: ______________________________

____

____

____

5.706

Model Approach Working Paper — Tests of Balances Sampling

Client: ______________________________

Financial Statement Date: ______________________________

1. Check the financial statement assertion(s) being tested:

a. Existence and occurrence ______ c. Completeness ______
b. Rights and obligations ______ d. Valuation or allocation ______

2. Description of sampling application: ______________________________

____

____

3. Total recorded population for ______________________________ $________

Less amount of individually significant items (Usually all items equal to or greater than 1/3 of tolerable misstatement) (________)

Sample population $________

4. Describe what will be considered to be a misstatement for testing purposes:

____

____

____

Assessment of inherent and control risk	Risk that other substantive procedures (e.g. analytical procedures) will fail to detect a material misstatement		
	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

5. Calculate the initial sample size with the following formula:

Sampling Population		Basic Allowance (Tolerable Misstatement)		Assurance Factor		Initial Sample Size
$ ______	÷	$ ______	×	______	=	______

6. Allocate the sample items:

	Population		Sample	
	Items	**Dollars**	**Items**	**Dollars**
a. Stratum 1—Items above the mean of the sampling population (select 2/3 of the sample items from this subpopulation)	____	$____	____	$____
b. Stratum 2—Items less than the mean of the sampling population (select 1/3 of the sample items from this subpopulation)	____	$____	____	$____
c. Total	____	$____	____	$____

5.707

Audit Sample Evaluation Form — Tests of Balances Sampling

Client: ____________________

Financial Statement Date: ____________________

1. Project the misstatement (use only one column if the sample population was not stratified):

	Stratum 1	Stratum 2
a. Misstatement in the sample	$________	$________
b. Dollar value of the sample	$________	$________
c. Dollar value of the strata	$________	$________
d. Projected misstatement in the sample stratum (c. ÷ b. × a.)	$________	$________
e. Total projected misstatement in the sample population (d.1 + d.2)	$________	

2. Evaluate sample risk:

a. Misstatements found in the group audited 100%	$________
b. Projected misstatement in the sample population (1.e.)	$________
c. Total projected and known misstatement (2.a. + 2.b.)	$________
d. Amount of above misstatement corrected	$________
e. Remaining known and projected misstatement (2.c.-2.d.)	$________*
f. Tolerable misstatement for the account (From the Model Approach Working Paper—Tests of Balances)	$________
g. Is the remaining known and projected misstatement (e.) less than 1/3 of the amount of tolerable misstatement (f.)?	Yes ____ No ____

If the answer to g is "No" sampling risk may be unacceptably high and additional testing should be considered.

* This amount should be posted to the Summary of Possible Journal Entries Form (chapter 8, section 8.904).

5.708

Random Selection With a Random Table Form

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS:

To use the random selection method with a random number table:

- Assign each element of the population a unique address that corresponds to the random number table.
- Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
- Place a pencil on a page to determine a random starting point.
- Modify the population numbers to the smallest possible number of digits to reduce discards.
- Pure random sampling should be applied to the entire population; stratified random sampling would separate the population according to some characteristic such as size of elements or features of the underlying transaction. This form should be used to document random selection with a random table or calculator. If a computer is used, a copy of the computer printout should be retained as documentation.

POPULATION DESCRIPTION

1. Type of document designated as the sampling unit. ____________________
   a. Largest document number plus 1 ____________________
   b. Smallest document number ____________________
   c. Population size ____________________
2. Nature of the sampling unit if not a document. ____________________
3. Description of the population if No. 2. is applicable (including population size and numbering of population). ____________________

RANDOM NUMBER TABLE

Name of table. ______________________

Page(s) used. ______________________

Correspondence between the table and sampling units (normally document number). ______________________

Number of digits used. ______________________

Starting point in table. ______________________

First usable sample number. ______________________

Last usable sample number. ______________________

Stopping point in table. ______________________

Number of sample items selected. ______________________

Modifications to reduce discards. ______________________

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

5.709

Random Selection With a Systematic Sample Form

Client: ______________________

Financial Statement Date: ______________________

INSTRUCTIONS:

This form is used to document systematic selection methods with random starts.

POPULATION DESCRIPTION

1. Type of document designated as the sampling unit. ______________
   a. Largest document number plus 1 ______________
   b. Smallest document number ______________
   c. Population size ______________
2. Nature of the sampling unit if not a document. ______________
3. Description of the population if No. 2. is applicable (including population size and numbering of population). ______________

$$\frac{\text{Population Size}}{\text{Sample Size}} = \text{initial interval}$$

Initial interval $\times$ number of desired starts =

adjusted interval

Rounded interval.

Random number(s) from the table.

First sample item(s).

Last sample item(s).

Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

5.710

Documentation of Compliance Sample Items Form

Client: ____________________

Financial Statement Date: ____________________

	Control Attributes			Compliance Requirements			
Item ID	A	B	C	A	B	C	D

Documentation of Compliance Sample Items Form (Continued)

	Control Attributes			Compliance Requirements			
Item ID	A	B	C	A	B	C	D

Key

Control Attributes:
A = ______________________
B = ______________________
C = ______________________

Compliance Requirements:
A = ______________________
B = ______________________
C = ______________________
D = ______________________

✓ = no deviation
× = deviation

Note: Item ID (e.g., check no.) should provide a trail to the specific item tested.

Internal Controls

CHAPTER 6

INTERNAL CONTROLS

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CHAPTER 6

INTERNAL CONTROLS

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CHAPTER 6

INTERNAL CONTROLS

6.000 CONSIDERATION OF INTERNAL CONTROLS IN NOT-FOR-PROFIT ORGANIZATION AUDITS

Introduction

6.001 This chapter covers the auditor's consideration of the internal control structure in audits of not-for-profit organizations' financial statements in accordance with generally accepted auditing standards (GAAS). As discussed in Chapter 5, the auditor's consideration of the internal control structure plays a vital role on the nature, timing, and extent of the audit procedures performed. This chapter provides guidance on the assessment, documentation, and testing of the internal controls used by not-for-profit organizations.

6.002 Statement on Auditing Standards (SAS) No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), indicates that an entity's internal control structure consists of the following three elements:

- the control environment,
- the accounting system, and
- control procedures.

6.003 **Control Environment.** Most auditors think of internal controls in terms of policies and procedures over the recording, processing, and reporting of financial data. While these specific internal control policies and procedures are certainly the backbone of good internal controls, SAS No. 55 emphasizes the need to consider other factors (referred to as the "control environment") that can greatly impact, both positively and negatively, an organization's internal controls. The following are examples of factors that should be considered in obtaining an understanding of an organization's control environment, as listed in paragraph 9 of SAS No. 55 (AU 319.09):

- Management or governing board's philosophy and operating style.
- The organizational structure.
- The functioning of the governing board and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management or governing board's control methods for monitoring and following up on performance.

- Personnel policies and practices.
- External influences that affect the organization's operations and practices.

6.004 As mentioned above, these factors can positively or negatively impact an organization's internal controls. For example, if the organization has established strong internal controls but management's attitude toward maintaining the controls is lax, then internal controls could easily be bypassed or overridden. Conversely, if internal controls are weak due to a lack of segregation of duties, active oversight by top management of the accounting and financial reporting process can mitigate the weakness. In most cases, considering the above factors gives the auditor a sufficient understanding of the control environment to understand top management's and the governing board's attitude, awareness, and actions towards the control environment.

6.005 Accounting System. The accounting system consists primarily of the organization's methods to identify, assemble, analyze, and record financial information. These methods are crucial to providing accountability of the organization's assets and liabilities. Effective accounting systems will:

- Identify and record all valid transactions.
- Classify financial transactions on a timely basis.
- Value these financial transactions in an appropriate manner.
- Identify the time period in which these financial transactions occurred.
- Adequately disclose these transactions in the financial statements.

6.006 Control Procedures. Control procedures are those policies and procedures, in addition to the control environment and accounting system, that have been established to provide reasonable assurance that specific organizational objectives will be achieved. Control procedures include:

- Proper authorization of transactions.
- Adequate segregation of duties.
- Providing a documented audit trail.
- Safeguarding of assets.
- Independent review of other procedures performed.

6.007 The auditor must understand the procedures an organization utilizes to attain the objectives outlined above in order to adequately plan and perform an audit.

Documentation of Internal Control Structure

6.008 In all audits, the auditor is required to obtain and document his or her understanding of the three elements of the control structure in order to plan the engagement. The Internal Controls Questionnaire, section 6.100, and the Initial Survey of EDP Controls, section 6.200, can assist the auditor in accomplishing these objectives for an engagement in which the ABC System is selected. For audits using the All Substantive Approach, the All Substantive Approach Questionnaire in Chapter 5, section 5.703, along with the EDP Questionnaires in this chapter, documents the auditor's understanding of the control structure. The Internal Controls Questionnaire has been customized to reflect the controls typically required for a not-for-profit organization. For example, the questions address controls over special events, direct solicitation of funds, pledges, grants, donations of materials, services and facilities, and other areas unique to not-for-profit organizations. The EDP Questionnaires aid the auditor in documenting his or her understanding of the EDP controls.

6.009 As discussed in sections 5.303-5.309 of Chapter 5, completing the Internal Controls Questionnaire helps the auditor select the appropriate system (A, B, or C) for each major audit area. The system selected should be noted on the Planning Matrix in section 5.702 in Chapter 5 for use in determining the nature, timing, and extent of tests.

6.010 The following describes the process for selecting a system:

1. Within each of the six sections of the Internal Controls Questionnaire, identify the most advanced system classification, A, B or C, with a majority of "yes" answers. Because tests of controls often require less time than tests of balances, the objective should be to perform tests of controls to the maximum extent practical.

2. Consult with the partner to determine if tests of controls for the system classification selected are practical in light of past experience with the client. Prior years' unacceptable results from tests of controls, and the resulting high reliance on tests of balances, may cause the in-charge to select a lower system classification, i.e., B or C, and minimize controls testing. In other words, this decision may prevent inefficient auditing.

3. For all "no" answers, i.e., potential weaknesses, up to and including the system selected in each section, perform the following:

   a. Determine if the "no" answer is, in fact, a weakness.

   b. For the potential weakness, review any "yes" answers to other controls for possible offsetting strengths. Such strengths could be included within the system classification selected or in a more advanced system. For example, a weakness in a System B (a "no" answer) could be offset by another control within System B (a "yes" answer) or by a control in System A.

6.011 The Internal Controls Questionnaire may be completed by the client's employees or by engagement personnel. If the client's employees are used, their work should be reviewed by the in-charge to ensure that questions are answered correctly.

6.012 Rather than complete a new Questionnaire every year, many firms merely update the prior year's questionnaire and any supplementary narratives and flowcharts. As mentioned above, client personnel should be used whenever possible to perform the updates.

Testing the Internal Control Structure

6.013 An inverse relationship exists between the amount of tests of controls and the substantive testing performed in an audit. For engagements using the ABC System (see section 5.300, Chapter 5) the auditor will perform tests of controls.

6.014 Similar to the Internal Controls Questionnaire, the Tests of Controls Programs contain the three levels of controls: System C, (accounting system), System B (primary controls), and System A (secondary controls). As a result, the auditor should complete the Tests of Controls Programs that correspond to the systems selected in the Internal Controls Questionnaire. (See discussion in sections 6.008–6.012.)

6.015 Because the Tests of Controls procedures within a system correspond directly to that system's control procedures in the Internal Controls Questionnaire, the auditor may need to modify the Tests of Controls Programs for any compensating controls considered in the Internal Controls Questionnaire. For example, if a control in a System A offsets a weakness in System B, that control would not otherwise be tested under the System B Tests of Controls Program. To rely on the offsetting System A control, a modifying test of that control must be added to the System B program.

6.016 Standard Tests of Controls Programs, section 6.400, have been coordinated with the Internal Controls Questionnaire with particular attention paid to the special needs of not-for-profit organizations. Completing and evaluating the results of these tests may reduce substantive procedures.

Tests of Compliance for Circular A-133 Engagements

6.017 In addition to the above assessment of internal controls, auditors of not-for-profit organizations subject to the provisions of OMB Circular A-133 must report on the organization's compliance with applicable laws and regulations. The basic compliance and reporting requirements under Circular A-133 are discussed in Chapter 4. Audit programs for testing compliance are provided in section 6.300. Included in these audit programs, are discussions of the basic objectives of each applicable law or regulation.

Documenting Internal Control Structure Weaknesses

6.018 In completing the Internal Controls Questionnaire and the Initial Survey of EDP Controls and in performing the tests of controls, the auditor may become aware of deficiencies in the design or operation of the control that could adversely affect the organization's ability to properly record, summarize, and process financial data. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325), defines such matters as "reportable conditions" and requires that they be communicated to the organization's audit committee or governing board. As the auditor becomes aware of reportable conditions during the course of the audit, he or she should record them on the Internal Control Structure Reportable Conditions Form in section 6.500 for inclusion in the communication to the audit committee or governing board. Chapter 8, sections 8.607–8.614, contains examples of such communications.

6.100 INTERNAL CONTROLS QUESTIONNAIRE

Use of Questionnaire

This questionnaire is divided into the following six major audit areas:

I.	Accounts and pledges receivable confirmations, compliance auditing, and completeness of private support.
II.	Vouching and inspecting fixed assets, search for unrecorded liabilities, purchases cutoff, expense account analysis and vouching, and compliance auditing.
III.	Vouching of purchases and sales of investments.
IV.	Payroll tests and compliance auditing.
V. Part I	Physical inventory observation, and pricing and clerical tests—no perpetual inventory records.
V. Part II	Physical inventory observation, and pricing and clerical tests—perpetual inventory records.
VI.	Compliance auditing.

Each of the six sections are further divided into three levels: Accounting System (System C); Primary Controls (System B); and Secondary Controls (System A).

System C will result in control risk being assessed at the maximum or slightly below the maximum for most financial statement assertions. The absence of significant aspects of an effective accounting system may mean the client's system is not auditable or that significant reconstruction of records must take place before the audit begins.

System B includes an adequate accounting system and significant primary control procedures, which allows control risk to be assessed at a moderate level for some financial statement assertions.

System A has a well-designed control environment, accounting system, and primary and secondary control policies and procedures. This system allows control risk to be assessed at a moderate or low level.

Instructions:

When appropriate, client personnel should complete the Questionnaire for review by the in-charge. This questionnaire should be used to select the standard system classification and the related Tests of Controls Programs for each major audit area.

In the "Personnel" column insert the name and title of the individual that performs the control procedure. If more than one individual is listed because the question relates to segregation of duties, briefly describe the procedure performed by each. "No" answers represent potential weaknesses. Material weaknesses and reportable conditions should be posted to the Internal Control Structure Reportable Conditions Form.

The client's systems may contain governing board or manager controls. The term "manager", as used in this questionnaire, describes a person performing internal verification functions. That person may be a board member, general manager, controller, bookkeeper, foreman, or other employee.

The systems selected in this questionnaire should be transferred to the Planning Matrix.

Internal Controls Questionnaire — Not-for-Profit Organizations

Section I

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREA:
1. Accounts and pledges receivable confirmations.
2. Compliance auditing.
3. Completeness of private support.

TRANSACTION CYCLES:
1. Receipts, support, and revenue.
2. Restrictions and their fulfillment.

	Personnel	Yes	No	N/A
ACCOUNTING SYSTEM (SYSTEM C)				
Receipts				
1. Cash receipts are deposited intact.	____	___	___	___
2. Cash receipts are deposited in separate bank accounts, when required.	____	___	___	___
3. The individual(s) who open the mail make a log of cash receipts, including notation of any restrictions, before the cash or documentation is routed to others.	____	___	___	___
4. Bank accounts are reconciled monthly.	____	___	___	___
5. A balancing cash receipts journal is maintained and includes notation of any donor-imposed restrictions.	____	___	___	___
6. Direct solicitation or special events collections are controlled, such as by prenumbered tickets or receipt forms.	____	___	___	___
7. Collections made by sales personnel are adequately controlled, such as by cash register tapes or prenumbered sales orders.	____	___	___	___
8. Receipt of payments on receivables are documented, such as by receipt forms or notations on pledge forms.	____	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I (Continued)

	Personnel	Yes	No	N/A
9. Sales invoices and credit memos are prenumbered.				
Support				
1. Documentation, including all correspondence, is maintained for each restricted contribution or grant.				
2. Pledges are logged when received, with notation of the date that payment is promised and any donor-imposed restrictions.				
3. Conditional pledges are logged separately when received, with notation of the donor imposed condition and any donor imposed restrictions.				
4. Records of gifts of future interest, such as bequests or remainder trusts are maintained.				
5. Direct solicitors are provided with appropriate identification.				
6. Direct solicitors complete reports of amounts collected, which are reconciled to the cash turned over for counting and recording.				
7. Sealed containers or remittance envelopes are used to control direct solicitation collections until they are counted and recorded.				
8. Records are maintained indicating the number of hours, type, value, and valuation method of donated services.				
9. Records are maintained indicating the type, value, and valuation method of donated material.				
10. For organizations that maintain collections of works of art, historical treasures, or similar assets, a log or other record is made of accessions purchased (with notation of any donor imposed restriction satisfied) and accessions donated (with a notation of any donor restrictions imposed).				
11. Records are maintained of donated facilities received.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I (Continued)

	Personnel	Yes	No	N/A
Revenue				
1. Billings for sales of services and goods are promptly recorded.				
2. Prices charged, such as service fees and rates for dues and subscriptions, are established by appropriate officials and are made public knowledge.				
3. For third-party reimbursements, a review and summary of contract terms is performed to ensure proper understanding of reimbursement calculations.				
4. The accounting system identifies and captures reimbursable costs to facilitate the billing process.				
5. Procedures exist for the deferral of unearned amounts, such as subscriptions, customer deposits, or prorated service fees.				
6. Sales are documented, such as by cash register tapes or prenumbered sales invoices.				
7. Copies of sales invoices, reimbursement requests or customer statements are mailed periodically.				
PRIMARY CONTROLS (SYSTEM B)				
Receipts				
1. A restrictive endorsement is placed on all checks when received.				
2. A contributions subsidiary ledger is maintained, including notations of any restrictions, and is balanced and reconciled to the general ledger monthly.				
3. For special event revenues, ticket data and cash receipts information are reconciled to ensure completeness of collections.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I (Continued)

	Personnel	Yes	No	N/A
4. Voided receipt forms, sales invoices, and credit memos are adequately defaced and are retained.				
5. Receipts on accounts are posted to an accounts receivable subsidiary ledger.				
6. A policy statement defines receipts which are custodial or flow-through in nature, as opposed to revenue or support.				
7. Prenumbered receipt forms, invoices, credit memos, and special event tickets are safeguarded and accounted for.				
8. Bank reconciliations are prepared by someone independent of all cash receipts functions.				
9. Persons directly receiving cash, such as in direct solicitations or at special events, are independent of general ledger, cash receipts journal and accounts receivable subsidiary ledger posting functions.				
Support				
1. Prenumbered contributions acknowledgement (or thank-you) forms, which include acknowledgement of any restrictions, are used.				
2. Donors are provided with visible recognition, such as their name being printed in a newsletter or program booklet.				
3. Direct solicitors give donors prenumbered receipt forms, copies of which are turned over to supervisors along with amounts collected.				
4. Solicitation material describes solicitor identification and notifies the donor to expect a prenumbered receipt.				
5. An analysis of conditional pledges whose conditions have not yet been met is reviewed, at least monthly, by a responsible official.				
6. Collection containers are controlled, such as by individual numbering, and they are safeguarded and accounted for.				

INTERNAL CONTROLS QUESTIONNAIRE —
NOT-FOR-PROFIT ORGANIZATIONS
SECTION I (Continued)

	Personnel	Yes	No	N/A
7. Distribution of collection containers is documented so that each container is trackable.				
8. Remittance envelopes and other material and identification used for direct solicitation are safeguarded and accounted for.				
9. A schedule is used to ensure that collection containers are timely retrieved and that containers not retrieved are investigated.				
10. A policy statement defines the types of donated services that should be recognized and how the value of those services should be calculated.				
11. Time sheets or other documentation are required to ensure the accumulation of data related to donated services.				
12. A policy statement defines the methods used for determining the values assigned to donated material.				
13. Donated material is inspected when received.				
14. Prenumbered receipts are issued for donated material received.				
15. Donated material is adequately safeguarded from unauthorized personnel.				
16. Use of donated material is approved by appropriate personnel.				
17. For organizations that maintain collections of works of art, historical treasures or similar assets, an inventory system is maintained to provide a complete record of all collection items, and new accessions are added to this inventory system.				
18. A policy statement establishes guidelines for the recognition and valuation of the use of donated facilities.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION I (Continued)

	Personnel	Yes	No	N/A
19. Prenumbered receipts are issued for donated material received and the numerical sequence is accounted for.				
20. Records of gifts of future interest, such as bequests or remainder trusts are periodically reviewed by a responsible official.				
21. Contributions and grants that can reasonably be estimated are budgeted.				
Revenue				
1. Sales are recorded in a sales journal in the period shipped, or in accordance with shipping terms, if different.				
2. The sales journal is posted to an accounts receivable subsidiary ledger.				
3. The accounts receivable subsidiary ledger is posted, balanced, and reconciled to the general ledger monthly.				
4. Procedures are established to determine that all reimbursable costs are billed.				
5. Prenumbered credit memos are safeguarded and accounted for.				
6. Prenumbered shipping documents are safeguarded and accounted for.				
7. Prenumbered sales invoices are safeguarded and accounted for.				
8. When applying for reimbursements from third parties, the contract terms are considered to ensure that all reimbursable costs are being captured, and reimbursement requested.				
9. Responsible officials approve all credit sales and discounts.				
10. Monthly statements or sales invoices are sent to customers or members.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I (Continued)

	Personnel	Yes	No	N/A
SECONDARY CONTROLS (SYSTEM A)				
Receipts				
1. Incoming mail is received, opened and logged, including notation of any restrictions, by at least two individuals, each independent of the cash receipts journal, general journal entry, and accounts receivable functions.	____	____	____	____
2. The log of mail receipts is reconciled to deposits by a person who is independent of the functions of handling or recording cash.	____	____	____	____
3. Lock-box (or cashiering) services are used to control access to mail receipts from major fundraising campaigns and membership drives.	____	____	____	____
4. Collections from special events or solicitations are reconciled to accompanying detail, such as tickets sold or receipt forms submitted, by a person independent of cash receipts or posting functions.	____	____	____	____
5. Deposited items returned by the bank are received unopened and are investigated by a person independent of the functions of handling or recording cash receipts.	____	____	____	____
6. Bank reconciliations are reviewed by a responsible official other than the preparer, who is independent of all cash receipts functions.	____	____	____	____
7. When hiring individuals who will be involved with handling of incoming mail or the handling or recording of cash receipts, a responsible official checks applicants' references and otherwise attempts to evaluate their integrity.	____	____	____	____
8. Account codings for receipts are reviewed by an individual other than the preparer.	____	____	____	____
9. For reimbursement type grants and contracts, reimbursements requested and received are reconciled at least monthly, and a responsible official investigates differences.	____	____	____	____

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I (Continued)

	Personnel	Yes	No	N/A
Support				
1. A person independent of the function of recording cash receipts compares the current year contributions subsidiary ledger to the prior period subsidiary ledger to identify prior significant donors with no recorded current contribution, and a responsible official follows up as necessary.				
2. Recorded contributions and grants are compared to approved budgets and significant variances are investigated by a responsible official.				
3. Specific personnel not involved in the recording function are responsible for identifying and ensuring compliance with donor-imposed restrictions.				
4. Complaints from contributors who do not receive normal recognition, such as a thank-you letter or listing in a program booklet, are investigated by a person independent of the functions of receiving or recording cash.				
5. The governing board receives frequent reports on the collection status of major pledges and pending grant applications.				
6. An analysis of aged pledges receivable is reviewed at least monthly by a person independent of the functions of handling and recording of cash receipts.				
7. Write-offs of uncollectible pledges are the responsibility of a person independent of the functions of handling or recording cash receipts.				
8. Records of pledges written off are documented and kept on file.				
9. A policy statement defines the circumstances under which delinquent pledges are to be enforced or written off.				
10. The contents of collection containers are counted and recorded in the presence of at least two persons.				

INTERNAL CONTROLS QUESTIONNAIRE – NOT-FOR-PROFIT ORGANIZATIONS
SECTION I (Continued)

	Personnel	Yes	No	N/A
11. Time sheets or other records of donated services are certified by a responsible official.				
12. Periodic physical inventory observations of donated material are taken by a person who is independent of the functions of receiving, recording, or having custody of the donated material.				
13. For organizations that maintain collections of works of art, historical treasures, or similar assets, a physical inventory count or sampling is routinely made at least annually of the inventory system maintained to provide a complete record of all collection items by persons independent of purchasing, receiving, or recording collection items.				
Revenue				
1. Sales invoices are matched with shipping reports and are posted to the sales journal by a person independent of the shipping and sales functions.				
2. An analysis of aged accounts receivable is reviewed at least monthly by a responsible person independent of the functions of handling or recording cash receipts.				
3. Bad debts written off are controlled by a person who is independent of the functions of handling or recording cash receipts.				
4. Account codings are reviewed by a second person.				
5. Prices and calculations on sales invoices and credit memos are doublechecked by a second person.				
6. Recorded revenues are compared to approved budgets and significant variances are investigated by a responsible official.				
7. The director or manager investigates customer complaints.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I (Continued)

	Personnel	Yes	No	N/A
8. Requests for reimbursements reviewed by someone who did not prepare the request for compliance with contract terms, and maximization of potential reimbursements.	______	___	___	___

Other comments:

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

	19___	19___	19___	19___	19___
Prepared by:					
Client	___	___	___	___	___
In-Charge	___	___	___	___	___
Reviewed by:					
Engagement Partner	___	___	___	___	___

(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Internal Controls Questionnaire — Not-for-Profit Organizations — Section II

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Vouching and inspecting fixed assets.
2. Search for unrecorded liabilities.
3. Purchases cutoff.
4. Expense account analysis and vouching.
5. Compliance auditing.

TRANSACTION CYCLES:
1. Acquisitions and payments.
2. Restrictions and their fulfillment.

	Personnel	Yes	No	N/A
ACCOUNTING SYSTEM (SYSTEM C)				
Acquisitions				
1. Vendor invoices, or other documents, indicate the date that goods or services were received.	______	___	___	___
2. A log or other notation is made of bargain purchases that include a contribution element.	______	___	___	___
3. Unpaid vendor invoices are filed separately from paid invoices.	______	___	___	___
4. For acquisitions through the use of federal funds, the organization has:				
a. implemented procedures to avoid the purchasing of unnecessary or duplicate items, including consideration of lease versus purchase.	______	___	___	___
b. implemented competitive bidding procedures that comply with the requirements of section 36 of the OMB Common Rule and that involve solicitations of bids from small and minority-owned businesses.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION II (Continued)

	Personnel	Yes	No	N/A
c. implemented procedures that do not restrict competitive bids, such as specifying brand names of products.				
d. implemented procedures to provide assurance that the type of contract executed is appropriate for the particular purchase and not a "cost plus" contract.				
e. implemented procedures for evaluation of the appropriateness of any contractors, including evaluations of their integrity and past performance.				
f. records and files for purchases in excess of $10,000 that included:				
(1) basis for contractor selection.				
(2) justification for lack of competition when competitive bids or offers are not obtained.				
(3) basis for award cost or price.				
g. implemented procedures for contract administration and monitoring to provide assurance of appropriate contractor performance.				
h. implemented procedures to assure that laborers and mechanics employed by contractors or subcontractors to work on construction contracts financed by federal assistance are paid wages not less than those established by the Secretary of Labor (Davis Bacon Act).				
i. implemented policies for construction contracts above $2,000 that provide assurance that the contracts include a provision for:				
(1) compliance with the Copeland "Anti-Kick Back" Act.				
(2) compliance with the Davis Bacon Act, requiring the payment of prevailing wage rates.				

INTERNAL CONTROLS QUESTIONNAIRE —
NOT-FOR-PROFIT ORGANIZATIONS
SECTION II (Continued)

	Personnel	Yes	No	N/A
j. implemented policies for construction contracts above $10,000 to provide assurance that the contracts include:				
(1) provisions that will allow appropriate remedies in instances of breach of contract.	______	___	___	___
(2) suitable provisions for termination by the organization.	______	___	___	___
(3) provisions requiring compliance with Executive Order 11246, entitled "Equal Employment Opportunity."	______	___	___	___
k. implemented policies for construction contracts above $100,000 to provide assurance that the bonding requirements of Circular A-110 are met.	______	___	___	___
l. implemented policies for construction contracts above $100,000 to provide assurance that the contracts include provisions that require compliance with the Clean Air Act, the Clean Water Act, and Environmental Protection Agency Regulations.	______	___	___	___
Payments				
1. A balancing cash disbursements journal is maintained for each bank account.	______	___	___	___
2. Cash disbursements are made by check (except for petty cash).	______	___	___	___
3. Cash disbursements are supported by vendors' invoices or other external documents.	______	___	___	___
4. Bank reconciliations are prepared timely for all accounts.	______	___	___	___
5. The accounting system identifies and captures payments which satisfy donor-imposed restrictions.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION II (Continued)

	Personnel	Yes	No	N/A
6. The accounting system captures information necessary either to identify the function for which each expense is incurred or to allocate each expense incurred among appropriate functions.	________	___	___	___

PRIMARY CONTROLS (SYSTEM B)

Acquisitions

	Personnel	Yes	No	N/A
1. Vendors are approved by a responsible official.	________	___	___	___
2. All purchases are approved by a responsible official.	________	___	___	___
3. A purchases journal is maintained.	________	___	___	___
4. An accounts payable subsidiary ledger is maintained and is reconciled to the general ledger monthly.	________	___	___	___
5. For organizations that do not maintain an accounts payable subsidiary ledger, a responsible official reviews available records, such as unpaid invoices, approved budgets and cash flow projections, and board minutes, to identify accounts payable that should be recorded.	________	___	___	___

Payments

	Personnel	Yes	No	N/A
1. An imprest petty cash fund is in use.	________	___	___	___
2. The governing board authorizes all bank accounts and check signers.	________	___	___	___
3. The bank is immediately notified of all changes of authorized check signers.	________	___	___	___
4. All invoices are approved for payment by a responsible official.	________	___	___	___
5. For disbursements that require special approval of the governing board, their approval is adequately documented.	________	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION II (Continued)

	Personnel	Yes	No	N/A
6. Vendor invoices are recalculated prior to checks being prepared.				
7. Checks are prepared by an individual independent of those approving vendor invoices.				
8. Check signers are independent of the functions of approving vendors' invoices and maintaining cash disbursement records.				
9. Checks are signed only when supported by approved invoices (not signed in advance).				
10. Check signers compare data on supporting documents to checks presented for their signatures.				
11. Check signers examine appropriate approval on supporting documents before signing checks.				
12. Checks are recorded in the disbursements journal, and when appropriate in the accounts payable subsidiary ledger.				
13. Checks are prenumbered and accounted for.				
14. Voided checks are adequately defaced and are easily accessible for review.				
15. The practice of cashing checks out of cash receipts is prohibited.				
16. Bank transfers are scheduled, and investigated to ascertain that both sides of the transaction are recorded.				
17. A policy exists which documents the rationale used to allocate expenses among functions, grants, or contracts.				
18. Bank reconciliations are prepared by someone independent of all cash disbursements functions.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II (Continued)

	Personnel	Yes	No	N/A
SECONDARY CONTROLS (SYSTEM A)				
Acquisitions				
1. Prenumbered receiving reports are prepared as support for purchases.	____	___	___	___
2. The person who reconciles the accounts payable subsidiary ledger to the general ledger is independent of the function of maintaining the subsidiary ledger.	____	___	___	___
3. All supporting documents are matched by a person independent of the ordering function, or the director or manager, before entry in the purchases journal.	____	___	___	___
4. Account codings are reviewed by someone other than the preparer.	____	___	___	___
5. Prenumbered purchase requisitions and/or purchase orders are prepared as authorization for purchases.	____	___	___	___
6. Approved vendor price lists are in use.	____	___	___	___
7. The numerical sequence of receiving reports is accounted for by a person independent of the preparation function.	____	___	___	___
8. The numerical sequence of purchase requisitions and purchase orders is accounted for by a person independent of the preparation function.	____	___	___	___
9. Accounts payable subsidiary ledger balances are periodically reconciled to vendors' statements by a person independent of the ordering and payments functions.	____	___	___	___
10. A voucher system with prenumbered vouchers approved by a director or manager is in use.	____	___	___	___
11. The governing board receives frequent reports of purchases from, and distributions to, related parties.	____	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II (Continued)

	Personnel	Yes	No	N/A
Payments				
1. The numerical sequence of checks issued is accounted for by someone independent of the preparation function.	________	___	___	___
2. Checks are mailed by a person independent of the function of recording cash disbursements.	________	___	___	___
3. The bank reconciliation is prepared by a person independent of the check signing or recording functions.	________	___	___	___
4. Bank reconciliations are reviewed by a manager or director.	________	___	___	___
5. Disbursements returned by the bank are received unopened and are investigated by a person independent of the functions of approving, preparing, or recording cash disbursements.	________	___	___	___
6. The check preparation function is independent of purchases journal, general ledger, and accounts payable subsidiary ledger posting functions.	________	___	___	___
7. Account codings and functional assignments are reviewed by someone other than the preparer.	________	___	___	___
8. Access to blank checks is limited to persons authorized to prepare checks, and check sequences are accounted for.	________	___	___	___
9. Dual authorization is required for large disbursements.	________	___	___	___
10. Disbursements that require special approval by the governing board are reviewed by a board designee for compliance with the intentions of the board.	________	___	___	___
11. All supporting documents are canceled to prevent duplicate payment.	________	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE —
NOT-FOR-PROFIT ORGANIZATIONS
SECTION II (Continued)

Other comments:

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

[1] Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

[2] Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

[3] Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION II (Continued)

	19____	19____	19____	19____	19____
Prepared by:					
Client	______	______	______	______	______
In-Charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

Internal Controls Questionnaire — Not-for-Profit Organizations

Section III

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: Vouching of purchases and sales of investments.

TRANSACTION CYCLES: Investments.

	Personnel	Yes	No	N/A
ACCOUNTING SYSTEM (SYSTEM C)				
1. A written investment policy has been adopted establishing investment guidelines, objectives, and limitations.	________	___	___	___
2. Detailed records are maintained of investments, and are periodically reconciled to the general ledger.	________	___	___	___
3. Investment transactions are adequately supported by documents from independent sources (brokers' confirmations, bank advices, etc.)	________	___	___	___
4. Gains and losses on investments are computed and recorded when realized.	________	___	___	___
5. Management and board members associated with investment decisions possess the technical competence to understand any complex off-balance-sheet financial instruments the organization may consider.	________	___	___	___
PRIMARY CONTROLS (SYSTEM B)				
1. Purchases, sales, and exchanges of investments are approved by the management, board of directors, or its designated committee in accordance with statutory provision and donor-imposed restrictions.	________	___	___	___
2. Marketable investments held at the organization are kept in a vault under dual control.	________	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION III (Continued)

	Personnel	Yes	No	N/A
3. Securities and other evidence of ownership are made out in the name of the organization.				
4. Recorded investments are periodically compared with safeguarding ledgers, custodial confirmations, and with current market values on a timely basis; differences are investigated and resolved; and appropriate supervisory personnel review and approve completed reconciliations on a timely basis.				
5. A responsible official periodically compares buy and sell orders to brokers to the brokers' advices.				
6. Investment income and dividend income is reviewed for accuracy by reference to supporting documentation.				
7. Valuations for reporting purposes are obtained from published values.				

SECONDARY CONTROLS (SYSTEM A)

	Personnel	Yes	No	N/A
1. Brokers used by the organization are approved by the governing board or its designated committee.				
2. The governing board or its designated committee periodically reviews the investment portfolio for quality ratings, risk assessment, and market value.				
3. Individuals who execute investment transactions are independent from the function of recording those transactions and maintaining investment records.				
4. Documents supporting investment transactions are reviewed by an individual who does not originate the transaction.				
5. A person independent from the function of authorizing investment transactions reviews investments for compliance with any donor-imposed restrictions on assets.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION III (Continued)

	Personnel	Yes	No	N/A
6. Responsible individuals who do not have access to the vault or records make periodic surprise inspections to ensure existence of investments and evidence of ownership.				
7. The governing board periodically reviews compliance with laws, regulations, and agreements regarding the purchases and sales of securities, segregation of securities, and use of income from securities.				
8. Monthly reports on investment and investment income are reviewed by a responsible official.				

Other comments:

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION III (Continued)

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

____
____
____
____
____
____
____
____
____
____
____

	19____	19____	19____	19____	19____
Prepared by:					
Client	______	______	______	______	______
In-Charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Internal Controls Questionnaire — Not-for-Profit Organizations

Section IV

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREA: 1. Payroll tests.
2. Compliance auditing.

TRANSACTION CYCLES: Payroll and personnel.

	Personnel	Yes	No	N/A
ACCOUNTING CONTROLS (SYSTEM C)				
1. A payroll journal is prepared and balanced.				
2. Payroll disbursements are made by check.				
3. Labor is functionally classified.				
4. Employees' time records are maintained.				
5. W-4 forms are maintained.				
6. Employees' earnings records are maintained.				
7. A payroll bank account reconciliation is prepared.				
8. Wage rates are authorized by the owner or manager (at least verbally).				
9. Adequate records are maintained to allow allocation of payroll costs to functions (including lobbying activities), specific grants and contracts.				
10. Procedures exist for appropriate allocation of expenses to those related to the organization's purpose and those that are used to generate unrelated business income.				
PRIMARY CONTROLS (SYSTEM B)				
1. Time sheets or cards are prepared by employees.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION IV (Continued)

	Personnel	Yes	No	N/A
2. The director or manager approves:				
a. Rates of pay.				
b. Withholdings.				
c. Changes in above.				
3. The payroll bank account reconciliation is prepared by someone independent of payroll preparation and check signing or by the owner or manager.				
4. Payroll checks are prenumbered and accounted for.				
5. Checks are recorded in the payroll journal as prepared.				
6. Payroll journals are posted at least monthly to employees' earnings records.				
7. Payroll checks are signed by the director or manager.				
8. Time cards are approved by a director or manager.				

SECONDARY CONTROLS (SYSTEM A)

	Personnel	Yes	No	N/A
1. A time clock is used to record time or time is logged by someone independent of payroll preparation, check-signing, and distribution functions.				
2. An imprest payroll bank account is used.				
3. All payroll calculations are checked by an independent person.				
4. Employees' earnings records are periodically reconciled to the general ledger by persons independent of payroll preparation and distribution.				
5. Account codings are reviewed by someone other than preparer.				

INTERNAL CONTROLS QUESTIONNAIRE— NOT-FOR-PROFIT ORGANIZATIONS
SECTION IV (Continued)

	Personnel	Yes	No	N/A
6. Adequate personnel files are maintained.				
7. Payroll checks are accounted for by a person independent of the preparation function.				
8. Payroll is prepared by persons independent of time card approval, check signing and check distribution.				
9. Payroll bank account reconciliation is reviewed by the director or manager.				
10. Unclaimed payroll checks are followed up on by the director or manager.				

Other comments:

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION IV (Continued)

Personnel	Yes	No	N/A

System selection (circle one):

System A(1) System B(2) System C(3)

Modification of standard tests:

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	19___	19___	19___	19___	19___
Prepared by:					
Client	___	___	___	___	___
In-Charge	___	___	___	___	___
Reviewed by:					
Engagement Partner	___	___	___	___	___

(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Internal Controls Questionnaire — Not-for-Profit Organizations

Section V — Part I

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Physical inventory observation.
2. Pricing and clerical tests of inventory.

TRANSACTION CYCLE: No perpetual inventory records. Maintained—inventory and warehousing.

(Controls apply to annual taking of inventory.)

	Personnel	Yes	No	N/A
ACCOUNTING CONTROLS (SYSTEM C)				
1. An annual physical inventory is taken and adequate count records (tags or sheets) are maintained.				
2. Adequate records of inventory pricing and summary are maintained.				
3. The inventory count is taken, checked, or supervised by a manager.				
PRIMARY CONTROLS (SYSTEM B)				
1. Obsolete and consigned goods are excluded from the count.				
2. Good physical cutoff procedures are utilized to insure an accurate count and recording of inventory.				
3. Physical inventory counters are given adequate instructions for an accurate count.				

INTERNAL CONTROLS QUESTIONNAIRE — SECTION V — Part I (Continued)

	Personnel	Yes	No	N/A
SECONDARY CONTROLS (SYSTEM A)				
1. Written inventory instructions are prepared and used.				
2. The receiving department inspects the quantity and quality of materials when receiving reports are prepared.				
3. All classes of inventory are stored under good physical controls.				
4. The following functions are doublechecked on a test basis by an independent person:				
a. Original inventory counts and recording of quantities.				
b. Pricing of inventory items.				
c. Extending and footing of inventory sheets and/or summaries.				
d. Footing of sheets' or summaries' page totals to grand totals.				

Other comments:

INTERNAL CONTROLS QUESTIONNAIRE—
NOT-FOR-PROFIT ORGANIZATIONS
SECTION V — Part I (Continued)

System selection (circle one):

System A[1] System B[2] System C[3]

Modification of standard tests:

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	19____	19____	19____	19____	19____
Prepared by:					
Client	______	______	______	______	______
In-Charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

Internal Controls Questionnaire — Not-for-Profit Organizations Section V — Part II

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Physical inventory observation.
2. Pricing and clerical tests inventory.

TRANSACTION CYCLE: Perpetual inventory records. Maintained—inventory and warehousing.

	Personnel	Yes	No	N/A
ACCOUNTING CONTROLS (SYSTEM B—THERE IS NO SYSTEM C)				
1. All inventory movements and inventory withdrawals are recorded in the perpetual records and the general ledger.				
2. Production activity is controlled by a report of the production process.				
3. Excess, obsolete, and slow-moving inventory is periodically identified and removed from the perpetual records and the general ledger.				
4. Withdrawals from inventory are based on prenumbered finished inventory requisitions and/or prenumbered shipping reports.				
5. All inventory write-offs are approved by a manager.				
6. All perpetual records are subjected to physical inventories at least annually.				
7. Physical inventory counters are given adequate instructions.				
8. Physical inventory records are posted the date of the counts to obtain a good cutoff.				

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION V — Part II (Continued)

	Personnel	Yes	No	N/A
SECONDARY CONTROLS (SYSTEM A)				
1. All classes of inventory are stored under good physical safeguards.	______	___	___	___
2. Materials costs, labor charges, and overhead costs are recorded in the perpetual records and the general ledger.	______	___	___	___
3. For a standard cost system:				
a. Significant variances are reported timely.	______	___	___	___
b. Standards are reviewed at least annually.	______	___	___	___
c. The system interfaces with the general ledger.	______	___	___	___
4. Periodic physical counts are made and agreed to perpetual records by persons independent of the inventory and warehousing functions or by a manager.	______	___	___	___
5. Written instructions are prepared and used for periodic physical counts.	______	___	___	___
6. The receiving department inspects the quantity and quality of materials when receiving reports are prepared.	______	___	___	___
7. The following documents are periodically accounted for:				
a. Labor charge documents				
b. Finished inventory requisitions.	______	___	___	___
c. Completed production orders.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION V — Part II (Continued)

	Personnel	Yes	No	N/A
8. The following functions are doublechecked on at least a test basis by manager or independent persons:				
a. Completion of finished goods requisitions.	______	___	___	___
b. Labor distributions.	______	___	___	___
c. Overhead allocations.	______	___	___	___
d. Production activity reports.	______	___	___	___
e. Posting of above to perpetual records.	______	___	___	___
9. The following functions are doublechecked on a test basis by an independent person:				
a. Year-end summarization of labor, materials, and overhead from the perpetual records.	______	___	___	___
b. Footing of summary sheets to page totals.	______	___	___	___
c. Footing of page totals to grand totals.	______	___	___	___
10. All production activities are based on prenumbered production orders approved by a manager.	______	___	___	___
11. Material and labor costs charged to inventory are controlled by bills of materials and charges approved by management.	______	___	___	___
12. Perpetual records are periodically reconciled to the general ledger by an independent person.	______	___	___	___

Other comments:

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INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS SECTION V — Part II (Continued)

System selection (circle one):

System A[1] System B[2]

Modification of standard tests:

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	19___	19___	19___	19___	19___
Prepared by:					
Client	____	____	____	____	____
In-Charge	____	____	____	____	____
Reviewed by:					
Engagement Partner	____	____	____	____	____

(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

Internal Controls Questionnaire — Not-for-Profit Organizations — Section VI

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: Compliance auditing.

TRANSACTION CYCLES: Government programs.

	Personnel	Yes	No	N/A
ACCOUNTING SYSTEM (SYSTEM C)				
Government Programs				
1. Accounting policies and procedures are adequate to maintain separate records of the receipts and expenditures related to each grant or award.	______	___	___	___
2. Expenditures for each grant or award are recorded according to each of the organization's budget categories.	______	___	___	___
3. Government funds are deposited in separate bank accounts or controlled separately, as required.	______	___	___	___
4. Requests for advances and reimbursements are approved by an appropriate official.	______	___	___	___
5. Procedures have been established to ensure that individuals are not discriminated against on the grounds of race, color, national origin, age, or handicap.	______	___	___	___
6. Policies have been established and distributed to employees that help ensure a drug-free workplace.	______	___	___	___
PRIMARY CONTROLS (SYSTEM B)				
1. A time schedule for financial reports is maintained to ensure timely filing.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION VI (Continued)

	Personnel	Yes	No	N/A
2. Financial reports, before they are filed, are reconciled to accounting records.	______	___	___	___
3. Policies that are specific to government programs are communicated to the organization's personnel.	______	___	___	___
4. Policies and procedures have been established to obtain prior approval of certain costs from the granting agency, as required by OMB Circular No. A-122, "Cost Principles for Nonprofit Organizations."	______	___	___	___
5. For social services under government programs, policies and procedures have been established to ensure that individuals or organizations receiving benefits are eligible under the specific requirements of the programs.	______	___	___	___
6. For programs with matching or earmarking requirements, policies and procedures have been established to ensure that the limits have been met in accordance with applicable laws and regulations.	______	___	___	___
SECONDARY CONTROLS (SYSTEM A)				
1. Cash management procedures, such as cash flow projections, are employed to help ensure a minimum time lapse between receipt of funds and the disbursement.	______	___	___	___
2. Costs charged directly or indirectly to grants are reviewed by a responsible official for compliance with regulations or agreements (including consideration of whether federal funds are used for partisan political activity).	______	___	___	___
3. Policies and procedures have been established to prevent charging grants for unreimbursable items, such as bad debt expenses, fines and penalties, interest, fund-raising, and financial costs.	______	___	___	___

INTERNAL CONTROLS QUESTIONNAIRE — NOT-FOR-PROFIT ORGANIZATIONS
SECTION VI (Continued)

Other comments:

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____

System selection (circle one):

System A[(1)] System B[(2)] System C[(3)]

Modification of standard tests:

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	19____	19____	19____	19____	19____
Prepared by:					
Client	____	____	____	____	____
In-Charge	____	____	____	____	____
Reviewed by:					
Engagement Partner	____	____	____	____	____

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(1) Represents a decision to assess control risk at a moderate or low level for most financial statement assertions.

(2) Represents a decision to assess control risk at a moderate level for some of the financial statement assertions.

(3) Represents a decision to assess control risk at the maximum or slightly below the maximum for most financial statement assertions.

6.200 INTERNAL CONTROLS OVER COMPUTER PROCESSING

6.201 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit,* requires the auditor to obtain an understanding of an organization's internal control structure, including the controls over computer processing. This understanding of computer processing controls, which is required even when an all substantive approach to the audit is taken, enables the auditor to design effective substantive tests. This section describes how the auditor can obtain this required understanding, and how it may be documented in the working papers. It also describes typical tests of computer processing controls.

6.202 Today's computer environment is very diverse. Many organizations use microcomputer systems to maintain all of their accounting records. Larger organizations use mainframe computers that are often linked to microcomputer work stations. This section may be used to evaluate the computer controls for clients that have a sophisticated computer system, as well as those that use microcomputers and purchased software products.

6.203 Paragraphs 6.204 through 6.206 explain the various types of computer controls that may be established by a client. Tests of computer controls are addressed in paragraphs 6.218 through 6.226. Paragraphs 6.222 through 6.232 describe the auditor's consideration of computer controls when a client has a significant accounting application that is processed by a service organization (e.g., a data processing service center, mortgage servicer, or benefit plan servicer). The following elements of documentation assistance are included in this section:

- The Microcomputer Questionnaire (section 6.215) — is designed to document the required understanding of computer processing controls in audit engagements in which the client's computer system is comprised of only microcomputers and purchased software products. If the computer system has some of the controls included in the Questionnaire, the procedures used to obtain an understanding of the computer processing controls will usually provide evidence that will support a lower assessed level of control risk.
- The General Computer Controls Questionnaire and the Application Computer Controls Questionnaire (sections 6.216 and 6.217) — designed to document the auditor's understanding of computer systems that are more sophisticated (e.g., when the client develops its own software).
- Service Organization Application Controls Questionnaire (section 6.233) — designed to document the auditor's understanding of the controls at a service organization when it is necessary to obtain and understand those controls and a service auditor's report is not available.
- The Service Auditor Report Evaluation Form (section 6.234) — designed to document the auditor's evaluation of the report of a service auditor when it is necessary to obtain an understanding of the controls applied at a service organization.

Computer System Controls

6.204 To evaluate a client's internal control structure, the auditor should have a general understanding of the different computer system controls. In this section the two major types of computer controls — general controls and application controls — are briefly described.

6.205 General controls affect all applications and include:

a. Adequate segregation of computer-related duties, e.g., computer operation, programming, and data input,

b. Controls over the development and testing of programs and systems,

c. Procedures to prevent unauthorized changes to existing programs and systems,

d. Controls over access to programs and data, and

e. Controls over computer operations.

6.206 Application computer controls are those that relate only to a specific accounting application, such as payroll. Application controls include those that relate to input, processing, and output of specific information. For example, application controls for payroll would include:

- Controls to ensure the accuracy of the input of hours and wage rates, such as reviews of credit reports.
- Controls over the accuracy of payroll checks and reports, such as reconciliation of control totals, or supervisory review of checks and reports.

Practice Tip:

General controls affect all computer applications. If a client has weak general controls, the auditor generally cannot place any reliance on application controls.

Obtaining an Understanding of Computer System Controls

6.207 As a part of planning the audit, the auditor should identify those account balances, transaction classes, and disclosure components of the financial statements that involve significant computer processing. This will define the scope of the auditor's review of computer system controls. If the systems are very complex, it may be useful to prepare flowcharts documenting significant computer applications. The information in these flowcharts may be obtained from prior knowledge of the client's business, discussions with client personnel, and reference to prior year's workpapers.

Practice Tip:

Flowcharts generally should be prepared only when the computer system is very complex and the auditor is planning to assess control risk at a moderate or low level.

6.208 Procedures to Obtain Understanding. The auditor obtains an understanding of computer-related controls through procedures such as inquiry, observation, and inspection of documents. For example, to obtain an understanding of the design of the computer system used to generate the general ledger, the auditor may make inquiries of appropriate personnel about input, processing, and output control procedures, and inspect application software documentation. The auditor may inquire about data security and database backup procedures, and inspect any control reports or logs. The auditor also may observe users of the system in actual performance of their duties and review the resultant documents and records.

6.209 The nature and extent of the auditor's understanding will vary from client to client, and is influenced by the size and complexity of the client's computer system and procedures. The auditor's prior experience with the client and assessments of inherent risk and materiality of the various account balances and transaction classes may also effect the nature and extent of the audit procedures performed to obtain an understanding of the computer controls.

6.210 Documenting Computer System Controls. The Microcomputer Questionnaire (section 6.215) may be used to document the client's controls when the computer system consists of microcomputers and purchased software products. This is the only computer questionnaire that should be completed for such clients.

6.211 For clients with more sophisticated computer systems, the auditor may complete:

- The General Computer Controls Questionnaire (section 6.216)
- The Application Computer Controls Questionnaire (section 6.217)

6.212 The General Computer Controls Questionnaire documents controls over the client's computer system environment. The areas addressed include data processing management issues, systems development practices, and policies regarding end-user developed systems. If the client does not develop any application software internally, many of the questions in this questionnaire will not apply.

6.213 The Application Computer Controls Questionnaire is used to document the nature of each major computer application. The information prepared to document the understanding of the internal control structure elements will vary depending on the size and complexity of the client and its computer systems.

6.214 In some cases, the auditor may find it necessary to prepare additional materials to adequately document complex applications. Block diagrams, flowcharts, database structure listings, video display layouts (screen shots), and narratives are sometimes used to document the flow of transactions through a complex system. Copies of key input forms, computer prepared documents, and reports also may help to describe the nature of the computer processing. For very complex computer systems, the auditor should consider getting a computer specialist to participate in the review.

6.215

Microcomputer Questionnaire

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS:

This questionnaire should be used to document controls when a client uses microcomputers and one or more purchased, standard, UNMODIFIED accounting packages to process accounting information.

1. Names and models of computers: ____________________

2. Name of operating system: ____________________

3. Name and version of software:

   Package 1 ____________________
   Package 2 ____________________
   Package 3 ____________________
   Package 4 ____________________

4. Major reports generated from software:

   Package 1 ____________________
   Package 2 ____________________
   Package 3 ____________________
   Package 4 ____________________

5. Key operators and their responsibilities:

Key Operator	Responsibilities

MICROCOMPUTER QUESTIONNAIRE (Continued)

Are any of their duties incompatible?_____ Explain. ________________________________

____

____

6. Describe any controls, such as user ID numbers, passwords and locking on/off switches that are used to prevent unauthorized access to programs and accounting data. ____________________

____

____

____

7. Describe controls that insure that all transactions are processed and that the same data is not processed twice.

____

____

____

____

____

____

8. Are users adequately trained and provided with adequate instructions on how to use the computer system? Yes __________ No __________

9. Who is responsible for reviewing the reports generated from the microcomputer?

Report	Reviewer
______________________________	______________
______________________________	______________
______________________________	______________
______________________________	______________

10. Have procedures been developed for periodic back-up of files? ____________________

____

11. Are backup files stored in a secure location? ______________________________

____

12. Has management considered developing a disaster plan, including arrangements for emergency equipment, facilities, insurance, etc.? Yes ____ No ____

MICROCOMPUTER QUESTIONNAIRE (Continued)

13. Tests of Controls

The inquiry, observation, and inspection procedures used to obtain an understanding of the computer system are usually sufficient to support an assessment of control risk at less than the maximum.

Describe any *additional* tests of microcomputer controls performed (e.g., inspection of evidence of review of computer output):

____
____
____
____
____

14. Summary of Findings

Describe the major control strengths noted:

____
____
____
____

Describe the major control weaknesses noted:

____
____
____
____

15. The auditor's understanding of computer controls, and the results of the tests of controls should be considered in the auditor's assessment of control risk for all financial statement assertions that are affected by computer processing.

Practice Tip:

Computer processing controls usually have an impact on the existence, completeness, and dollar value of related transactions and balances. For example, if the client has good internal controls over processing of sales and cash receipts, the auditor may reduce the extent of the tests of existence, completeness and gross dollar value of accounts receivable (e.g., the number of confirmations mailed may be reduced).

MICROCOMPUTER QUESTIONNAIRE (Continued)

	19____	19____	19____	19____	19____
Prepared or updated by:					
Client	________	________	________	________	________
In-Charge	________	________	________	________	________
Reviewed by:					
Engagement Partner	________	________	________	________	________

6.216

General Computer Controls Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This questionnaire should be completed and updated annually to document controls that are global to the client's computer system environment. For each item, place a "✓" in the "Yes" or "No" column to indicate whether the procedure is performed or in the "N/A" column if the procedure is not applicable to the client's control system. When you've completed the questionnaire, review your "Yes" and "No" responses and determine how they impact your assessment of control risk. The effects of any "No" answers should be considered and documented in the space provided. Also, "No" answers should be considered for required communication of internal control structure related matters as material weaknesses and reportable conditions. (See Chapter 8, section 8.607.) **(If the client's computer system uses only unmodified software products and the system is not complex, this questionnaire should not be completed. See section 6.215 for the Microcomputer Questionnaire.)**

Organizational Controls

	Yes	No	N/A
1. If available, attach a copy of the management information systems (MIS) department organization chart.	____	____	____
2. Does the MIS department have adequate organizational status to be independent of the other organizational groups that it serves?	____	____	____
3. Have written job descriptions been prepared for all key positions in the MIS department?	____	____	____
4. Have procedures been established to ensure that MIS department employee qualifications are matched to the specific requirements for each employee's position?	____	____	____
5. Are system operations, input, database control functions, and system development activities performed by separate individuals?	____	____	____
6. Are operations personnel periodically rotated between jobs or applications?	____	____	____

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

	Yes	No	N/A
7. Are operations personnel required to take vacations?	___	___	___
8. Are operations personnel prohibited from initiating transactions or making master file (table) changes?	___	___	___
9. Are departments (groups) that initiate changes to database master information provided a report showing changes actually made?	___	___	___
Application Development Controls (includes standard spreadsheets, databases used for computer applications, Lotus programs, etc.)			
10. Have formal documentation standards and procedures been established?	___	___	___
11. Have standards for systems development and programming been developed?	___	___	___
12. Have formal operator and user instructions been developed?	___	___	___
13. Have formal program testing procedures been established for new applications and revisions to existing applications?	___	___	___
14. Are programs tested by persons independent of the programmer(s) who developed the software?	___	___	___
15. Are the data used for testing and the results of testing maintained for supervisory review and historical purposes?	___	___	___
16. Are personnel that test programs prohibited from testing new or revised programs on live data files?	___	___	___
17. Have procedures been developed for the documentation of requests for program changes?	___	___	___
18. Are program change requests approved in writing by a supervisory level person?	___	___	___

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

	Yes	No	N/A
Operations Controls			
19. Have procedures been established to monitor operator/user adherence to prescribed instructions?	____	____	____
20. Are adequate computer operation logs maintained for batch processing of transactions?	____	____	____
21. Are adequate computer controls (transaction logging, etc.) established over interactive processing of transactions?	____	____	____
22. Is a schedule prepared of applications to be processed, and reports and documents to be produced?	____	____	____
23. Are control procedures over report distribution adequate?	____	____	____
24. Have procedures been established to prohibit computer operators or users from having access to system or program logic documentation?	____	____	____
Data, Program and Facilities Backup Controls			
25. Have procedures been established for the periodic backup of critical data and programs from all centralized computers and file servers?	____	____	____
26. Is the backup media (diskettes, tapes, tape cartridges, etc.) stored at a secure location?	____	____	____
27. Have procedures been established for the restoring of backed up data and programs in the event of a system failure?	____	____	____
28. Has the client's ability to restore critical data and programs been tested?	____	____	____
29. Has a written disaster recovery plan been developed and have arrangements for emergency equipment and facilities been made?	____	____	____
30. If necessary, are virus tests performed on a regular basis?	____	____	____

GENERAL COMPUTER CONTROLS QUESTIONNAIRE (Continued)

31. Tests of Controls:

    Inquiry, observation, and inspection procedures are typically the only procedures that are used to test general controls. Therefore, the procedures used to obtain an understanding of the general controls are usually sufficient to support an assessment of control risk at less than the maximum.

    Describe any additional procedures designed to test general computer controls:

    ____
    ____
    ____
    ____
    ____

32. Summary of Findings:

    Describe the major control strengths in the general controls:

    ____
    ____
    ____
    ____
    ____

    Describe the major control weaknesses in the general controls:

    ____
    ____
    ____
    ____
    ____

33. This evaluation of general computer controls and the evaluations of application computer controls should be considered in the assessment of control risk for the financial statement assertions that are affected by computer processing.

	19____	19____	19____	19____	19____
Prepared or updated by: In-Charge	________	________	________	________	________
Reviewed by: Engagement Partner	________	________	________	________	________

6.217

Application Computer Controls Questionnaire

Client: ____________________________

Financial Statement Date: ____________________________

INSTRUCTIONS:

This form should be completed and updated annually for each significant accounting application by the in-charge or a computer specialist, and reviewed by the engagement partner. Additional documentation obtained from the client, vendors, and others should be included in the workpapers with this form. **(If the client's computer system uses only unmodified software products and the system is not complex, this form should not be completed. See section 6.215 for the Microcomputer Questionnaire.)**

Attach copies of any computer input screens, input documents, and reports that are considered necessary to document the internal controls.

Application Name: ____________________________
System Name: ____________________________

Application Narrative: (describe in non-technical terms what the application does)

____

____

____

____

Describe how critical this application is to the mission of the client. Discuss the impact on the client of not having this application operational.

____

____

____

____

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Section 1 — Technology Employed by the Application

Computer Hardware

Mainframe (centralized) Computer: ____________________

File server(s): ____________________

Stand Alone Workstations: ____________________

Other Significant Hardware Devices (e.g. point of sale terminals, bar code readers, image scanners, etc.): ____________________

Systems Software

Mainframe (centralized) computer: ____________________

File server(s): ____________________

Stand Alone Workstations: ____________________

Application and Utility Software

Name (including version #): ____________________
Vendor: ____________________

Name (including version #: ____________________
Vendor: ____________________

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Name (including version #): ____________________
Vendor: ____________________

Name (including version #: ____________________
Vendor: ____________________

Section 2 — Application Database/File Structure

List the major master files/tables in the application and a brief description of their contents: ____________________

List the key transaction files/tables in the application and a brief description of their contents: ____________________

ATTACH COPIES OF EACH FILE OR TABLE STRUCTURE LISTING

Section 3 — Master File/Table and Transaction Entry

Describe the nature of the transaction including:

Significant Source Documents and Contents

Input Screens

Retention Policy

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Who is responsible for reviewing the completeness and accuracy of the input?

Describe forms, logs, reconciliation's, etc. used to control input.

Form	Description

Describe the controls established to insure that all transactions are processed and that the same data is not processed more than once.

Section 4 — Report, Query and Other Output

Describe the nature of computer output including:

Printed Documents

Listings, journals, subsidiary ledgers, ledgers, summaries, etc.

Control reports and listings

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Describe the tests made by accounting or user personnel to verify the accuracy of the information processed.

Describe the procedures for error correction and reprocessing.

Describe the retention policy.

Section 5 — Personnel

Identify all persons performing any computer or accounting function related to the application.

Name and Job Title	Related Duties

Do any of the above persons have other duties that are incompatible?

Is segregation of duties adequate for the application?

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Is cross-training of personnel adequate to provide for vacations, emergency leaves and unplanned terminations?

Section 6 — Custody of Assets and Authorization of Transactions

Do computer operations, programming or other computer systems personnel have access to client assets or the ability to authorize transactions?

Section 7 — Security

Describe how the following security features of the operating system and/or network operating system are implemented for this application.

Software:

User numbers and password protection

File and subdirectory user and group rights assignment

Hardware/Operating System:

Disk mirroring, duplexing, transaction tracking and other data protection and error recovery features.

APPLICATION COMPUTER CONTROLS QUESTIONNAIRE (Continued)

Describe any other security features

____

____

____

Section 8 — Tests of Controls:

The inquiry, observation, and inspection procedures used to obtain an understanding of the application controls are usually sufficient to support an assessment of control risk at less than the maximum.

Describe any additional procedures designed to test application computer controls:

____

____

____

____

____

____

Section 9 — Summary of Findings

The application computer controls analyzed in this questionnaire (in conjunction with your evaluation of general computer controls) should be considered determining the assessed level of control risk for the related financial statement assertions.

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions:

____

____

____

____

	19____	19____	19____	19____	19____
Prepared or updated by:					
Client	________	________	________	________	________
In-Charge	________	________	________	________	________
Reviewed by:					
Engagement Partner	________	________	________	________	________

Tests of Controls

6.218 In addition to obtaining an understanding of the internal control structure, the auditor may perform tests of controls. These tests provide evidential matter to support an assessed level of control risk below the maximum. Tests of controls may be directed toward the effectiveness of the design of internal control structure policies and procedures, or they may be directed toward the effectiveness of operation of the policies and procedures during the period under audit.

6.219 Microcomputer Systems. Tests of controls in a microcomputer environment are not significantly different from those in a manual accounting environment. Control over a microcomputer can be achieved in one of two ways:

- Adequate segregation of duties exists, and access to the computer system is controlled to prevent changes in programs and data by unauthorized employees. or
- Adequate segregation of duties does not exist or access to the computer system is not adequately controlled, but these weaknesses are mitigated by the fact that appropriate personnel (e.g., the owner/manager) perform a detailed review of the computer reports.

6.220 These controls can generally be tested with observation, inquiry, and inspection of computer reports. The Microcomputer Questionnaire (section 6.215) may be used to document the auditor's tests of controls in a microcomputer environment.

6.221 Sophisticated Computer Systems. In more sophisticated computer systems, the auditor will generally begin by testing general controls. If these controls are weak, no reliance can be placed on application controls.

6.222 General controls over computer systems are generally tested by observation, inquiry, and inspection of documents and control logs. Controls that are most significant include:

- Segregation of duties within the MIS department, so that individuals with knowledge of programs and programming language cannot make unauthorized changes in programs or data,
- Procedures for developing and testing, and implementing new programs, and
- Security controls to prevent unauthorized changes to data by users, e.g., passwords and control logs.

6.223 The procedures used to obtain an understanding of the general controls generally are sufficient to obtain evidence about their operating effectiveness.

6.224 Applications controls are designed to assure the accuracy and completeness of specific data. The controls that are most significant to the auditor include:

- Controls that prevent unauthorized changes to data, such as passwords, user numbers, and control reports,
- Controls that insure the accuracy of data input, such as validity tests of data as it is entered into the system, review of edit reports that summarize changes to data, and control totals,

- Procedures for correcting and reprocessing data that was entered incorrectly, such as follow-up procedures on computer error reports,
- Training of user personnel about how to input data, and
- Adequate user instructions (i.e., in user manuals).

6.225 Application controls in sophisticated computer systems can be tested in a number of ways. The most common approach to testing application controls is described below:

- Observation and inquiry about the use of passwords and the application of validity tests as actual data is entered,
- Inspection of computer output, including error reports and related follow-up,
- Inspection of documents that evidence the review of computer output by appropriate personnel, and
- Inquiry about the training of user personnel and inspection of user instructions.

6.226 The procedures performed in obtaining an understanding of application controls generally are sufficient to allow control risk to be assessed at a level below the maximum. If the client's general and application controls are very effective, these procedures may be sufficient to justify a moderate level of control risk for the related assertions. If the auditor wishes to further reduce the level of control risk, he or she may add tests of controls to the General Applications Computer Controls Questionnaires.

Processing of Transactions by Service Organizations

6.227 SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* provides guidance to the auditor when his or her client uses a service organization to process a significant application. The Statement also provides guidance for auditors who issue reports on the processing of transactions by service organizations for use by other auditors, but for purposes of this discussion, we will focus on the guidance for auditors whose clients use the service organization.

6.228 When auditing a client that uses a service organization, the auditor should consider the significance that the service organization's policies, procedures, and records have on the client's financial statements. Factors the auditor considers include:

- The financial statement assertions affected by the service organization's processing,
- The nature of the services provided by the service organization,
- The client's internal control policies and procedures that are applied to the transactions processed by the service organization and the availability of auditable data in the client's possession,
- The terms of the contract between the client and the service organization, and
- The service organization's capabilities, including its —
  - Record of performance

— Insurance coverage

— Financial stability.

6.229 In many situations the client will have adequate controls over the data processed by the service organization. In these circumstances, there is no need to obtain an understanding of the controls at the service organization. As an example, a client that uses a service bureau to process payroll will usually have adequate controls to provide reasonable assurance that the service bureau is processing the payroll transactions accurately. These controls might consist of a review and testing of the payroll records that are received from the bureau.

6.230 An understanding of the controls at the service organization is generally needed only when the service organization both authorizes and processes transactions. An example of this organization would be a trust (e.g., a pension trust), in which the servicing financial institution makes investment decisions and maintains records of the transactions.

6.231 When the auditor decides that an understanding of the service organization's controls is necessary, this understanding may be obtained by:

- Reviewing manual or system documentation held by the client that describes the service organization's controls over the client's transactions, or
- Obtaining a report from a service auditor who performed procedures at the service organization for the benefit of multiple users.

6.232 In rare circumstances, the auditor may decide that it is necessary to perform procedures at the service organization to gain the required understanding of internal control.

6.233 If the auditor decides that an understanding of the controls at the service organization is necessary and a report by the service auditor is not available, he or she may complete the Service Organization Application Controls Documentation Form, shown in section 6.238.

6.234 If a service auditor report is available, it will be of one of the following two types:

- a report on policies and procedures placed in operation, or
- a report on policies and procedures placed in operation and tests of operating effectiveness.

6.235 Report on Policies and Procedures Placed in Operation. This report addresses the policies and procedures that the service organization has put into effect in the processing of the client's transactions. More specifically, it addresses (1) whether the policies and procedures were suitably designed to achieve specified control objectives, and (2) whether they have been placed in operation as of a specified date. This type of report is useful for obtaining an understanding of the controls at the service organization, but it does not provide evidence to reduce the assessed level of control risk.

6.236 Report on Policies and Procedures Placed in Operation and Tests of Operating Effectiveness. In addition to describing the service organization's controls over the client's transactions, this report addresses the effectiveness of the related controls during the period specified. Therefore, this type of report provides evidence that may allow the user auditor to reduce the assessed level of control risk.

6.237 Evaluating the Service Auditor Report. The Service Auditor Evaluation Form, shown in section 6.239, may be used to evaluate a service auditor report.

6.238

Service Organization Application Controls Questionnaire

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used when (1) the service organization both authorizes and maintains records of significant transactions, and (2) there is no service auditor's report available. The information should be used to evaluate the need to visit the service center to perform a detailed evaluation of the center's internal controls, to document information obtained during the visit and to identify any material weaknesses for follow-up.

This form should be completed by the in-charge, or computer specialist and reviewed by the engagement partner.

Any weaknesses or strengths noted should be evaluated by the auditor in assessing control risk.

Section 1 — General Information

Name of service center: ______________________________

____

Address: ______________________________

____

Name of individual(s) in client's organization responsible for service center application:

____

____

____

____

Is there a formal agreement? _____ If so, obtain copy.

Is there insurance protection for the following:

1. Program or software destruction? _____

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

2. Loss of data? _____

3. Business interruption? ______

4. Errors and omissions? _____

Application Narrative: (describe in non-technical terms what the application does) ________________

____
____
____
____
____

Describe how critical this application is to the client. Discuss the impact on the client of not having this application operational. ____

____
____
____

Section 2 — Technology Employed by the Application

Computer Hardware

Provide a general description of the service organization's hardware that is used to process client transactions: ____

____
____
____
____

Systems and Application Software

Provide a general description of the service organization's systems and application software that is used to process client transactions: ____

____
____
____
____
____

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Section 3 — Transaction Entry

Describe the nature of the transaction including:

Significant Source Documents and Contents ______

Input Screens ______

Retention Policy ______

Who is responsible for reviewing the completeness and accuracy of the input? ______

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe any forms, logs, reconciliations, etc. used to control input.

Form	Description

Describe the controls established to insure that all transactions are processed and that the same data is not processed more than once.

Describe how information is submitted to the service organization.

Section 4—Report, Query, and Other Output Received From the Service Organization

Describe the nature of computer output including:

Printed Documents

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Listings, journals, subsidiary ledgers, ledgers, summaries, etc.

Describe any tests made by service organization personnel to verify the completeness and the accuracy of the information processed.

Describe any tests made by user accounting or other user personnel to verify the completeness and the accuracy of the information processed.

Describe the procedures for error correction and reprocessing.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Section 5 — Information Retained by the Service Organization

Describe significant documents, transaction files, master tables/files, etc. retained by the service organization and the security and retention procedures employed.

Section 6 — Custody of Assets and Authorization of Transactions by the Service Organization

Describe the nature of service organization personnel's access to client assets and ability to authorize transactions.

Section 7 — Security

Describe the segregation of duties related to the processing of the client's transactions.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe how the following security features of the operating system and/or network operating system are implemented for this application.

User numbers and password protection

Describe any other security features.

Section 8 — Summary of Findings

Describe the major control strengths noted.

SERVICE ORGANIZATION APPLICATION CONTROLS QUESTIONNAIRE (Continued)

Describe the major control weaknesses noted.

____

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions.

____

	19____	19____	19____	19____	19____
Prepared or updated by:					
In-Charge	______	______	______	______	______
Reviewed by:					
Engagement Partner	______	______	______	______	______

6.239

Service Auditor Report Evaluation Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be used when (1) the service organization both authorizes and maintains records of significant transactions, and (2) there is a service auditor's report available.

This form should be completed by the in-charge or computer specialist and reviewed by the engagement partner.

Include a copy of the service auditor's report in the workpapers.

Section 1 — General Information

Name of service center: ______________________________

____

Address: ______________________________

____

Name of individual(s) in client's organization responsible for service center application:

____

____

____

____

____

Is there a formal agreement? _____ If so, obtain copy.

Is there insurance protection for the following:

1. Program or software destruction? _____
2. Loss of data? _____

SERVICE AUDITOR REPORT EVALUATION FORM (Continued)

3. Business interruption? ______

4. Errors and omissions? _____

Application Narrative: (describe in non-technical terms what the application does) ________________

Describe how critical this application is to the client. Discuss the impact on the client of not having this application operational: ________________

Section 2 — Service Auditor

Name of the service auditor: ________________

Does the Service Auditor have a good reputation? _______

Section 3 — The Service Auditor's Report

A. Describe the type of report issued by the service auditor. ________________

B. Describe the major control strengths in the service organization's processing.

C. Describe the major control weaknesses in the service organization's processing.

SERVICE AUDITOR REPORT EVALUATION FORM (Continued)

D. If the service auditor performed tests of the operating effectiveness of controls, identify those tests that will be relied upon in assessing control risk for the client.

____
____
____
____

Section 4 — Client Involvement

A. Describe any control procedures performed by client personnel to test the accuracy of service organization processing.

____
____
____
____

Section 5 — Summary of Findings:

Describe the effect of your understanding and the tests of controls performed on your assessment of control risk for the related financial statement assertions:

____
____
____
____

	19____	19____	19____	19____	19____
Prepared or updated by: In-Charge	________	________	________	________	________
Reviewed by: Engagement Partner	________	________	________	________	________

6.300

Tests of Controls Programs — Not-for-Profit Organizations

Section I: System A

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS:
1. Accounts and pledges receivable confirmations.
2. Compliance auditing.
3. Completeness of private support.

TRANSACTION CYCLES:
1. Receipts, support and revenue.
2. Restrictions and their fulfillment.

Procedure	Done By	Date	W/P Ref.
Receipts			
1. Determine by inquiry, observation, or inspection that the incoming mail is received, opened, and logged by at least two individuals who are independent of cash receipts journal, general journal entry, and accounts receivable functions.	______	______	______
2. Determine by observation or inspection that a restrictive endorsement is placed on all checks.	______	______	______
3. Determine by observation or inquiry that persons directly receiving cash, such as in direct solicitations or at special events, are independent of the general ledger, cash receipts journal, and accounts receivable subsidiary ledger posting functions.	______	______	______
4. Determine by observation or inquiry that a person independent of cash receipts or posting functions reconciles collections from solicitations or special events to accompanying detail such as tickets sold or receipt forms submitted.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
5. Determine by inquiry, observation, or inspection that collections made by sales personnel are adequately controlled, such as by cash register tapes or prenumbered sales orders.	_____	_____	_____
6. Examine evidence that account codings for receipts are reviewed by an individual other than the preparer.	_____	_____	_____
7. Examine evidence, inquire, and observe that persons reconciling bank accounts are independent of cash receipts and cash disbursement functions.	_____	_____	_____
8. Examine evidence that a person independent of cash receipts and posting functions reconciles the log of mail receipts to deposits.	_____	_____	_____
9. Determine by inquiry, observation, or inspection that deposit items returned by the bank are received unopened and investigated by a person independent of the functions of handling or recording cash receipts.	_____	_____	_____
10. Examine evidence that prenumbered cash receipts forms, invoices, credit memorandums, and special events tickets are safeguarded and accounted for.	_____	_____	_____
11. Select a sample _____ entries in the cash receipts journal and trace amounts and date to supporting logs of mail receipts.	_____	_____	_____
12. Select a sample of _____ daily logs of mail receipts and perform the following steps:			
a. Trace to posting in cash receipts journal.	_____	_____	_____
b. Determine proper account coding.	_____	_____	_____
c. Obtain supporting authenticated detailed deposit slips and remittance advices and:			
(1) Trace deposit slip total to bank statement noting agreement of date and amount.	_____	_____	_____

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
(2) Compare total and individual amounts on deposit slips and remittance advices to daily cash receipts.	______	______	______
d. Trace individual amounts to postings in the accounts receivable and contributions subsidiary ledgers noting agreement of names, dates, and amounts.	______	______	______
13. Select a sample of _____ daily cash register reports and/or daily over-the-counter receipt forms, and trace to duplicate deposit slips.	______	______	______
14. Examine evidence that a responsible official has investigated differences between amounts received and requested for reimbursement from third parties.	______	______	______
15. Examine evidence of monthly balancing of the accounts receivable and contributions subsidiary ledgers to the general ledger.	______	______	______
Support			
1. Examine evidence and/or observe the follow-up on contributors' complaints by a person independent of the functions of receiving and recording cash.	______	______	______
2. Examine evidence that a responsible official reviews, at least monthly, an analysis of conditional pledges whose conditions have not been met.	______	______	______
3. Examine evidence of a periodic physical inventory, made at least annually by a person independent of purchasing, receiving or recording collection items, of collections of works of art, historical treasures, or similar assets.	______	______	______
4. Examine evidence of the follow-up on significant variances from budgeted amounts of contributions by a responsible official.	______	______	______
5. Review evidence of periodic review of records of gifts of future interests (e.g., bequests).	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
6. If direct solicitation is used:			
a. Inquire about the supervision of area chairman, division chairman, etc.	______	______	______
b. Inspect evidence that sealed containers or remittance envelopes used for direct solicitation are accounted for.	______	______	______
c. Inspect evidence that prenumbered receipts used for direct solicitation are reconciled to amounts remitted by each solicitor.	______	______	______
7. If collection containers are used:			
a. Inspect receipts used to transfer the cash from individuals counting the collections to the individuals making cash deposits.	______	______	______
b. Determine by observation, inquiry, or inspection that collections in containers are counted in the presence of two persons.	______	______	______
c. Inspect the collection schedule used for canister collections.	______	______	______
8. If donated services are recorded, inspect the organizations's policy statement that defines the types of donated or contributed service that should be accounted for and reported.	______	______	______
9. Determine by observation, inquiry, or inspection that time sheets for donated services are approved by a responsible official.	______	______	______
10. If donated material is received, inspect evidence that a policy statement defines the methods used for determining the values assigned to donated material.	______	______	______
11. Inspect evidence that the numerical sequence of receipts for donated material is accounted for.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
12. Determine that documentation, including all correspondence, is maintained for each restricted contribution or grant.	______	______	_____
13. Review evidence that personnel not involved in the recording function identify and monitor compliance with donor-imposed restrictions.	______	______	_____
14. Examine evidence that a responsible official independent of the cash receipts and handling functions approves write-offs of uncollectible pledges.	______	______	_____
Revenue			
1. Determine by observation and examining evidence that sales invoices are matched with shipping reports and are posted to the sales journal by a person independent of the shipping and sales function.	______	______	_____
2. Examine evidence of review of the monthly analysis of aged accounts receivables by a responsible person independent of the functions of handling or recording of cash receipts, and that this person investigates as necessary.	______	______	_____
3. Select a sample of _____ entries in the sales journal, obtain sales invoices or credit memos and examine for evidence of:			
a. Approval of account codings.	______	______	_____
b. Doublechecking of calculations and prices.	______	______	_____
4. Examine evidence and/or observe that the director or manager investigates customer complaints.	______	______	_____
5. Observe that an approved sales price list is in use.	______	______	_____
6. Examine evidence that the following prenumbered documents are accounted for:			
a. Credit memos.	______	______	_____

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
b. Shipping reports.	______	______	______
c. Sales invoices.	______	______	______
7. Select a sample of _____ shipping reports issued during the year, compare to sales invoices and entries in the sales journal for name, date, and amount.	______	______	______
8. Select a sample of _____ entries in the sales journal and perform the following:			
a. Trace to sales invoices and shipping reports and compare similarity of name, date, and amount.	______	______	______
b. Verify prices and recalculate invoices.	______	______	______
c. Trace postings to accounts receivable subsidiary ledger and compare name, date, and amount.	______	______	______
d. Check propriety of account codings.	______	______	______
9. Examine evidence of the investigation of significant variances from budgeted revenue amounts.	______	______	______
10. Inspect evidence of approval by appropriate officials of service fee rates, dues, subscriptions, fees, etc.	______	______	______
11. Examine evidence of monthly balancing of the accounts receivable subsidiary ledger to the general ledger.	______	______	______
12. Inspect evidence of approval by appropriate officials of requests for reimbursements from third parties.	______	______	______
13. Examine evidence that a responsible official independent of the functions of handling and recording cash receipts approves bad debt write-offs.	______	______	______
14. Examine evidence or observe that a responsible official approves all credit sales, purchase discounts, and allowances.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
15. Other procedures: ____________________ ____________________ ____________________ ____________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section I: System B

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Accounts and pledges receivable confirmations.
2. Compliance auditing.
3. Completeness of private support.

TRANSACTION CYCLES:
1. Receipts, support and revenue.
2. Restrictions and their fulfillment.

Procedure	Done By	Date	W/P Ref.
Receipts			
1. Determine by observation or inspection that a restrictive endorsement is placed on all checks.	______	______	______
2. Examine evidence or observe that the person reconciling bank accounts is independent of the cash collections function or that the reconciliation is reviewed by an independent official.	______	______	______
3. Observe that over-the-counter receipts are controlled, such as by a cash register or prenumbered receipt forms.	______	______	______
4. Examine evidence of monthly balancing of the accounts receivable contributions and subsidiary ledgers to the general ledger.	______	______	______
5. Examine evidence that prenumbered cash receipts forms, invoices, credit memorandums, and special event tickets are safeguarded and accounted for.	______	______	______
6. Observe and inquire about the timely deposit of cash receipts.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
Support			
1. If direct solicitation is used, determine by observation, inquiry or inspection that sealed prenumbered containers or remittance envelopes are used, safeguarded, and accounted for.	______	______	______
2. Examine evidence that a responsible official reviews, at least monthly, an analysis of conditional pledges whose conditions have not been met.	______	______	______
3. Examine evidence that an inventory system is maintained for collections of works of art, historical treasures, or similar assets.	______	______	______
4. If donated services are recorded, inspect the organization's policy statement that defines the types of donated or contributed services that should be accounted for and reported.	______	______	______
5. Inspect the records of donated services, material, facilities, and gifts of future interests.	______	______	______
6. Determine by observation, inquiry or inspection that time sheets for donated services are approved by a responsible official.	______	______	______
7. If donated material is received, inspect evidence that a policy statement defines the methods used for determining the values assigned to donated material.	______	______	______
8. Inspect evidence that the numerical sequence of receipts for donated material is accounted for.	______	______	______
9. Inspect documentation and records of restricted grants or contributions.	______	______	______
10. Examine evidence of periodic review of records of gifts of future interests (e.g., bequests).	______	______	______
Revenue			
1. Examine evidence that monthly statements or sales invoice copies are sent to customers or members.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
2. Examine evidence of approval by the governing board service fee rates, dues, subscriptions, fees, etc.	______	______	______
3. Examine evidence that the following prenumbered documents are accounted for:			
a. Credit memos.	______	______	______
b. Shipping reports.	______	______	______
c. Sales invoices.	______	______	______
4. Examine evidence that a responsible official approves all credit sales, purchase discounts and allowances.	______	______	______
5. Other procedures: ______ ______ ______ ______	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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____
____
____
____
____
____
____

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section I: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Accounts and pledges receivable confirmations.
2. Compliance auditing.
3. Completeness of private support.

TRANSACTION CYCLES:
1. Receipts, support and revenue.
2. Restrictions and their fulfillment.

Procedure	Done By	Date	W/P Ref.
Receipts			
1. Examine evidence that over-the-counter sales are controlled by sales or receipts tickets.	______	______	______
2. Determine by observation, inquiry, or inspection that a log of conditional pledges received is maintained.	______	______	______
3. Determine by observation, inquiry, or inspection that a log of collections of works of art, historical treasures, or similar assets is maintained.	______	______	______
4. Observe and inquire about the timely deposit of cash receipts.	______	______	______
Support			
1. Determine by observation, inquiry, or inspection that sealed containers or remittance envelopes are used for direct solicitation.	______	______	______
2. Inspect the records of donated services, material, facilities, and gifts of future interest.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION I: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
3. Inspect documentation and records of restricted grants or contributions.	______	______	______
Revenue			
1. Observe and inquire about the preparation and mailing of receipts or sales invoices.	______	______	______
2. Examine evidence of approval by the governing board of service fee rates, dues, subscriptions, fees, etc.	______	______	______
3. Other procedures: ______ ______ ______ ______	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section II: System A

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Vouching and inspecting fixed assets.
2. Search for unrecorded liabilities.
3. Purchases cutoff.
4. Expense account analysis and vouching.
5. Compliance auditing.

TRANSACTION CYCLES:
1. Acquisitions and payments.
2. Restrictions and their fulfillment.

Procedure	Done By	Date	W/P Ref.
Acquisitions			
1. Determine by inquiry, observation, or by examining evidence that all supporting documents are matched by a person independent of the ordering function before entry in the purchases journal.	______	______	______
2. Examine evidence of an independent second person review of purchases account codings.	______	______	______
3. Examine evidence, or observe, that approved vendors' price lists are being used.	______	______	______
4. Examine evidence, or observe, that the numerical sequence of receiving reports are being accounted for.	______	______	______
5. Examine evidence, or observe, that the numerical sequence of purchase orders and/or purchase requisitions are being accounted for.	______	______	______
6. Examine evidence, or observe, that accounts payable subsidiary ledger balances are periodically reconciled to vendors' statements by a person independent of the ordering and payments function.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
7. Select a sample of _____ entries in the cash disbursements journal and perform the following procedures:			
a. Obtain paid check and:			
(1) Examine signature and endorsement.	______	______	______
(2) Compare to entry for payee, date, and amount.	______	______	______
b. Obtain supporting documents and:			
(1) Determine that documents agree with disbursement and that the vendor and nature of purchase are proper.	______	______	______
(2) Examine approval for payment by the director or manager or another appropriate official.	______	______	______
(3) Compare vendor name and amount to entry.	______	______	______
(4) Determine if discount was taken where appropriate.	______	______	______
(5) Examine approval of disbursement account coding.	______	______	______
(6) Determine if supporting documents are canceled to prevent duplicate payment.	______	______	______
(7) Trace postings to the accounts payable subsidiary ledger.	______	______	______
c. If the disbursement is made under a federal financial assistance program inspect the supporting documents for compliance with the requirements of the program, including:			
(1) Allowability of the types of goods and services acquired.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
(2) Eligibility of the individual or organization receiving financial assistance.	______	______	______
(3) Allocation to the appropriate grant or contract.	______	______	______
(4) Other specific requirements that apply to the program.	______	______	______
8. Select a sample of _____ receiving reports issued during the year and trace to vendor invoices and entries in the purchases journal. Compare:			
a. Type of merchandise.	______	______	______
b. Name of vendor.	______	______	______
c. Dates received.	______	______	______
d. Quantities.	______	______	______
e. Amounts.	______	______	______
9. Select a sample of _____ entries in the purchases journal and perform the following:			
a. If paid, trace check number to entry in cash disbursements journal. If unpaid, investigate reasons.	______	______	______
b. Obtain vendor invoice, receiving report, purchase order, and/or purchase requisition and perform the following:			
(1) Compare name, dates, and amounts.	______	______	______
(2) Review invoice for approval of purchase by the director or manager.	______	______	______
(3) Review receiving report for proper approval.	______	______	______
(4) Review purchase order and/or purchase requisition for proper approval.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
(5) Verify prices and recalculate footings and extensions on invoices.	______	______	______
(6) Compare quantities and descriptions.	______	______	______
(7) Check propriety of account codings.	______	______	______
(8) Determine that supporting documents are canceled to prevent re-use.	______	______	______
10. For acquisitions for federal assistance programs, determine by inspection and inquiry that the organization has implemented purchasing policies that:			
a. Avoid the purchasing of unnecessary or duplicative items, including consideration of lease versus purchase.	______	______	______
b. Include competitive bidding procedures that comply with the requirements of section 36 of the OMB Common Rule and that involve solicitations of bids from small and minority-owned businesses.	______	______	______
c. Do not restrict competitive bids (e.g., specifying brand names of products).	______	______	______
d. Provide assurance that the type of contract executed is appropriate for the particular purchase and not a "cost plus" contract.	______	______	______
e. Involve evaluation of the appropriateness of any contractors, including evaluations of their integrity and past performance.	______	______	______
11. Determine by inspection that records and files for purchases in excess of $10,000 included:			
a. Basis for contractor selection.	______	______	______
b. Justification for lack of competition when competitive bids or offers are not obtained.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
c. Basis for award cost or price.	______	______	______
12. Determine by inspection and inquiry that the organization has implemented policies and procedures for executing contracts that provide assurance that:			
a. Construction contracts above $2,000 include a provision for:			
(1) Compliance with the Copeland "Anti-Kick Back" Act.	______	______	______
(2) Compliance with the Davis-Bacon Act, requiring the payment of prevailing wage rates.	______	______	______
b. Construction contracts above $10,000 include:			
(1) Provisions that will allow appropriate remedies in instances of breach of contract.	______	______	______
(2) Suitable provisions for termination by the organization.	______	______	______
(3) Provision requiring compliance with Executive Order 11246, entitled "Equal Employment Opportunity."	______	______	______
c. Construction contracts above $100,000 comply with the bonding requirements of OMB Circular A-110.	______	______	______
d. Construction contracts above $100,000 include provisions that require compliance with the Clear Air Act, the Clean Water Act, and Environmental Protection Agency Regulations.	______	______	______
13. Examine _____ large contracts executed during the year and determine whether the contract meets the appropriate requirements described above.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
Payments			
1. Examine evidence to determine that supporting documents are being approved and canceled at time of check signing.	______	______	______
2. Examine evidence or observe that the numerical sequence of checks is accounted for by someone independent of the preparation function.	______	______	______
3. Inquire or observe that checks are mailed by an individual independent of the functions of maintaining cash disbursement records and preparing checks.	______	______	______
4. Examine evidence of the monthly balancing of the accounts payable subsidiary ledger to the general ledger.	______	______	______
5. Examine evidence, inquire, or observe that the bank reconciliation is prepared by an individual independent of the check signing function and that the reconciliation is reviewed by an independent official.	______	______	______
6. Determine by inquiry, observation, or inspection that the check preparation function is independent of the purchases journal, general ledger, and accounts payable subsidiary ledger posting functions.	______	______	______
7. Determine by inquiry, observation, or inspection that items returned by the bank are received and opened by the director or manager.	______	______	______
8. Examine evidence or observe that the receiving department inspects the quantity and quality of materials when receiving reports are prepared.	______	______	______
9. Other procedures: ______ ______ ______ ______ ______	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section II: System B

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS:
1. Vouching and inspecting fixed assets.
2. Search for unrecorded liabilities.
3. Purchases cutoff.
4. Expense account analysis and vouching.
5. Compliance auditing.

TRANSACTION CYCLES:
1. Acquisitions and payments.
2. Restrictions and their fulfillment.

Procedure	Done By	Date	W/P Ref.
Acquisitions			
1. Examine evidence that a responsible official approves purchases.	______	______	______
2. Test by observation and inquiry that vendors' invoices or other documents are included as support for all purchases.	______	______	______
3. Examine evidence that vendors are approved by a responsible official.	______	______	______
4. For acquisitions for federal assistance programs, determine by inspection and inquiry that the organization has implemented purchasing policies that:			
a. Avoid the purchasing of unnecessary or duplicative items, including consideration of lease versus purchase.	______	______	______
b. Include competitive bidding procedures that comply with the requirements of section 36 of the OMB Common Rule and that involve solicitations of bids from small and minority-owned businesses.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
c. Do not restrict competitive bids (e.g., specifying brand names of products).	______	______	______
d. Provide assurance that the type of contract executed is appropriate for the particular purchase and not a "cost plus" contract.	______	______	______
e. Involve evaluation of the appropriateness of any contractors, including evaluations of their integrity and past performance.	______	______	______
5. Determine by inspection that records and files for purchases in excess of $10,000 included:			
a. Basis for contractor selection.	______	______	______
b. Justification for lack of competition when competitive bids or offers are not obtained.	______	______	______
c. Basis for award cost or price.	______	______	______
6. Determine by inspection and inquiry that the organization has implemented policies and procedures for executing contracts that provide assurance that:			
a. Construction contracts above $2,000 include a provision for:			
(1) Compliance with the Copeland "Anti-Kick Back" Act.	______	______	______
(2) Compliance with the Davis-Bacon Act, requiring the payment of prevailing wage rates.	______	______	______
b. Construction contracts above $10,000 include:			
(1) Provisions that will allow appropriate remedies in instances of breach of contract.	______	______	______
(2) Suitable provisions for termination by the organization.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
(3) Provision requiring compliance with Executive Order 11246, entitled "Equal Employment Opportunity."	_____	_____	_____
c. Construction contracts above $100,000 comply with the bonding requirements of OMB Circular A-110.	_____	_____	_____
d. Construction contracts above $100,000 include provisions that require compliance with the Clear Air Act, the Clean Water Act, and Environmental Protection Agency Regulations.	_____	_____	_____
7. Examine _______ large contracts executed during the year and determine whether the contract meets the appropriate requirements described above.	_____	_____	_____
Payments			
1. Test by observation and inquiry that the individual signing the check reviews supporting documents.	_____	_____	_____
2. Examine evidence that checks are prenumbered and accounted for.	_____	_____	_____
3. Test by observation and inquiry that checks are prepared by an individual independent of those approving vendors' invoices.	_____	_____	_____
4. Examine evidence that a responsible official approves invoices for payment.	_____	_____	_____
5. Examine evidence, inquire, or observe that the bank reconciliation is prepared by an individual independent of the check signing function or that the reconciliation is reviewed by an independent official.	_____	_____	_____
6. Examine evidence that vendor invoices are recalculated prior to the preparation of checks.	_____	_____	_____

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM B (Continued)

Procedure	Done By	Date	W/P Ref.
7. Other procedures: ____________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ____________________ Date: ____________________
(In-Charge)

Reviewed by: ____________________ Date: ____________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section II: System C

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Vouching and inspecting.
2. Search for unrecorded liabilities.
3. Purchases cutoff.
4. Expense account analysis and vouching.
5. Compliance auditing.

TRANSACTION CYCLES:
1. Acquisitions and payments.
2. Restrictions and their fulfillment.

Procedure	Done By	Date	W/P Ref.
Acquisitions			
1. Examine evidence that payments are approved by the director or manager.	______	______	______
2. Examine evidence that a log is being maintained of the contribution element of bargain purchases.	______	______	______
3. For acquisitions for federal assistance programs, determine by inspection and inquiry that the organization has implemented purchasing policies that:			
a. Avoid the purchasing of unnecessary or duplicative items, including consideration of lease versus purchase.	______	______	______
b. Include competitive bidding procedures that comply with the requirements of section 36 of the OMB Common Rule and that involve solicitations of bids from small and minority-owned businesses.	______	______	______
c. Do not restrict competitive bids (e.g., specifying brand names of products).	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
d. Provide assurance that the type of contract executed is appropriate for the particular purchase and not a "cost plus" contract.	______	______	______
e. Involve evaluation of the appropriateness of any contractors, including evaluations of their integrity and past performance.	______	______	______
4. Determine by inspection that records and files for purchases in excess of $10,000 included:			
a. Basis for contractor selection.	______	______	______
b. Justification for lack of competition when competitive bids or offers are not obtained.	______	______	______
c. Basis for award cost or price.	______	______	______
5. Determine by inspection and inquiry that the organization has implemented policies and procedures for executing contracts that provide assurance that:			
a. Construction contracts above $2,000 include a provision for:			
(1) Compliance with the Copeland "Anti-Kick Back" Act.	______	______	______
(2) Compliance with the Davis-Bacon Act, requiring the payment of prevailing wage rates.	______	______	______
b. Construction contracts above $10,000 include:			
(1) Provisions that will allow appropriate remedies in instances of breach of contract.	______	______	______
(2) Suitable provisions for termination by the organization.	______	______	______
(3) Provision requiring compliance with Executive Order 11246, entitled "Equal Employment Opportunity."	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION II: SYSTEM C (Continued)

Procedure	Done By	Date	W/P Ref.
c. Construction contracts above $100,000 comply with the bonding requirements of OMB Circular A-110.	______	______	______
d. Construction contracts above $100,000 include provisions that require compliance with the Clear Air Act, the Clean Water Act, and Environmental Protection Agency Regulations.	______	______	______
6. Examine ________ large contracts executed during the year and determine whether the contract meets the appropriate requirements described above.	______	______	______
Payments			
1. Examine evidence that cash disbursements are supported by vendors' invoices or other external documents.	______	______	______
2. Examine evidence that bank accounts are reconciled.	______	______	______
3. Other procedures: ____________________ ____________________ ____________________ ____________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section III: System A

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: Vouching of purchases and sales of investments.

TRANSACTION CYCLES: Investments.

Procedure	Done By	Date	W/P Ref.
1. Determine by inquiry or inspection that purchases and sales of investments are authorized by the governing board, or a responsible committee or official.	______	______	______
2. Inspect monthly reports on investments and investment income for evidence of review by the governing board or a responsible official.	______	______	______
3. Determine by inquiry or inspection that the governing board reviews compliance with laws, regulations, agreements, and donor-imposed restrictions regarding the purchase and sale, segregation of securities, and use of income from securities.	______	______	______
4. Determine by observation or inspection that investments are reconciled to records by an individual who does not authorize or record investment transactions.	______	______	______
5. Determine by observation and inquiry that the responsibility for recording transactions is segregated from the employees responsible for executing the transactions.	______	______	______
6. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION III: SYSTEM A (Continued)

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ____________________ Date: ____________________
(In-Charge)

Reviewed by: ____________________ Date: ____________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section III: System B

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: Vouching of purchases and sales of investments.

TRANSACTION CYCLES: Investments.

Procedure	Done By	Date	W/P Ref.
1. Determine by inspection or inquiry that purchases, sales and exchanges of securities are reviewed by management, governing board, or its designated committee for compliance with statutory provisions and donor-imposed restrictions.	______	______	______
2. Inquire about the location of securities and the procedures for protecting them.	______	______	______
3. Determine by inspection or inquiry that recorded amounts of securities are periodically compared with safeguarding ledgers and custodial statements, and differences are investigated.	______	______	______
4. Other procedures: ____________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION III: SYSTEM B (Continued)

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section III: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS: Vouching of purchases and sales of investments.

TRANSACTION CYCLES: Investments.

Procedure	Done By	Date	W/P Ref.
1. Determine by inspection that a written policy has been established dealing with guidelines regarding the nature of investments that are allowed.	______	______	______
2. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section IV: System A

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREA:
1. Payroll tests.
2. Compliance auditing.

TRANSACTION CYCLES: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
1. Observe that a time clock is used to record time or that time is logged by persons independent of the payroll preparation, check signing, or distribution functions.	______	______	______
2. Examine evidence of doublechecking of payroll rates and calculations by an independent person.	______	______	______
3. Examine evidence of periodic reconciliations of employees' earnings records to general ledger by persons independent of payroll preparation and distribution.	______	______	______
4. Select ______ payroll labor distributions and examine evidence that account codings are reviewed by someone other than the preparer.	______	______	______
5. Select ______ personnel files and examine written evidence of the following:			
a. Wage rate authorization.	______	______	______
b. W-4 form signed by the employee.	______	______	______
c. Withholdings authorizations signed by employees and approved by the director or manager or another appropriate official.	______	______	______
6. Examine evidence or observe that payroll checks are accounted for by a person independent of the preparation function.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION IV: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
7. Examine evidence that the payroll bank account reconciliation is performed by a person independent of the preparation and distribution functions and reviewed by a responsible official.	_______	_______	_____
8. Select a sample of _______ series of _______ duplicate payroll checks and:			
a. Account for the numerical sequence.	_______	_______	_____
b. Trace to payroll journal entries for name, date, and amounts.	_______	_______	_____
9. Select a sample of _______ entries in the payroll journal, obtain canceled checks, time cards, and personnel files and:			
a. Recompute gross pay.	_______	_______	_____
b. Scan withholdings and other deductions for reasonableness.	_______	_______	_____
c. Examine time cards for approval by supervisors or the director or manager.	_______	_______	_____
d. Examine check for signature of director or manager.	_______	_______	_____
e. Examine or obtain the director or manager approval of rates of pay and withholdings.	_______	_______	_____
f. Compare signature on W-4 form to check endorsement.	_______	_______	_____
g. Trace postings to employees' earnings records.	_______	_______	_____
h. Check account classification.	_______	_______	_____
i. If the amount was charged to a federal award or contract, determine that the payroll costs are properly reimbursable under the program.	_______	_______	_____

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION IV: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
10. Other procedures: ________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ____________________ Date: ____________________
(In-Charge)

Reviewed by: ____________________ Date: ____________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section IV: System B

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREA:
1. Payroll tests.
2. Compliance auditing.

TRANSACTION CYCLES: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
1. Test by observation and inquiry that time cards are prepared by employees.	______	______	______
2. Test by observation and inquiry that time cards are approved by a supervisor, director, or manager.	______	______	______
3. Test by observation, inquiry, or inspection that the director or manager or another appropriate official approves rates of pay and withholding and changes thereto.	______	______	______
4. Examine evidence that the payroll bank account is reconciled by someone independent of payroll preparation, approvals and check signing or by the director or manager.	______	______	______
5. Examine evidence that payroll checks are prenumbered and accounted for.	______	______	______
6. Other procedures: ____________________	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION IV: SYSTEM B (Continued)

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ______________________ Date: ______________
(In-Charge)

Reviewed by: ______________________ Date: ______________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section IV: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREA:
1. Payroll tests.
2. Compliance auditing.

TRANSACTION CYCLES: Payroll and personnel.

Procedure	Done By	Date	W/P Ref.
1. Review selected payroll journals and personnel records.	_____	_____	_____
2. Other procedures: ______________________________	_____	_____	_____

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

____

Prepared by: ______________________________ (In-Charge) Date: ______________________________

Reviewed by: ______________________________ (Engagement Partner) Date: ______________________________

Tests of Controls Programs — Not-for-Profit Organizations Section V — Part II: System A

Client: ______________________

Financial Statement Date: ______________________

MAJOR AUDIT AREAS:
1. Physical inventory observation.
2. Pricing and clerical tests of inventory.

TRANSACTION CYCLE:
1. Perpetual inventory records.
2. Maintained — inventory and warehousing.

Procedure	Done By	Date	W/P Ref.
1. Observe that all inventory is stored under good physical safeguards:	______	______	______
2. Examine evidence or observe that physical counts are made and agreed with perpetual records by persons independent of the inventory and warehousing cycle.	______	______	______
3. Examine copies of instructions for periodic physical counts.	______	______	______
4. Examine evidence or observe that the receiving department inspects the quantity and quality of materials when receiving reports are prepared.	______	______	______
5. Examine evidence of reconciliation of perpetual records with the general ledger by an independent person.	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

____

____

____

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations Section V — Part II: System B

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS:
1. Physical inventory observation.
2. Pricing and clerical tests of inventory.

TRANSACTION CYCLE:
1. Perpetual inventory records.
2. Maintained—inventory and warehousing.

Procedure	Done By	Date	W/P Ref.
1. Test by observation and inquiry that inventory counters are given adequate instructions.	______	______	______
2. Test by observation and inquiry that adequate cutoff procedures are utilized to insure an accurate count.	______	______	______
3. Test by observation and inquiry that obsolete and consigned goods are excluded from the count.	______	______	______
4. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________________ Date: ______________________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section VI: System A

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: Compliance auditing.

TRANSACTION CYCLES: Government programs.

Procedure	Done By	Date	W/P Ref.
1. Inspect the organization's documentation of the accounting policies and procedures used to maintain separate records of the receipts and expenditures related to each grant or award.	______	______	______
2. Determine by inspection and inquiry that expenditures for each grant or award are recorded according to each of the organization's budget categories.	______	______	______
3. Inspect the organization's time schedule for submission of federal financial reports.	______	______	______
4. Determine by inspection or inquiry that federal financial reports are reconciled to the accounting records before they are filed.	______	______	______
5. Determine by inspection and inquiry that the organization has implemented policies and procedures to minimize the time lapse between receipt of funds and disbursement.	______	______	______
6. Determine by inspection and inquiry that the organization has implemented policies for obtaining prior approval of costs from the granting agency, as required.	______	______	______
7. Determine by observation, inquiry, and inspection that the organization has implemented adequate policies and procedures for determining that individuals or organizations receiving financial assistance are eligible under the program.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION VI: SYSTEM A (Continued)

Procedure	Done By	Date	W/P Ref.
8. Determine by observation, inquiry, and inspection that the organization has implemented adequate policies and procedures for ensuring that applicable matching or earmarking requirements are met.	______	______	______
9. Select a sample of ______ items charged to government programs and:			
a. Examine for evidence of review by the designated official.	______	______	______
b. Determine that the items are reimbursable under the program.	______	______	______
10. Other procedures: ______________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

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Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section VI: System B

Client: ____________________

Financial Statement Date: ____________________

MAJOR AUDIT AREAS: Compliance auditing.

TRANSACTION CYCLES: Government programs.

Procedure	Done By	Date	W/P Ref.
1. Inspect the organization's documentation of the accounting policies and procedures used to maintain separate records of the receipts and expenditures related to each grant or award.	______	______	______
2. Determine by inspection and inquiry that expenditures for each grant or award are recorded according to each of the organization's budget categories.	______	______	______
3. Inspect the organization's time schedule for submission of federal financial reports.	______	______	______
4. Determine by inspection or inquiry that federal financial reports are reconciled to the accounting records.	______	______	______
5. Determine by inspection and inquiry that the organization has implemented policies and procedures to minimize the time lapse between receipt of funds and disbursement.	______	______	______
6. Determine by inspection and inquiry that the organization has implemented policies for obtaining prior approval of costs from the granting agency, as required.	______	______	______
7. Determine by observation, inquiry and inspection that the organization has implemented adequate policies and procedures for determining that individuals or organizations receiving financial assistance are eligible under the program.	______	______	______

TESTS OF CONTROLS PROGRAMS — NOT-FOR-PROFIT ORGANIZATIONS
SECTION VI: SECTION B (Continued)

Procedure	Done By	Date	W/P Ref.
8. Determine by observation, inquiry, and inspection that the organization has implemented adequate policies and procedures for ensuring that applicable matching or earmarking requirements are met.	______	______	______
9. Other procedures: ______ ______ ______ ______	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

Tests of Controls Programs — Not-for-Profit Organizations

Section VI: System C

Client: ______________________________

Financial Statement Date: ______________________________

MAJOR AUDIT AREAS Compliance auditing.

TRANSACTION CYCLES: Government programs.

Procedure	Done By	Date	W/P Ref.
1. Inspect the organization's documentation of the accounting policies and procedures used to maintain separate records of the receipts and expenditures related to each grant or award.	______	______	______
2. Determine by inspection and inquiry that expenditures for each grant or award are recorded according to each of the organization's budget categories.	______	______	______
3. Other procedures: ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

Modification of analytical procedures and tests of balances (cross-referenced to related tests of control step above) and reasons therefor:

____
____
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____
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Prepared by: ______________________________ Date: ______________________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________________
(Engagement Partner)

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Tests of Compliance Audit Program for Not-for-Profit Organizations Receiving Federal Awards — Section I

Client: ______________________________

Financial Statement Date: ______________________________

AUDIT OBJECTIVE: To plan the performance of compliance auditing procedures under OMB Circular A-133.

Procedure	Done By	Date	W/P Ref.
A. Review applicable laws, regulations, and other references governing performance of federal financial assistance.	______	______	_____
B. Obtain a copy of the organization's organization-wide audit report from the preceding year. Make note of federal programs, reportable conditions relating to the internal control structure, and any compliance findings. Obtain copy of the organization's corrective action plan. Determine if any state programs are to be included in the scope.	______	______	_____
C. Review and discuss with responsible local government officials the procedures used to administer federal programs.	______	______	_____
D. Obtain a schedule of Federal financial assistance, reconcile the schedule to the accounting records, and:			
1. Determine that the schedule includes all types of Federal assistance as defined by OMB Circular A-133.	______	______	_____
2. Determine that the schedule reports Federal "programs", not individual grants.	______	______	_____
3. When appropriate, contact the cognizant agency and receive input on important areas.	______	______	_____

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS
SECTION I (Continued)

Procedure	Done By	Date	W/P Ref.
E. Rank the Federal programs in descending order by expenditure amount, determine the major program threshold, and identify the major Federal assistance programs.			
F. For testing internal controls, if expenditures from all major programs does not exceed 50 percent of total Federal financial assistance program expenditures, select the largest nonmajor programs until at least 50 percent of total Federal financial assistance expenditures are included.			
G. Review samples selected during tests of the internal control structure and the examination of the general purpose financial statements and identify nonmajor program transactions included therein.			
H. Prepare a working paper showing the Federal programs to be subjected to further auditing procedures and indicate the nature of the procedures to be applied to each program. Such procedures may include:			
1. Internal control structure evaluation (required for all major programs and nonmajor programs selected pursuant to the "50 percent rule").			
2. Program compliance review (required for all major programs to determine compliance with laws and regulations material in effect to the respective program).			
3. Transaction compliance review (required for nonmajor program transactions selected for testing as a result of the audit of the general purpose financial statements).			
I. Obtain a copy of grant agreements for those programs selected from testing from the permanent file. Review the documents for unusual provisions, budgets, or other items of significance. Also, obtain other sources of compliance information, for example, the OMB Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions.			

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION I (Continued)

Procedure	Done By	Date	W/P Ref.
J. Identify the requirements that could have a material effect on each major Federal program.	______	______	______
K. Determine if the organization has an indirect cost allocation plan.	______	______	______

Tests of Compliance Audit Program for Not-for-Profit Organizations Receiving Federal Awards

Section II

Client: ______________________________

Financial Statement Date: ______________________________

AUDIT OBJECTIVE: Provide a basis for the auditor's report on the organization's internal control structure over compliance with laws and regulations required by OMB Circular A-133.

Procedure	Done By	Date	W/P Ref.
A. Identify the significant categories of internal controls.	______	______	______
B. For major and nonmajor programs, obtain an understanding of the internal control structure policies and procedures relevant to the programs administration.	______	______	______
C. For major programs (and selected nonmajor programs selected pursuant to the "50% rule"), perform tests of controls to evaluate the effectiveness of the design and operation of the internal control structure policies and procedures relevant to preventing or detecting material noncompliance with specific requirements and general requirements of the programs. (These procedures are contained in the System A internal control questionnaires and tests of controls.)	______	______	______

Tests of Compliance Audit Program for Not-for-Profit Organizations Receiving Federal Awards — Section III

Client: ______________________________

Financial Statement Date: ______________________________

AUDIT OBJECTIVE: Provide a basis for the auditor's report on the general requirements applicable to major Federal financial assistance programs as required by OMB Circular A-133.

Procedure	Done By	Date	W/P Ref.
Political Activity			
Federal funds cannot be used for partisan political purposes of any kind by any person or organization involved in the administration of federally-assisted programs.			
A. Scan expenditure records for any indications of activities, publications, or other materials intended for influencing legislation or similar type costs.	______	______	______
B. In performing tests of expenditures, determine by examining supporting documentation whether any expenditures were intended to influence legislation.	______	______	______
C. In testing payroll transactions and records, identify any persons whose responsibilities or activities include partisan political activities.	______	______	______
D. Test whether any political activity costs identified were charged directly or indirectly to Federal assistance programs.	______	______	______
Davis-Bacon Act			
When required by Federal grant program legislation, all laborers and mechanics employed by contractors or subcontractors to work on construction projects financed by Federal assistance			

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION III (Continued)

Procedure	Done By	Date	W/P Ref.
must be paid wages not less than those established for the locality of the project by the Secretary of Labor.			
A. Identify any Federal assistance programs that involve construction activities.	______	______	______
B. Review selected contracts with construction contractors and determine whether they contain provisions requiring the payment of the "prevailing wage rate."	______	______	______
C. Review the adequacy of the organization's system for monitoring compliance of contractors with respect to payment of the prevailing wages.	______	______	______
D. If the monitoring system is not adequate, obtain, from the organization, payroll registers of the construction companies and test to determine whether the wages paid are at prevailing wages.	______	______	______
Civil Rights			
No person shall, on the grounds of race, color, national origin, age, or handicap, be excluded from participation in or be subjected to discrimination in any program or activity funded in whole or in part, by Federal funds. Discrimination on the basis of sex or religion is also prohibited in some Federal programs.			
A. Determine whether the organization has announced a formal policy of nondiscrimination.	______	______	______
B. For recipients employing 15 or more persons, ascertain whether a person has been designated to oversee civil rights compliance.	______	______	______
C. Obtain an understanding of how the organization's civil rights program operates.	______	______	______
D. Ascertain from the grant agreements whether any of the programs prohibit discrimination on the basis of sex or religion.	______	______	______

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS
SECTION III (Continued)

Procedure	Done By	Date	W/P Ref.
E. Ascertain the number of complaints of discrimination filed with Federal, State and/or local agencies, the status of unresolved complaints, and the actions taken on resolved complaints.	______	______	______
F. Ascertain whether any programs contain prohibitions against discrimination in employment. For those programs review the annual report filed with the Equal Employment Opportunity Commission, if any;	______	______	______
(1) Ascertain the numbers of complaints or completed investigations of employment discrimination;	______	______	______
and			
(2) Review the status of unresolved complaints and action taken on resolved complaints.	______	______	______
G. Determine whether facilities financed by Federal funds that are required to be located in a nondiscriminatory manner are so located.	______	______	______
H. Obtain representations from management about any civil rights suits that have been adjudicated or are pending.	______	______	______

Cash Management

Recipient financial management systems shall include procedures to minimize the time elapsed between the transfer of funds from the U.S. Department of Treasury and the disbursement of funds by the grantee.

Advances made by primary recipients to subrecipients shall conform substantially to the same standards of timing and amount as apply to advances by Federal agencies to primary recipient organizations.

Recipients shall maintain advances of Federal funds in interest-bearing accounts. Interest earned on Federal advances deposited

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION III (Continued)

Procedure	Done By	Date	W/P Ref.
in such accounts shall be remitted promptly, but at least quarterly, to the Federal agencies that provided the funds. Interest amounts up to $100 per year may be retained by the recipient for administrative expenses. However, some nonprofit institutions may be instrumentalities of a State covered by the provisions of the Cash Management Improvement Act of 1990.			
A. Review the organization's cash forecasting process and evaluate its adequacy.	______	______	______
B. Review the organization's system for requesting Federal funds and evaluate whether it is adequate to keep Federal funds held to a minimum.	______	______	______
C. For selected grant programs:			
(1) Determine dates and amounts of selected advances, drawdowns and other receipts of Federal funds and compare to the dates the funds were disbursed and/or checks were presented to the banks for payment,	______	______	______
and			
(2) Evaluate the size of the balances in relation to the program's needs.	______	______	______
D. Review selected cash reports submitted by subrecipients and determine if the reports show large amounts of excess cash.	______	______	______
E. Review the organization's system for maintaining Federal funds in interest-bearing accounts, calculating interest earned on these funds, and remitting the interest promptly.	______	______	______
Relocation Assistance and Real Property Acquisition			
A. Ascertain whether the recipient is administering a Federal program that involves the acquisition of property or the displacement of households or businesses by a public agency.	______	______	______

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION III (Continued)

Procedure	Done By	Date	W/P Ref.
B. Review the organization's system for compliance with relocation assistance and real property acquisition requirements and evaluate for adequacy.	______	______	______
C. Review the monitoring system for relocation and acquisition activity for selected programs and determine whether there is adherence to the prescribed procedures.	______	______	______

Federal Financial Reports

Most Federal programs require the periodic submission of financial reports. The special requirements for each grant program are presented in the Reporting Requirements (III-D) section for the program. The suggested audit procedures are provided below to facilitate the requirements for the auditor to comment on completeness and accuracy [OMB Circular A-110, and Treasury Circular 1075, "Withdrawal of Cash from the Treasury for Advances under Federal Grant and Other Programs"].

A. OMB Circular A-110 lists four required financial reports that apply to most of the programs described in this supplement.

- Financial Status Reports (SF-269 and SF-269A)—Report status of funds for all nonconstruction programs.

- Request for Advance or Reimbursement (SF-270)—Requests funds for nonconstruction programs when advance letter of credit or predetermined advance payments are not used.

- Outlay Report and Request for Reimbursement for Construction Programs (SF-271)—Requests reimbursements and reports status of funds for construction programs.

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION III (Continued)

Procedure	Done By	Date	W/P Ref.
• Federal Cash Transactions (SF-272 and SF272A)—Reports cash transactions and balances for grantees receiving advances or reimbursement by Treasury checks.			
B. Certain Federal agencies have received OMB approval to adopt the above reports or require other financial reports to meet their particular program needs.			
1. Test selected reports to determine whether they were actually submitted to the Federal agency.	______	______	______
2. Review the adequacy of the organization's procedures for preparing Federal financial reports.	______	______	______
3. Select several Federal financial reports from major programs, review for completeness of submission and trace data to the supporting documentation, i.e., worksheets, ledger, etc.	______	______	______

Allowable Costs/Cost Principles

Note: Compliance requirements and procedures to test this requirement are tested in the program titled Tests of Compliance Audit Program for Not-for-Profit Organizations Receiving Federal Awards — Specific Requirements.

Drug-Free Workplace

All recipients receiving grants, including cooperative agreements, from any Federal agency must certify that they will provide a drug-free workplace, or in the case of a grantee who is an individual, certify to the agency that his or her conduct of grant activity will be drug-free. Making the required certification has been a precondition of receiving a grant from a Federal agency since March 18, 1989. Every recipient is required to make this certification for each grant.

The recipient certifies that it will provide a drug-free workplace by:

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION III (Continued)

Procedure	Done By	Date	W/P Ref.
A. Publishing a policy statement notifying employees that the unlawful manufacture, distribution, dispensing, possession or use of a controlled substance is prohibited in the grantee's workplace and specifying the actions that will be taken against employees for violation of such prohibition.	______	______	______
B. Establishing an ongoing drug-free awareness program to inform employees about:			
1. The dangers of drug abuse in the workplace.	______	______	______
2. The grantee's policy of maintaining a drug-free workplace.	______	______	______
3. Any available drug counseling, rehabilitation, and employee assistance programs.	______	______	______
4. The penalties that may be imposed upon employees for drug abuse violations occurring in the workplace.	______	______	______
C. Making it a requirement that each employee to be engaged in the performance of the grant be given a copy of the statement required by paragraph (a).	______	______	______
D. Notifying the employee in the statement required by paragraph (a) that as a condition of employment under the grant the employee will:			
1. Abide by the terms of the statement.	______	______	______
2. Notify the employer in writing of any criminal drug statute conviction for a violation occurring in a workplace no later than five calendar days after such conviction.	______	______	______
E. Notifying the agency in writing within ten calendar days after receiving notice under subparagraph (d) (2) from an employee or otherwise receiving actual notice of such conviction.	______	______	______

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION III (Continued)

Procedure	Done By	Date	W/P Ref.
F. Taking one of the following actions, within 30 calendar days of receiving notice under subparagraph (d)(2), with respect to any employee who is so convicted—			
1. Taking appropriate personnel action against such an employee, up to and including termination; or	______	______	______
2. Requiring such employee to participate satisfactorily in a drug abuse assistance or rehabilitation program approved for such purposes by a Federal, State, or Local health, law enforcement, or other appropriate agency.	______	______	______
G. Determine through discussions with employees and written communications to employees whether the organization has taken action to provide a copy of the drug-free policy statement to each employee.	______	______	______
H. Ascertain whether the statement contains all the necessary notifications.	______	______	______
I. Determine whether the report made to Federal grantor agencies on convictions of employees is filed and complete.	______	______	______
J. Test a sample of files of convicted employees and determine whether the report made to Federal grantor agencies on convictions was reported within 10 calendar days after the employer received any notice of an employee's conviction.	______	______	______
K. Ascertain whether the organization took the required personnel or treatment referral action within 30 calendar days after receiving notice of an employee conviction.	______	______	______

Administrative Requirements

Program income consists of earnings from federally-supported activities, i.e., income from service fees, sale of commodities, usage or rental fees, and royalties on patents and copyrights. Program income may be used in one of three ways; as a general rule, program income must be used as a deduction from total

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION III (Continued)

Procedure	Done By	Date	W/P Ref.
project costs. If permitted by the terms of awards, such income may be used instead, to further eligible program objectives, or finance the nonfederal share of the project. The auditor should refer to the agreement to determine which option applies. Program income excludes interest earned on advances.			
The institution must have procedures to ensure proper accountability for program income (Circular A-110, Attachment D).			
The institution must maintain a property management system for its Federal award programs and related activities that is adequate to meet the standards of OMB Circular A-110, Attachment N, and the requirements of OMB Circular A-21 or A-122.			
The institution must have a procurement system which meets the requirements of OMB Circular A-110, Attachment O.			
Determine if any of the other administrative requirements listed above are material to Federal awards.			
A. Ascertain whether the organization is subject to any administrative requirements that are material to federal awards (e.g., maintenance of a property management system and a procurement system in accordance with OMB Circular A-110).	______	______	______
B. Tests transactions for compliance.	______	______	______

Tests of Compliance Audit Program for Not-for-Profit Organizations Receiving Federal Awards

Section IV

Client: ____________________

Financial Statement Date: ____________________

AUDIT OBJECTIVES:

1. To determine that the organization has not violated any laws and regulations that would have a direct and material effect on the organization's financial statements.
2. To determine that the organization has not violated any laws and regulations that would have a direct and material effect on specific (e.g., major) federal financial assistance programs.

Procedure	Done By	Date	W/P Ref.
A. Review grant agreement for requirements and provisions that could have a direct and material effect on the organization's financial statements.	______	______	______
B. For each federal assistance program that is material to the financial statements, or under an organization-wide audit for each major federal program, select a sample of expenditures charged and determine that:			
(1) Expenditures appear reasonable and necessary for the program.	______	______	______
(2) Expenditures were for allowable charges under the terms of the program and were adequately documented.	______	______	______
(3) Expenditures were properly authorized and recorded as to program, account, amount, and period.	______	______	______
(4) Records document that those who received services or benefits were eligible to receive them.	______	______	______
(5) Expenditures were in accordance with the provisions of OMB Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Organizations applicable to the transaction.	______	______	______

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS
SECTION IV (Continued)

Procedure	Done By	Date	W/P Ref.
(6) Expenditures were not in violation of State or Local laws.	______	______	______
(7) Expenditures were net of applicable credits for purchase discounts, trade-ins, refunds, etc.	______	______	______
(8) Expenditures were specifically approved by the granting agency, if required (e.g., for purchase of equipment and for foreign travel).	______	______	______
(9) Expenditures were in conformance with any limitations or exclusions set forth in the applicable cost principles, or with any limitations in the program agreement or specific requirements in the program regulations.	______	______	______
(10) Expenditures were given consistent treatment with policies, regulations, and procedures applied uniformly to Federal and nonfederal activities of the organization.	______	______	______
(11) Expenditures were given consistent accounting treatment within and between accounting periods.	______	______	______
(12) Expenditures were not allocable to, or included as a direct cost of, a Federal program if the same or similar costs are allocated to the Federal program as an indirect cost.	______	______	______
(13) Expenditures were not included as a cost or used to meet cost-sharing requirements of another federally-supported activity.	______	______	______
(14) Expenditures were allocable under the cost principles provided in HHS OASC-3, if applicable, and OMB Circulars A-21 and A-122.	______	______	______
(15) Expenditures were supported by underlying documentation.	______	______	______

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION IV (Continued)

Procedure	Done By	Date	W/P Ref.
C. For depreciation or use charges determine that:			
(1) A combination of depreciation and use charges are not used for assets in the same class.	______	______	______
(2) The depreciation or use charge is based on the cost of purchased assets or the fair market value on the date of donation for donated assets.	______	______	______
(3) The depreciation is not related to the cost of assets that were used to satisfy matching requirements.	______	______	______
(4) Depreciation is not taken on assets that are fully depreciated (a use allowance may be negotiated with the agency).	______	______	______
(5) The annual use allowance does not exceed 6 2/3 percent of the acquisition cost for equipment and 2 percent of the acquisition cost for buildings.	______	______	______
D. For indirect costs charged to programs:			
(1) Obtain and read the cost allocation plan or current negotiation agreement or other documents related to the types of rates and procedures required.	______	______	______
(2) Inquire about whether the rates used or amounts charged are final or predetermined or are still open to adjustment or revision.	______	______	______
(3) Evaluate whether direct costs of other activities have been included in the indirect costs charged to the Federal program.	______	______	______
E. Review on a test basis supporting documentation for indirect costs to determine whether:			
(1) The indirect cost pools contain only items that are consistent with the applicable cost principles and negotiated agreements.	______	______	______

TESTS OF COMPLIANCE AUDIT PROGRAM FOR NOT-FOR-PROFIT ORGANIZATIONS RECEIVING FEDERAL AWARDS SECTION IV (Continued)

Procedure	Done By	Date	W/P Ref.
(2) The methods of allocating costs are in accordance with the provisions of the appropriate cost principles, applicable regulations, and agreements and produce equitable distribution of costs.	_____	_____	_____
(3) Operating data (e.g., square footage, personnel costs, etc.) used in the proposed allocation bases are current and reasonable.	_____	_____	_____
(4) Personnel activity reports, time and effort reports, or other methods used to allocate salary and wage costs are mathematically accurate, are implemented as approved, and are based on the actual efforts devoted to various activities.	_____	_____	_____
(5) The indirect costs charged to federal programs are supported by amounts recorded in the accounting records.	_____	_____	_____
F. For each major Federal and State financial program examine evidence that applicable matching or earmarking requirements have been met.	_____	_____	_____
G. For each major Federal financial program examine evidence that Federal financial reports and claims for advances and reimbursements contain information that is supported by the accounting records.	_____	_____	_____
H. For each major Federal financial program examine evidence that special tests and provisions have been met that federal agencies have determined could materially affect the program.	_____	_____	_____
I. Prepare the schedule of findings and questioned costs.	_____	_____	_____

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Internal Control Structure Reportable Conditions Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This form should be completed by the in-charge or supervised staff, and reviewed by the engagement partner for all audit engagements. The information should be used to complete the required communication of internal control structure related matters and other matters.

The Internal Controls Questionnaire — Not-for-Profit Organizations, any internal control narratives, and the results of tests of controls are primary sources for identifying reportable conditions. Reportable conditions are significant deficiencies in the design or operation of the control structure, including the accounting system and primary and secondary controls, that could adversely affect the organization's ability to record, process, and summarize financial data consistent with management's assertions in the financial statements. Weaknesses should be classified as material or immaterial. Other operations or management suggestions may also be included on this form.

The form is designed to include the documentation source of the conditions, the audit areas affected by the conditions, and a format for writing comments.

Prepared by: ______________________________ Date: ____________________
(In-Charge)

Reviewed by: ______________________________ Date: ____________________
(Engagement Partner)

REPORTABLE CONDITIONS

Documentation Source	Audit Areas Affected by Condition	Situation	Problem	Recommendation	Discussed With	Disposition

Substantive Testing

CHAPTER 7

SUBSTANTIVE TESTING

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CHAPTER 7

SUBSTANTIVE TESTING

7.000 PURPOSE

7.001 Substantive tests are procedures applied to account balances or classes of transactions to determine if there are material misstatements in the financial statements.

7.002 The nature, timing, and extent of substantive tests are generally based on the assessment of inherent and control risk made during the planning phase of the engagement. For example, the higher the assessment of control risk, the more comprehensive the substantive tests should be. If analytical procedures performed during the planning phase of the engagement suggest that some account balances are unexpectedly high or low, the auditor may determine that those balances warrant more testing. Tests' effectiveness can be modified by changing their nature (for example, tests of balances versus analytical procedures), timing (testing as of the balance-sheet date versus an interim date), or extent (testing 100% versus sampling). Similarly, the auditor may be able to change the same factors to make audits more efficient. While the main objective is to perform an effective audit, if alternative tests are equally effective, the auditor should choose the most efficient one.

7.003 Planning occurs throughout the engagement and as a result the auditor might have to reassess risk as the engagement unfolds. For example, even if tests of controls indicated that an area had low risk and the auditor planned substantive tests accordingly, information might come to the auditor's attention during the audit that requires reassessment of the risk. Such information might include, for example, unexpected deviations from control procedures, misstatements that the internal controls should have caught, or new information about transactions or balances.

The ABC System Approach to Substantive Testing

7.004 Before beginning substantive tests under the ABC System, two important documents should be reviewed: (1) the Planning Matrix, which outlines the auditor's plan for performing tests of controls, analytical procedures, and tests of balances for each major audit area; and (2) the Tests of Controls Programs. The Tests of Controls Programs should be reviewed to ensure that the tests of controls provided satisfactory results, in which case the auditor can proceed with the planned strategy for analytical procedures and tests of balances, as outlined in the Planning Matrix. If tests of controls did not provide satisfactory results, the auditor should alter the planned reliance on analytical procedures and/or tests of balances to ensure that sufficient evidence will be obtained from substantive tests. This decision can be documented by amending the Planning Matrix.

7.005 Contained in this Chapter are an Analytical Procedures Program — Not-for-Profit Organizations and Tests of Balances Programs — Not-for-Profit Organizations. These programs are organized by major audit area in the same manner as the Internal Controls Questionnaire and the Tests of Controls Programs. This allows the auditor to coordinate obtaining the appropriate mix of evidence from tests of controls, analytical procedures, and tests of balances for each major audit area. The major audit areas that are included in the programs discussed above are meant to represent the major areas of a typical not-for-profit organization. The auditor should modify these programs by adding, deleting or both as necessary procedures reflective of the specific audit being performed.

7.006 In most cases, analytical procedures should be relied upon to the maximum extent possible, because they are often more efficient to perform than tests of balances. The auditor should document the analytical procedures performed by completing the Analytical Procedures Program — Not-for-Profit Organizations in section 7.400. This program will assist the auditor in developing the types of analytical procedures that are prevalent in not-for-profit organizations. The auditor should tailor this program to fit the specific circumstances of the organization being audited.

The All Substantive Approach to Substantive Testing

7.007 The All Substantive Approach should be used on engagements for which a substantive approach is the most cost-beneficial. Under this approach, control risk is assessed at the maximum (or slightly below the maximum) and no or little reliance is placed on tests of controls. This approach requires that all testing be done as of the balance-sheet date. If the organization is subject to the requirements of OMB Circular A-133, this approach would not be appropriate.

7.100 TYPES OF SUBSTANTIVE TESTS

7.101 There are two broad categories of substantive tests: tests of balances and analytical procedures.

- Tests of balances are procedures applied to the <u>individual items</u> that compose an account balance or class of transactions. The tests involve confirmation, inspection, or observation procedures to provide evidence about the recorded amount.
- Analytical procedures are tests applied to the <u>total</u> recorded amounts and are based on the existence of plausible and consistent relationships among financial statement elements or between financial and nonfinancial amounts.

7.102 The auditor may obtain evidence from any combination of tests of balances and analytical procedures. As a general rule, tests of balances provide stronger evidence and, therefore, are more effective. But analytical procedures can also be effective:

- For certain types of assertions (for example, the completeness assertion, which cannot be tested directly using a test of balances on recorded amounts).
- When the relationships between amounts are very predictable.
- When the data used to develop expectations based on the relationship are reliable.
- When relatively precise expectations can be developed.

7.200 ANALYTICAL PROCEDURES

7.201 Analytical procedures can provide evidence supporting financial statement assertions and, thus, can be used as substantive tests. Analytical procedures are often the least expensive tests. Accordingly, they should be used whenever practical.

7.202 SAS No. 56, *Analytical Procedures* (AU 329), describes analytical procedures as follows:

> Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:
>
> a. Financial information for comparable prior period(s) giving consideration to known changes.
>
> b. Anticipated results — for example, budgets, or forecasts including extrapolations from interim or annual data.
>
> c. Relationships among elements of financial information within the period.
>
> d. Information regarding the industry in which the client operates — for example, gross margin information.
>
> e. Relationships of the financial information with relevant nonfinancial information.

7.203 Whenever analytical procedures are applied as substantive tests, the auditor must apply the following procedures:

1. Consider whether the relationship is plausible and predictable.
2. Consider whether the data used for the comparison is reliable.
3. Consider whether the account balance tested is consistent with the auditor's expectations. If it is not consistent, obtain the client's explanation for the variance and get evidence to corroborate the client's explanation.

7.204 The Analytical Procedures Program — Not-for-Profit Organizations contains recommended analytical procedures. But be alert for additional opportunities to apply these or other additional procedures whenever they are effective and practical.

7.205 Preliminary analytical procedures done in planning are discussed in Chapter 3, sections 3.360 to 3.363.

7.206 The auditor should prepare workpapers that support the Analytical Procedures Program — Not-for-Profit Organizations. These workpapers should indicate the purpose of the workpapers, calculations of applicable relationships, and any conclusions reached as a result of performing these procedures.

7.207 At the conclusion of the audit, the auditor should compare the final financial statements to previous years and to industry data as an overall review. The Engagement Performance Review Checklist in Chapter 8, section 8.910 contains a step that requires and documents performance of the overall review.

7.300 TESTS OF BALANCES

7.301 Testing of not-for-profit organizations consists largely of tests of balances. The following sections discuss how the timing and extent of the tests is determined.

Timing

7.302 Tests of balances are generally done on balances as of the balance-sheet date, although in some cases balances may be tested as of an interim date. If the auditor elects to perform substantive testing at an interim date, rollforward work should be performed to provide evidence relating to the account balances at the balance-sheet date. In addition, if balances are tested at an interim date, the auditor should:

- Consider whether there are rapidly changing economic conditions that might predispose management to misstate the financial statements in the period after the date tested,
- Compare information concerning the balance at the balance-sheet date with comparable information at the interim date tested to identify unusual amounts,
- Apply additional tests of balances or analytical procedures to provide a reasonable basis for extending the conclusions about the balance at the interim date to the balance at the balance-sheet date, and
- Consider coordinating the tests of interrelated accounts and cutoffs.

7.303 Generally balances are tested as of an interim date only when control risk for the related assertions are assessed at below the maximum. That is, when controls have been tested and found to be effective for that assertion.

Sampling

7.304 The requirements for both statistical and nonstatistical sampling are established by SAS No. 39, *Audit Sampling* (AU 350), and explained in the AICPA Audit and Accounting Guide, *Audit Sampling* (AAG-SAM). These pronouncements discuss the factors that are considered in deciding whether to sample, determining sample sizes, and evaluating sample results. Sampling guidance for tests of balances is provided in Chapter 5, section 5.500.

Tests of Balances Programs — Not-for-Profit Organizations

7.305 The test of balances program located in section 7.500, has been designed to provide substantive evidence (when combined with appropriate planning and, when appropriate, evidence from tests of controls) that is sufficient to support the assertions in the client's financial statements. The program should be modified for each audit to reflect overall engagement risk, risks of potential misstatements, the results of analytical procedures done in planning, and the selection of the most cost-beneficial audit approaches and procedures.

7.306 The program addresses the financial statement assertions discussed in SAS No. 31 (AU 326), *Evidential Matter*:

- Existence or occurrence — whether the assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period.
- Completeness — whether all transactions and accounts that should be presented in the financial statements are so included.
- Rights and obligations — whether assets are the rights of the entity and liabilities are obligations of the entity at a given date.
- Valuation or allocation — whether asset, liability, revenue, and expense components of the financial statements have been included in the financial statements at appropriate amounts.
- Presentation and disclosure — whether particular components of the financial statements are properly classified, described, and disclosed.

7.307 The in-charge should modify the standard program based on the assessment of overall engagement risk from the Client Acceptance and Continuance Form, the Risk of Potential Misstatements Evaluation Form, the Internal Controls Questionnaire — Not-for-Profit Organizations, the Planning Matrix, the Tests of Controls Programs — Not-for-Profit Organizations, and Analytical Procedures Program — Not-for-Profit Organizations. The partner should review the tests of balances program after interim work. Any inapplicable or unnecessary procedures should be marked "N/A" before the year-end field work is begun.

7.400

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
I. CASH								
1. Compare account balances with preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
2. Compute quick current ratios (cash, cash equivalents and net receivables/current liabilities) and compare with preceding year's.	____	____	____	____	____	____	____	____
II. ACCOUNTS RECEIVABLE AND SALES								
1. Compare balances of accounts receivable and revenues with preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
2. Investigate large and/or unusual balances classified as "other account receivables."	____	____	____	____	____	____	____	____
3. Compute the following ratios and compare with preceding year's:								
a. Number of days net sales in trade accounts receivable	____	____	____	____	____	____	____	____
b. Year-end trade accounts receivable as a percentage of gross sales	____	____	____	____	____	____	____	____
c. Net pledges receivable/total contributions	____	____	____	____	____	____	____	____
d. Net grants receivable/total grant revenue	____	____	____	____	____	____	____	____

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
III. ALLOWANCE FOR DOUBTFUL ACCOUNTS								
1. Compare balances in allowance for doubtful accounts, bad debts, sales returns, and allowances with the preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
2. Compute the following ratios and compare with preceding year's:								
a. Sales returns and allowances as a percentage of gross sales	____	____	____	____	____	____	____	____
b. Sales returns and allowances as a percentage of gross sales by product line	____	____	____	____	____	____	____	____
c. Bad debts expense as a percentage of gross sales	____	____	____	____	____	____	____	____
d. Allowance for doubtful accounts as a percentage of trade accounts receivable	____	____	____	____	____	____	____	____
e. Aging categories as a percentage of total accounts receivable compared to prior year's	____	____	____	____	____	____	____	____
IV. ALLOWANCE FOR UNCOLLECTIBLE PLEDGES								
1. Compare balances in allowance account with preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
2. Compute ratio of allowance for uncollectable pledges/pledges receivable and compare with preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
V. NOTES AND OTHER ACCOUNTS RECEIVABLE								
1. Compare balances in notes receivable and interest income with the preceding year's. Investigate significant changes.	___	___	___	___	___	___	___	___
2. Compute the ratio of interest earned to the average notes receivable outstanding and compare with preceding year's.	___	___	___	___	___	___	___	___
VI. INVENTORIES								
1. Compare balances of inventory and contract costs of sales classifications with the preceding year's.	___	___	___	___	___	___	___	___
2. Compare inventory classifications as a percentage of total inventory with preceding year's.	___	___	___	___	___	___	___	___
3. Compute gross margin and compare with preceding year's.	___	___	___	___	___	___	___	___
4. Compute gross margin by product line or division and compare with preceding year's.	___	___	___	___	___	___	___	___
5. Compute inventory turnover and compare with preceding year's.	___	___	___	___	___	___	___	___
6. Compute inventory turnover by major product or division and compare with preceding year's.	___	___	___	___	___	___	___	___

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
VII. INVESTMENTS								
1. Compare balances in investments and related revenue and expense accounts with preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
2. Compute rate of return on major classes of investments and compare with preceding year's.	____	____	____	____	____	____	____	____
VIII. PREPAID EXPENSES								
1. Compare balances in prepaid expense accounts with preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
IX. FIXED ASSETS								
1. Compare balances in fixed assets, capitalized leased assets, accumulated depreciation, accumulated amortization, depreciation, repairs and maintenance, rents, supplies, small tools, and similar expense accounts with preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
X. DEFERRED CHARGES AND INTANGIBLES								
1. Compare balances in deferred charges, intangibles, accumulated amortization, and research and development accounts with the preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
XI. ACCOUNTS PAYABLE AND PURCHASES								
1. Compare balances in trade accounts payable and purchases with the preceding year's. Investigate significant changes.	___	___	___	___	___	___	___	___
XII. OTHER CURRENT LIABILITIES								
1. Compare balances in other current liability accounts to the preceding year's. Investigate significant changes.	___	___	___	___	___	___	___	___
XIII. NOTES PAYABLE AND LONG-TERM DEBT								
1. Compare balances in long-term and interest expense with preceding year's. Investigate significant changes.	___	___	___	___	___	___	___	___
2. Compute interest expense as a percentage of average balance of notes payable and long-term debt outstanding and compare to preceding year's.	___	___	___	___	___	___	___	___
XIV. NET ASSETS								
1. Compute the following ratios and compare with preceding year's:								
a. Unrestricted net assets to total net assets	___	___	___	___	___	___	___	___
b. Unrestricted net assets/total expenses	___	___	___	___	___	___	___	___

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
c. Unrestricted net assets/gross payroll	___	___	___	___	___	___	___	___
d. (If endowments are significant.) Total endowment fund balances/total expenses	___	___	___	___	___	___	___	___
XV. REVENUE								
1. Compare account balances with preceding year's. Investigate significant changes.	___	___	___	___	___	___	___	___
2. For each program that earns revenue, compute the ratio of program revenue earned/program expense. Compare to preceding year's and investigate significant differences.	___	___	___	___	___	___	___	___
3. Compute the ratio of total nonreciprocal revenues/total expenses. Compare with preceding year's and investigate significant changes.	___	___	___	___	___	___	___	___
4. Compute the ratio of total nonreciprocal revenues/fund raising expenses. Compare with preceding year's and investigate significant changes.	___	___	___	___	___	___	___	___
5. Compute the ratio of excess of revenue over expenses/total revenue. Compare with preceding year's and investigate significant changes.	___	___	___	___	___	___	___	___

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
XVI. SALARIES, WAGES, AND COMMISSIONS								
1. Compare account balances with the preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
2. Compute the following as a percentage of net sales:								
a. Direct labor	____	____	____	____	____	____	____	____
b. Indirect labor	____	____	____	____	____	____	____	____
c. Commissions	____	____	____	____	____	____	____	____
d. Office salaries	____	____	____	____	____	____	____	____
3. Compute payroll tax expenses as a percentage of total of wages, salaries, and commissions.	____	____	____	____	____	____	____	____
XVII. EXPENSE ACCOUNTS								
1. Compare balances in expense accounts with the preceding year's. Investigate significant changes.	____	____	____	____	____	____	____	____
2. Compare individual expense accounts with budgeted amounts. Investigate significant variations.	____	____	____	____	____	____	____	____
3. Compare individual expense accounts as a percentage to total expenses for the following categories:								
a. Selling expenses	____	____	____	____	____	____	____	____
b. Manufacturing expenses	____	____	____	____	____	____	____	____

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
c. General and administrative expenses								
4. For each function, compare expense account balances with preceding year's. Investigate significant changes.								
5. For each function, compare individual expense account balances with the budgeted amounts. Investigate significant changes.								
6. Compare payroll expense allocated to functions with allocations made in the previous year.								
7. Compare rent expense allocated to functions with allocations made in the previous year.								
8. Calculate total general and administrative expenses/total expenses. Compare with preceding year's and investigate significant changes.								
9. Calculate total fund raising expense/total expenses. Compare with preceding year's and investigate significant changes.								

ANALYTICAL PROCEDURES PROGRAM — NOT-FOR-PROFIT ORGANIZATIONS
(Continued)

Procedures	Done	Date	N/A	W/P Ref.	Acceptable Results (Yes or No)	Follow-up Procedures W/P Ref.	Follow-up Procedures Acceptable? (Yes or No)	Modification of Tests of Balances for "No" Answers
XVIII. OVERALL REVIEW								
[To be done in conjunction with *Engagement Performance Review Checklist* (Section 8.910)].								
1. Read the financial statements and notes and consider:								
a. The adequacy of the evidence gathered in response to unusual or unexpected balances identified in planning the audit or in the course of the audit.	___	___	___	___	___	___	___	___
b. Unusual or unexpected balances or relationships that were not previously identified.	___	___	___	___	___	___	___	___

Prepared by: ______________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________ Date: ______________________
(Engagement Partner)

7.500

Tests of Balances Program — Not-for-Profit Organizations

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This program has been developed for use on all not-for-profit organization audit engagements. It is not a substitute for professional judgment. The minimum tests of balances procedures and sample sizes should be selected for an A or B System provided the results from tests of controls and analytical procedures are satisfactory. Certain additional procedures and/or increased sample sizes in tests of balances may be required for financial statement assertions with assessed control risk at maximum, i.e., System C. The same will be required for the tests of balances on small, noncomplex engagements. Sampling guidance for this section is found in Chapter 5, section 5.500.

The Planning Matrix, the Internal Controls Questionnaire, the Risk of Potential Misstatements Evaluation Form, and the results of the tests of controls and analytical procedures should be used for guidance when modifying this program and selecting sample sizes under the ABC System. The Small, Noncomplex Engagement Questionnaire and the results of the tests of controls and analytical procedures should guide modification for these types of engagements.

After the tests of controls and the analytical procedures have been completed, this Tests of Balances Program should be modified by the in-charge and reviewed by the engagement executive. Each step should be initialed and dated by the engagement personnel who performed the work. References to supporting workpapers should be placed in the "W/P Ref." column. Also, "N/A" should be placed in the "W/P Ref." column for any steps that are not applicable.

TESTS OF BALANCES PROGRAM

INDEX

TESTS OF BALANCES PROGRAM

I. CASH

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Existence — To determine that cash exists and is owned by the organization. (Assertions E and R)
- Proper cutoff — To determine that cash balances reflect a proper cutoff of cash receipts and disbursements. (Assertions E, C, and P)
- Complete — To determine that cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit, or on deposit with third parties. (Assertions E, C, and P)
- Proper classification — To determine that cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed. (Assertions R and P)

Procedures	Done By	Date	W/P Ref.
A. At the balance-sheet date, perform the following:			
1. Count undeposited funds on hand at _____ locations and control until deposited. (E and R)	_______	_______	______
2. Count _____ petty cash and change funds paying particular attention to the nature of transactions in the fund. (E and R)	_______	_______	______

> **Practice Tip:**
>
> It is often a good idea to scan petty cash vouchers to determine types of expenses that are paid out of petty cash. Be on the lookout for items that might need to be capitalized.

TESTS OF BALANCES PROGRAM

I. CASH (Continued)

Procedures	Done By	Date	W/P Ref.
3. Obtain last unused check numbers by physical inspection. (C)	_____	_____	_____
4. List any checks prepared and recorded prior to the balance-sheet date, but not yet issued. (C)	_____	_____	_____
5. Prepare and mail standard bank confirmations for ___ demand and time deposit accounts. (E, R, and C)	_____	_____	_____
6. Prepare and mail a request for cutoff bank statements on _____ bank accounts to be sent directly to the auditors. Prove any requested statement not received directly by agreeing the totals of enclosures to amounts on the statement. (E, R, and C)	_____	_____	_____
B. Review the results of applicable sections of the Tests of Controls and Analytical Procedures Programs. (E, R, and C)	_____	_____	_____
C. Obtain a bank reconciliation for _______ accounts as of the balance-sheet date and perform the following:			
1. Foot reconciliations.	_____	_____	_____
2. Trace book balances to general ledger.	_____	_____	_____
3. Trace bank balances to cutoff bank statement.	_____	_____	_____
4. Agree bank balances to confirmations from bank.	_____	_____	_____
5. Trace reconciling items to bank cutoff statements or other supporting documents. Items not clearing during cutoff period should be challenged for propriety and traced to supporting documents.	_____	_____	_____
6. Determine items in bank cutoff statement relating to periods before, or on, reconciliation date are properly reflected on the reconciliation.	_____	_____	_____

TESTS OF BALANCES PROGRAM

I. CASH (Continued)

Procedures	Done By	Date	W/P Ref.
7. Agree last deposit amount and last unissued check number obtained at balance-sheet date to the source journals.	______	______	______
8. Examine material enclosures returned with bank cutoff statements for any unusual items or unrecorded transactions taking place prior to the balance-sheet date.	______	______	______
9. For checks dated for the first ______ days after the reconciliation date, examine the date of the first bank endorsement to determine if they precede the reconciliation date.	______	______	______
10. Trace lists of any held checks to outstanding check lists. (E, R, and C)	______	______	______
D. Schedule interbank and intrabank transfers for _____ days before and after the balance-sheet date by reference to:			
1. Deposits in transit and outstanding checks on bank reconciliations.	______	______	______
2. Cash receipts and disbursements journals or duplicate deposit slips and check copies.	______	______	______
3. Enclosures in cutoff bank statements. (E, R, and C)			
E. Determine that all such transfers were:			
1. Recorded on the books in the same period for both bank accounts.	______	______	______
2. Properly accounted for in the bank reconciliations. (E, R, and C)	______	______	______
F. Review bank confirmations for details applicable to other areas of the financial statements. (P)	______	______	______

TESTS OF BALANCES PROGRAM

I. CASH (Continued)

Procedures	Done By	Date	W/P Ref.
G. Segregate any bank overdrafts or funds subject to withdrawal restrictions. (P)	______	______	______
H. Review any compensating balances arrangements for the benefit of the organization or related parties. (P)	______	______	______
I. Additional procedures: ________________ ________________ ________________ ________________	______	______	______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

TESTS OF BALANCES PROGRAM

II. TRADE ACCOUNTS RECEIVABLE

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Existence of trade accounts receivable — To determine that receivables exist, are authentic obligations owed to the organization, contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive. (Assertions E, R, and V)
- Proper disclosure — To determine that proper disclosure is made of any pledged, discounted, or assigned trade receivables. (Assertions R and P)
- Revenue recognition — To determine that interest on trade accounts receivable has been properly recorded. (Assertions C, R, and V)
- GAAP conformity — To determine that presentation and disclosure of trade accounts receivable is in conformity with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Procedures Programs. (E, C, R, and V)	______	______	______
B. Obtain a list of aged accounts receivable at the balance-sheet date, foot, and trace to the general ledger (or prepare adjusting entry). (E and C)	______	______	______
C. Trace ____ of the accounts receivable to the detail ledger for name, amount, and aged categories. Select ___ accounts in the subledger and compare to the aging. If no subledger is available, examine underlying sales invoices and collections documentation. (V)	______	______	______
D. Review and document collections on accounts receivable for ____ days after the balance-sheet date. (E, R, and V)	______	______	______

TESTS OF BALANCES PROGRAM

II. TRADE ACCOUNTS RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
E. Request confirmation of accounts receivable as follows:			
1. Positive requests on individually significant accounts with balances in excess of $ ____.	____	____	____
2. Positive requests on accounts from the sampling population as follows: ____________________ ____________________ ____________________ ____________________	____	____	____
(E, R, and V)			
F. If customer addresses have not been verified during transactions tests, select ____ accounts (at least 10) and independently verify addresses by reference to phone or business directories, phone calls to customers, documents received from customer, credit checks, etc. (E, R, and V)	____	____	____
G. Send second requests on positive nonreplies. (E, R, and V)	____	____	____
H. Perform alternative procedures on nonreplies to second requests by examining posting dates for subsequent collections on the accounts receivable subledger for system A or B. If no or partial subsequent collections, examine shipping and sales documents. Consider examining supporting documents for any unusually large account balances or for all nonreplies when such nonreplies are extensive. Examine subsequent collections documentation and shipping reports or sales invoices for System C and All Substantive Approach. (E, R, and V)	____	____	____
I. Reconcile all confirmation exceptions by reference to the accounts receivable subledger or other documents. Be alert to explanations that may be evidence of overall conditions affecting the financial statements. Follow up on such conditions. (E, R, and V)	____	____	____

TESTS OF BALANCES PROGRAM

II. TRADE ACCOUNTS RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
J. Summarize the results of the confirmation procedures. (E and V)	_____	_____	_____
K. Test the sales cutoff by tracing entries in the sales journal for ____ days before and after the balance-sheet date to shipping reports, if available, and/or sales invoices. (E and C)	_____	_____	_____
L. Determine, confirm, and disclose accounts pledged, discounted, sold, assigned, or guaranteed by others. (R and P)	_____	_____	_____
M. Reclassify any material credit balances. (P)	_____	_____	_____
N. If sending confirmations at a date other than the balance-sheet date (Systems A and B), perform the following in addition to steps above:			
1. Select confirmations from a source that is reconciled to the general ledger.	_____	_____	_____
2. Review transactions from the confirmation date to the balance-sheet date for material or unusual items. Review supporting documents for such transactions.	_____	_____	_____
3. Consider confirming several material account balances at the balance-sheet date: Positive ______________________	_____	_____	_____
Negative ______________________	_____	_____	_____
(E and V)			

TESTS OF BALANCES PROGRAM

II. TRADE ACCOUNTS RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
O. If receivables are not confirmed because (1) they are immaterial to the financial statements; or (2) the risk of material misstatement is low and, in conjunction with the evidence expected to be provided by other substantive procedures, is sufficient to reduce audit risk to an acceptably low level for the applicable financial statement assertions; or (3) the use of confirmations would not be effective, document the reason for not confirming receivables and document any alternative procedures performed.	______	______	______
P. Additional procedures: ______________________ ______________________ ______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

III. GRANTS RECEIVABLE

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Existence of grants receivable — To determine that receivables exist, are authentic obligations owed to the organization, contain no significant amounts that should be written off, and that allowances for uncollectable amounts are adequate and not excessive. (Assertions E, R, and V)
- Proper disclosure — To determine that proper disclosure is made of any grants receivable that are pledged, discounted, or assigned. (Assertions R and P)
- GAAP conformity — To determine that presentation and disclosure of grants receivable is in conformity with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Proceduress Programs. (E, C, R, and V)	______	______	_____
B. Obtain a list of aged grants receivable at the balance-sheet date, foot, and trace to the general ledger (or prepare adjusting entry). (E and R)	______	______	_____
C. Trace ____ of the grants receivable to the detail ledger for name, amount and aged categories. Select ____ accounts in the subledger and compare to the aging. If no subledger is available, examine underlying award letters and cash receipts documentation. (E, R, and V)	______	______	_____
D. Review and document collections on grants receivable for ____ days after the balance-sheet date. (E, R, and V)	______	______	_____
E. Request confirmation of amounts and restrictions of grants receivable as follows:			
1. Positive requests of individually significant grants with balances in excess of $ ____.	______	______	_____

TESTS OF BALANCES PROGRAM

III. GRANTS RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
2. Positive requests on grants from the sampling population as follows: ____ ____ ____ ____ (E and R)	____	____	____
F. If grantor addresses have not been verified during tests of controls, select ____ grants (at least 10) and independently verify addresses by reference to phone or business directories, phone calls to grantors, documents received from grantor, etc. (E and R)	____	____	____
G. Send second requests on positive nonreplies. (E and R)	____	____	____
H. Perform alternative procedures on nonreplies to second requests by examining posting dates for subsequent collections on the grants receivable subledger for System A or B. Consider examining supporting documents for any unusually large balances or for all nonreplies when such nonreplies are extensive. Examine subsequent collections documentation for System C and All Substantive Approach. (E and R)	____	____	____
I. Reconcile all confirmation exceptions by reference to the grants receivable subledger or other documents. Be alert to explanations that may be evidence of other matters affecting the financial statements. Follow up on such matters. (E, R, and P)	____	____	____
J. Summarize the results of the confirmation procedures. (E and R)	____	____	____
K. Determine, confirm, and disclose grants pledged, discounted, sold, assigned or guaranteed by others. (R and P)	____	____	____

TESTS OF BALANCES PROGRAM

III. GRANTS RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
L. If sending confirmations at a date other than the balance-sheet date (Systems A and B), perform the following in addition to steps above:			
1. Select confirmations from a source that is reconciled to the general ledger.	______	______	______
2. Review transactions from the confirmation date to the balance-sheet date for material or unusual items. Review supporting documents for such transactions.	______	______	______
3. Consider confirming several material account balances at the balance-sheet date: Positive ______	______	______	______
Negative ______	______	______	______
(E and R)			
M. Additional procedures: ______ ______ ______ ______	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

IV. PROMISES TO GIVE RECEIVABLE

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Existence of promises to give receivable — To determine that receivables exist, are authentic promises to the organization, contain no significant amounts that should be written off, and that allowances for uncollectable promises to give are adequate and not excessive. (Assertions E, R, and V)

- Proper disclosure — To determine that proper disclosure is made of any pledged, discounted, assigned, or donor-imposed restrictions on promises to give (pledges) receivable. (Assertions R and P)

- GAAP conformity — To determine that presentation and disclosure of promises to give receivable is in conformity with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Procedures Programs. (E, C, R, and V)	______	______	______
B. Obtain a list of aged promises to give receivable at the balance-sheet date, foot and trace to the general ledger (or prepare adjusting entry). (E and R)	______	______	______
C. Determine that the organization has properly accounted for long-term promises receivable by:			
1. Discounting long-term pledges receivable to the present value of the estimated future cash flows in accordance with APB No. 21.	______	______	______
2. Recording subsequent accruals of the interest element as contribution income. (E, R, and V)	______	______	______

TESTS OF BALANCES PROGRAM

IV. PROMISES RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
D. Trace ____ of the promises to give receivable to the detail ledger for name, amount, and aged categories. Select ___ promises to give in the subledger and compare to the aging. If no subledger is available, examine underlying documentation. (E, R, and V)	______	______	______
E. Review and document collections on promises to give receivable for _____ days after the balance-sheet date. (E, R, and V)	______	______	______
F. Request confirmation of promises to give receivable as follows:			
1. Positive requests on individually significant promises to give in excess of $ _____.	______	______	______
2. Positive requests on promises to give from the sampling population as follows: ________________________ ________________________ ________________________ ________________________			
3. In addition to amounts, consider confirming other information such as the existence or absence of restrictions, the absence of conditions, and the periods over which the promises to give become due. (E and R)	______	______	______
G. If donor addresses have not been verified during transactions tests, select ____ donors (at least 10) and independently verify addresses by reference to phone or business directories, phone calls to donors, documents received from donors, etc. (E and R)	______	______	______
H. Send second requests on positive nonreplies. (E and R)	______	______	______

TESTS OF BALANCES PROGRAM

IV. PROMISES RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
I. Perform alternative procedures on nonreplies to second requests by examining posting dates for subsequent collections on the promises to give receivable subledger for System A or B. Consider examining supporting documents for any unusually large account balances or for all nonreplies when such nonreplies are extensive. Examine subsequent collections documentation for System C or for the All Substantitve Approach. (E and R)	______	______	______
J. Reconcile all confirmation exceptions by reference to the promises to give receivable subledger or other documents. Be alert to explanations that may be evidence of other matters affecting the financial statements. Follow up on such matters. (E, R, and P)	______	______	______
K. Summarize the results of the confirmation procedures. (E and R)	______	______	______
L. Determine, confirm and disclose amounts pledged, discounted, sold, assigned or guaranteed by others. (R and P)	______	______	______
M. If sending confirmations at a date other than the balance-sheet date (Systems A and B), perform the following in addition to steps above:			
1. Select confirmations from a source that is reconciled to the general ledger.	______	______	______
2. Review transactions from the confirmation date to the balance-sheet date for material or unusual items. Review supporting documents for such transactions.	______	______	______
3. Consider confirming several material account balances at the balance-sheet date:			
Positive ______________________________	______	______	______
Negative ______________________________			
(E and R)	______	______	______

TESTS OF BALANCES PROGRAM

IV. PROMISES RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
N. Additional procedures:			
______________________			
______________________			
______________________			
______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

V. OTHER ACCOUNTS RECEIVABLE

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Existence of other accounts receivable — To determine that the other receivables exist, are authentic obligations owed to the organization, contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive. (Assertions E, R, and V)

- Proper disclosure — To determine that proper disclosure is made of any pledged, discounted, or assigned receivables. (Assertions R and P)

- Revenue recognition — To determine that interest on other accounts receivable has been properly recorded. (Assertions C, R, and V)

- GAAP conformity — To determine that presentation and disclosure of other accounts receivable is in conformity with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the Analytical Proceduress Program and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. Inquire about the existence of other accounts receivable. Determine that all have been recorded. (C)	______	______	______
C. Obtain a list of other accounts receivable and agree to the general ledger. (E, R, and C)	______	______	______
D. Request positive confirmations of all significant balances. Send second requests on nonreplies. (E, R, and V)	______	______	______
E. Perform alternative procedures on accounts not responding to second requests. (E, R, and V)	______	______	______
F. Reconcile any exceptions received. (E, R, and V)	______	______	______

TESTS OF BALANCES PROGRAM

V. OTHER ACCOUNTS RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
G. Additional procedures:			
______________________			
______________________			
______________________			
______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

VI. NOTES RECEIVABLE

Financial Statement Assertions:

1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Existence of other notes receivable — To determine that the notes receivable exist, are authentic obligations owed to the organization, contain no significant amounts that should be written off, and that allowances for doubtful accounts are adequate and not excessive. (Assertions E, R, and V)
- Proper disclosure — To determine that proper disclosure is made of any pledged, discounted, or assigned notes receivable. (Assertions R and P)
- Revenue recognition — To determine that interest on notes receivable has been properly recorded. (Assertions C, R, and V)
- GAAP conformity — To determine that presentation and disclosure of notes receivable is in conformity with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the Analytical Proceduress Program and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. Inquire about the existence of notes receivable. Determine that all have been recorded. (E, R, and C)	______	______	______
C. Obtain a list of notes receivable and agree to the general ledger. (E and C)	______	______	______
D. Examine properly signed and dated notes and any collateral supporting balances due. (E, R, and V)	______	______	______
E. Request positive confirmation on all significant balances. Send second requests on nonreplies. (R and V)	______	______	______
F. Examine evidence of periodic or subsequent payments on notes not responding to second requests. (E, R, and V)	______	______	______

TESTS OF BALANCES PROGRAM

VI. NOTES RECEIVABLE (Continued)

Procedures	Done By	Date	W/P Ref.
G. Reconcile any confirmation exceptions received. (E, R, and V)	______	______	_____
H. Separately classify notes from related parties. (P)	______	______	_____
I. Test calculation of any accrued interest receivable and consider reconciling to interest income. (E)	______	______	_____
J. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	_____

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

VII. ALLOWANCE FOR DOUBTFUL ACCOUNTS

Financial Statement Assertions:
1. Valuation or allocation. (V)
2. Presentation and disclosure. (P)

Objectives:
- To determine that allowances for doubtful accounts are adequate and not excessive. (Assertion V)
- Proper disclosure — To determine that proper disclosure is made of any allowances for doubtful accounts. (Assertion P)
- GAAP conformity — To determine that presentation and disclosure of allowance for doubtful accounts is in conformity with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of applicable sections of the Analytical Proceduress Program and assess impact on tests of balances. (V)	______	______	_____
B. Obtain an analysis of the bad debt expense and allowance for doubtful accounts for the year. Challenge the reasonableness of the chargeoffs and recoveries. Discuss with management. (V and P)	______	______	_____
C. Examine correspondence files and discuss with management significant accounts written off during the year. (V)	______	______	_____
D. Review the aged trial balance and other lists of notes and accounts and discuss balances over ____ days old with management. Determine the need to include such accounts in the allowance. (V)	______	______	_____
E. Examine credit memos issued after the balance-sheet date and determine need for an allowance for discounts, returns, and allowances. (V)	______	______	_____
F. Summarize results of procedures above and evaluate the adequacy of the allowance. (V)	______	______	_____
G. Prepare a memo describing the procedures performed and conclusions reached. (V)	______	______	_____

TESTS OF BALANCES PROGRAM

VII. ALLOWANCE FOR DOUBTFUL ACCOUNTS (Continued)

Procedures	Done By	Date	W/P Ref.
H. Additional procedures:			
____________________			
____________________			
____________________			
____________________	______	______	______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

TESTS OF BALANCES PROGRAM

VIIIa. INVENTORIES (NO PERPETUAL RECORDS)

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Inventory exists — To determine that the inventory exists and is the organization's property. (Assertions E and R)
- Clerical accuracy — To determine that the inventories are summarized and priced with clerical accuracy, and the records have been adjusted to the physical inventory. (Assertions C and V)
- GAAP conformity — To determine that inventory classifications and carrying amounts are determined and presented in the financial statements in conformity with GAAP consistently applied (for example, assumptions about the cost flow, such as FIFO and LIFO, and lower of cost or market considerations). (Assertion P)
- Encumbrances identified — To determine that any encumbrances such as pledges or liens are identified and adequately disclosed in the financial statements. (Assertions R, V, and P)

Procedures	Done By	Date	W/P Ref.
A. Review the Internal Controls Questionnaire and assess its impact on the nature, extent and timing of inventory tests of balances procedures. (E, C, R, and V)	______	______	______
B. Review the client's plans for taking inventory at all locations, control over tags and count sheets, identifying obsolete items, consigned and customers' goods, controlling movement of inventory during the count and control over shipping and receiving. (E, C, R, and V)	______	______	______
C. Review or assist in preparing physical inventory instructions. (E, C, R, and V)	______	______	______

TESTS OF BALANCES PROGRAM

VIIIa. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
D. Review last year's inventory summaries and current production records. Consider selecting representative test count items in advance. Observe the taking of the physical inventory.			
1. Obtain a copy of the tag or sheet control form. (E, R, and C)	______	______	______
2. Obtain last receiving and shipping report numbers and sales invoice numbers. (E and C)	______	______	______
3. Determine that movement of goods is controlled during the count and that the physical cutoff is proper. (V)	______	______	______
4. Identify and record any obsolete goods for follow-up. (E and C)	______	______	______
5. Observe counting and recording procedure by all inventory crews to see that inventory instructions are being followed. (E and C)	______	______	______
6. Make and record representative test counts for later tracing to inventory computation sheets as follows:			
a. Record counts for individually significant items with totals in excess of $______.	______	______	______
b. Record counts for representative items from sampling population as follows: ______________________________ ______________________________ ______________________________ ______________________________ ______________________________ (E and C)	______	______	______

TESTS OF BALANCES PROGRAM

VIIIa. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
7. See that tags or count sheets contain adequate descriptions, units of measure, last operation completed (WIP), and appraisal of inventory condition if obsolete or slow-moving. (E, C, and V)	______	______	______
8. Make a final walk-through to determine that all goods were counted, obsolete or consigned goods were identified and that all inventory tags or sheets have been collected. (C and V)	______	______	______

> **Practice Tip:**
>
> Be on the lookout for items that appear old, e.g., last year's inventory tag is still attached, items are dusty from nonuse. Sometimes, general conversation with client personnel doing inventory will help in identifying old goods.

Procedures	Done By	Date	W/P Ref.
9. Prepare a memo describing the observation procedures and conclusions reached. (E, C, and V)	______	______	______
E. Trace shipping and receiving report numbers obtained during the observation to determine they were recorded in the proper period.	______	______	______
1. Examine shipping and receiving reports for ___ days before and after the inventory date, trace to the appropriate source journal and cutoff numbers and determine a proper cutoff was made. (E, R, and C)	______	______	______
2. Review reconciliation of inventory to engagement date if counted at another date. Examine supporting documents or source journals for major items on reconciliation. (E and C)	______	______	______

TESTS OF BALANCES PROGRAM

VIIIa. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
3. Review credit memos for ___ days before and after inventory to determine they were recorded in the proper period. (E and C)	______	______	______
F. Obtain a copy of client's final inventory summary, agree to general ledger and trace ___ items to and from tags or sheets control form. Examine support for material or unusual reconciling items. (E and C)	______	______	______
G. Trace test counts to summary. (E and C)	______	______	______
H. Determine that all individually significant items test counted are included in the summary and extended and footed properly. (C and V)	______	______	______
I. Foot ___ pages and ___ page totals and extend ___ line items in the sampling population. (V)	______	______	______
J. Review summary to determine that obsolete goods noted during observation have been excluded or priced at net realizable value. (V)	______	______	______
K. Compare major items categories with the prior year and investigate material changes. (E, C, and V)	______	______	______
L. 1. Determine client's pricing method for raw materials and make a selection of items for price testing from the sampling population as follows: ______________________________ ______________________________ ______________________________ ______________________________ (V)	______	______	______

TESTS OF BALANCES PROGRAM

VIIIa. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
2. Compare prices to vendor invoices or price lists. If client uses LIFO method, additional procedures for testing base prices and computations should be designed and performed. Determine that the method is consistent. (V)	____	____	____
3. Perform price tests for all individually significant items of raw materials that were included in test counts. (V)	____	____	____
M. Review ____ price computations for work-in-process and finished goods for propriety and consistency. (V)	____	____	____
N. 1. Verify price computations for work-in-process and finished goods items in the sampling population by reference to invoices, bills of materials and charges and cost accounting records as follows: ________ ________ ________ ________ (V)	____	____	____
2. Verify price computations for all individually significant items of work-in-process and finished goods that were included in test counts. (V)	____	____	____
O. Determine that all classes of inventory have been subjected to tests of replacement costs and/or net realizable value. (V)	____	____	____
P. Test, or prepare, an allocation of overhead to work-in-process and finished goods. Determine if the method is consistent with prior years. (V and P)	____	____	____
Q. Prepare any necessary inventory adjustments, or review client's adjustments, and complete the Analytical Proceduress Program. (E, C, and V)	____	____	____

TESTS OF BALANCES PROGRAM

VIIIa. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
R. Determine that customers' goods have been excluded from inventory. If material, consider confirming. (E)	______	______	______
S. Determine any intercompany or interfund profit to be eliminated in consolidation. (P)	______	______	______
T. Determine if any inventory has been pledged. (P)	______	______	______
U. For significant amounts of inventory stored at outside locations, consider performing the following procedures:			
1. Review and test management's control procedures for investigating the warehouseman and evaluating the warehouseman's performance. (E and C)	______	______	______
2. Obtain an independent auditor's report on the warehouseman's system of internal accounting control relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable. (E and C)	______	______	______
3. Observe physical counts of the goods, if practicable and reasonable. (E and C)	______	______	______
4. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate). (E and P)			
5. Confirm goods out on consignment or at outside warehouses. (E and P)	______	______	______
V. Additional procedures: ______________________________ ______________________________ ______________________________ ______________________________	______	______	______

TESTS OF BALANCES PROGRAM

VIIIa. INVENTORIES (NO PERPETUAL RECORDS) (Continued)

Note: Stronger controls over the count and inventory compilation may allow less observation time, fewer test counts and smaller pricing and clerical tests. The existence of internal controls over the count, however, must be verified during the count observation. Refer to the Internal Controls Questionnaire, the Planning Matrix or the All Substantive Approach Questionnaire for a determination of the extent of procedures to be performed. Pursuant to SAS No. 39, *Audit Sampling*, sample selections must be representative and consider the materiality of the inventory items. The following guidelines will apply to the nature and timing of tests unless otherwise approved by the engagement partner.

All Substantive Approach, Systems B and C — all items counted simultaneously at or near the balance-sheet date.

System A — all items counted simultaneously within a reasonable time period near the balance-sheet date.

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

VIIIb. INVENTORIES (PERPETUAL RECORDS)

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Inventory exists — To determine that the inventory exists and is the organization's property. (Assertions E and R)
- Clerical accuracy — To determine that the inventories are summarized and priced with clerical accuracy, and the records have been adjusted to the physical inventory. (Assertions C and V)
- GAAP conformity — To determine that inventory classifications and carrying amounts are determined and presented in the financial statements in conformity with GAAP consistently applied (for example, assumptions about the cost flow, such as FIFO and LIFO, and lower of cost or market considerations). (Assertion P)
- Encumbrances identified — To determine that any encumbrances such as pledges or liens are identified and adequately disclosed in the financial statements. (Assertions R, V, and P)

Procedures	Done By	Date	W/P Ref.
A. Review results of the applicable Tests of Controls Program and Analytical Proceduress Program and assess their impact on the nature, extent and timing of inventory tests of balances procedures. (E, C, R, and V)	_______	_______	_______
B. Review the client's plans for taking inventory at all locations, control over tags and count sheets, identifying obsolete items, consigned and customers' goods, controlling movement of inventory during the count and control over shipping and receiving. (E, C, and V)	_______	_______	_______
C. Review or assist in preparing physical inventory instructions. (E, C, and V)	_______	_______	_______
D. Review last year's inventory summaries and current perpetual records. Select items for observation in advance. (E, C, and V)	_______	_______	_______

TESTS OF BALANCES PROGRAM

VIIIb. INVENTORIES (PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
E. Observe the taking of the physical inventory of selected items:			
1. Obtain a copy of the tag or sheet control form. (E and C)	_____	_____	_____
2. Obtain last receiving and shipping report numbers, sales invoice numbers, and lost check numbers at date of count. (E and C)	_____	_____	_____
3. Determine that any movement of goods is controlled during the count and that the physical cutoff is proper. (E and C)	_____	_____	_____
4. Identify and record any obsolete goods for follow-up. (V)	_____	_____	_____
5. Observe counting and recording procedures by all inventory crews to ensure that inventory instructions are being followed. (E, C, and V)	_____	_____	_____
6. Make and record representative test counts for later tracing to inventory compilation sheets as follows:			
a. Record counts for individually significant inventory items with totals in excess of $ ____.	_____	_____	_____
b. Record counts for representative items from sampling population as follows: ______________________ ______________________ ______________________ ______________________ (E and C)	_____	_____	_____

TESTS OF BALANCES PROGRAM

VIIIb. INVENTORIES (PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
7. See that tags or count sheets contain adequate description, units of measure, last operations completed (WIP) and appraisal of inventory condition if obsolete or slow-moving. (E, C, and V)	______	______	______
8. Make a final walk-through to determine that all goods are counted, obsolete or consigned goods were identified, and that all inventory tags or sheets have been collected. (E, C, and V)	______	______	______
9. Prepare a memo describing the observation procedures and conclusions reached. (E, C, and V)	______	______	______
F. Trace shipping and receiving report numbers obtained during the observation to determine that they were recorded in the proper period. (E and C)	______	______	______
G. 1. Examine shipping and receiving reports for ____days before and after the inventory date, trace to the appropriate source journal and cutoff numbers and determine a proper cutoff was made. (E and C)	______	______	______
2. Review credit memos for ____ days before the inventory to determine that they were recorded in the proper period. (E and C)	______	______	______
H. Obtain a copy of client's inventory summary, agree to general ledger and trace ____ items to tags or sheets and control form. (E and C)	______	______	______
I. Trace all test counts to summary. (E and C)	______	______	______
J. Determine that perpetual records have been adjusted to the physical count. Obtain balance-sheet date inventory summary:			
1. Foot ___ pages and ___ page totals and extend ___ line items in the sampling population. (V)	______	______	______

TESTS OF BALANCES PROGRAM

VIIIb. INVENTORIES (PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
2. Determine that all individually significant items test counted are included in the summary and extended and footed properly. (C and V)	______	______	______
3. Review summary to determine that obsolete goods noted during observation have been excluded or priced at net realizable value. (V)	______	______	______
4. a. Determine client's pricing method for raw materials, work-in-process and finished goods, and select items for price testing from the sampling population as follows: ______ ______ ______ (V)	______	______	______
b. Compare prices to perpetual records. Determine that the method is consistent. (V and P)	______	______	______
c. Examine support for price computations for all individually significant items of raw materials, work-in-process and finished goods that were included in test counts. (V)	______	______	______
5. Trace ____ items to perpetual records. Compare amounts and unit prices. (V)	______	______	______
K. Confirm goods out on consignment at the balance-sheet date. (E and C)	______	______	______
L. Determine that all classes of inventory have been subjected to tests of replacement cost and/or net realizable value. (V)	______	______	______
M. If standard or job costs are used, review calculations and variances to determine that they approximate actual amounts computed on the client's costing method. (V and P)	______	______	______
N. Determine if any inventory has been pledged. (P)	______	______	______

TESTS OF BALANCES PROGRAM

VIIIb. INVENTORIES (PERPETUAL RECORDS) (Continued)

Procedures	Done By	Date	W/P Ref.
O. Determine that customers' goods have been excluded from inventory. If material, consider confirming. (E and C)	____	____	____
P. If overhead allocations were not tested during Tests of Controls, test the allocation of overhead to work-in-process and finished goods. Determine if the method is consistent with prior years. (V and P)	____	____	____
Q. Determine if intercompany or interfund profit is to be eliminated in consolidation. (V)	____	____	____
R. For significant amounts of inventory stored at outside locations, consider performing the following procedures:			
1. Review and test management's control procedures for investigating the warehouseman and evaluating the warehouseman's performance. (E and C)	____	____	____
2. Obtain an independent auditor's report on the warehouseman's system of internal accounting control relevant to custody of goods and, if applicable, pledging of receipts, or apply alternative procedures at the warehouse to gain reasonable assurance that information received from the warehouseman is reliable. (E and C)	____	____	____
3. Observe physical counts of the goods, if practicable and reasonable. (E and C)	____	____	____
4. If warehouse receipts have been pledged as collateral, confirm with lenders pertinent details of the pledged receipts (on a test basis, if appropriate). (E and P)	____	____	____
S. Additional procedures: ____________ ____________ ____________	____	____	____

TESTS OF BALANCES PROGRAM

VIIIb. INVENTORIES (PERPETUAL RECORDS) (Continued)

Note: A stronger perpetual inventory system and stronger controls over physical counts and inventory compilations may allow observation of the count of fewer items, fewer test counts and smaller pricing and clerical tests. Refer to the Internal Controls Questionnaire and the Planning Matrix for a determination of the extent of procedures to be performed. Pursuant to SAS No. 39, sample selections must be representative and consider the materiality of the inventory items. The following guidelines will apply to the nature and timing of tests, unless otherwise approved by the engagement partner:

All Substantive Approach — all items counted at or near the balance-sheet date. Not all counts observed.

System B and C — all items counted at or near the balance-sheet date. Not all counts observed.

System A — cycle counts taken. Observations take place throughout the year. Not all counts observed.

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

IX. INVESTMENTS

Financial Statement Assertions:

1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Existence of marketable securities — To determine that the organization owns the securities at the balance sheet date and has physical evidence of ownership (securities, receipts from responsible custodians, etc.). (Assertions E, C, and R)
- Proper valuation — To determine that the market or other fair value of the securities has been determined as objectively as practicable. (Assertion V)
- Income recognition — To determine that related income from the marketable securities is properly recorded and received. (Assertions C, R, and V)
- Restrictions identified — To determine that restrictions, pledges or liens on any of the marketable securities and related liabilities are identified and adequately disclosed in the financial statements. (Assertions E, C, R, and P)
- GAAP conformity — To determine that the financial statements presentation and disclosure of marketable securities and related income (classification, amounts such as cost, market, share of equity) is in conformity with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Proceduress Programs and assess impact on tests of balances. (E, C, R, and P)	______	______	______
B. Determine the organization's policy for valuing investments and securities, and ensure that it is in accordance with GAAP. (V and P)	______	______	______
C. Obtain a list of securities and investments at the balance-sheet date, including descriptions, number of shares, cost, carrying amount, and market value. Trace balances to the general ledger. Review subsequent transactions to determine completeness of list. (E and C)	______	______	______

TESTS OF BALANCES PROGRAM

IX. INVESTMENTS (Continued)

Procedures	Done By	Date	W/P Ref.
D. Examine securities and investments on hand at the balance-sheet date and obtain a receipt for their return. (E)	_____	_____	_____
E. Obtain confirmation of securities and investments held by others at the balance-sheet date. (E, R, and C)	_____	_____	_____
F. Test computations of _____ carrying amounts, including bond premium and discount amortization, accrued and earned income, and gains or losses during the period. (V)	_____	_____	_____
G. Review published reporting services for stock dividends, exchanges, splits, etc. (R and V)	_____	_____	_____
H. For marketable equity or debt securities, review the calculation of carrying value, trace major values to documentaion, and determine whether the carrying value is in accordance with the organization's adopted policy. (C, V, and P)	_____	_____	_____
I. Examine brokers' advices and/or directors' approval for major transactions during the period. (V)	_____	_____	_____
J. Determine proper classification by reference to the nature of the security and management's intention (marketable securities, marketable equity securities, current or noncurrent). (P)	_____	_____	_____
K. Determine if any securities or investments are pledged or restricted. (P)	_____	_____	_____
L. If the organization has adopted SOP 94-3, determine whether it has reported its ownership of a for-profit entity or relationship with another not-for-profit organization in accordance with SOP 94-3. (C)	_____	_____	_____
M. If investments are carried on the equity method:			
1. Determine the organization's equity in net assets at year-end and earnings (losses) and distributions for the year based on audited information.	_____	_____	_____

TESTS OF BALANCES PROGRAM

IX. INVESTMENTS (Continued)

Procedures	Done By	Date	W/P Ref.
2. Obtain a reconciliation of intercompany transactions and balances. Determine reasonableness.	______	______	______
3. Check computation of amortization of cost over book value. (V)	______	______	______
N. For consolidated statements, determine if presentation is in accordance with GAAP. (P)	______	______	______
O. Additional procedures: ______ ______ ______ ______	______	______	______

Prepared by: ______ Date: ______

Reviewed by: ______ Date: ______

TESTS OF BALANCES PROGRAM

X. PREPAID EXPENSES

Financial Statement Assertions:

1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Properly recorded — To determine that the balances represent costs which are properly allocable to future periods in conformity with generally accepted accounting principles. (Assertions E, C, R, and V)
- Additions supported — To determine that additions are adequately supported. (Assertions E, C, R, and P)
- Amortization appropriate — To determine that amortization is determined by a rational and systematic method consistently applied. (Assertions V and P)
- Impairment recognized — To determine that any permanent impairment of balance is recognized by write-downs charged to operations. (Assertions E, C, V, and P)
- Proper classification — To determine that balances and related expenses are properly described and classified in the financial statements. (Assertion P)
- Contingencies disclosed — To determine whether there are uninsured risks that should be considered for disclosure. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the applicable section of the Analytical Proceduress Program and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. Obtain a schedule of prepaid insurance and expense. Review for reasonableness. (E, C, and V)	______	______	______
C. Inquire as to the adequacy of insurance coverage. (P)	______	______	______
D. Obtain analysis of other prepaid expenses, deferred charges and intangibles. Investigate and support as considered necessary. (E, C, and V)	______	______	______

TESTS OF BALANCES PROGRAM

X. PREPAID EXPENSES (Continued)

Procedures	Done By	Date	W/P Ref.

Practice Tip:

Be alert to insurance confirmations indicating locations of inventory. Trace locations listed to inventory totals to determine all locations listed as covered by insurance have been included in the inventory summary.

E. Additional procedures:

____

____

____

______________________________ ______ ______ ______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

TESTS OF BALANCES PROGRAM

XI. FIXED ASSETS

Financial Statement Assertions:

1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Fixed assets exist — To determine that recorded fixed assets exist and are owned by the organization. (Assertion E)

- Additions appropriate — To determine that fixed asset additions are authentic, recorded at cost if purchased, or at market value if donated, and properly distinguished from maintenance and repairs expense. (Assertions E, C, and R)

- Retirements recorded — To determine that retirements of fixed assets together with the proceeds from salvage and related cost to remove the assets are properly recognized. (Assertions E, C, and V)

- Proceeds from disposition - To determine that proceeds from each disposition are properly recorded under donor's restrictions or client's accounting policies. (Assertions R, V, and P)

- Depreciation appropriate — To determine that a proper amount of depreciation expense is allocated to the period based on the asset cost, estimated life and salvage, and use of acceptable methods consistently applied, and adequately presented in the financial statements. (Assertions V and P)

- Recoverable value — To determine that the net carrying value as presented in the financial statements is expected to be recoverable through the ordinary course of business. (Assertion V)

- Encumbrances identified — To determine that any encumbrances, liens, or other liabilities are identified and adequately disclosed in the financial statements. (Assertion P)

- Proper classification — To determine that significant amounts of idle fixed assets are properly stated, classified and described. (Assertion P)

- Proper disclosure — To determine that significant amounts of fully depreciated assets are considered for disclosure. (Assertion P)

TESTS OF BALANCES PROGRAM

XI. FIXED ASSETS (Continued)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls Program and Analytical Proceduress Program and determine impact on tests of balances. (E, C, R, and V)	______	______	_____
B. Obtain a schedule showing cost and accumulated depreciation and amortization by beginning balance, additions, retirements and ending balances and agree to the general ledger. (E, C, V, and P)	______	______	_____
C. Obtain detailed schedules of additions and retirements:			
1. Vouch major additions to vendors' invoices, construction cost records, titles or deeds, or contracts to determine assets are being recorded in accordance with GAAP. (E and V)	______	______	_____
2. Physically inspect _______ assets and/or examine tax bills, deeds, licenses, etc. (E)	______	______	_____
3. Determine that the capitalization policy is being consistently applied. (V)	______	______	_____
4. If a plant fund is maintained and additions are purchased with resources from another fund, ensure that the transfer is recorded in each fund balance and that, if restricted resources are used, the purchase is consistent with donor restrictions. (P)	______	______	_____
5. If the organization is subject to income tax or unrelated business income tax, determine the investment credit and recapture on disposals. Summarize for tax return and provision computation. (V and P)	______	______	_____
D. Obtain or prepare a schedule of gain or loss on sale of assets. Trace major amounts to supporting documents and records and review for reasonableness. (V and P)	______	______	_____

TESTS OF BALANCES PROGRAM

XI. FIXED ASSETS (Continued)

Procedures	Done By	Date	W/P Ref.
E. If a plant fund is maintained, ensure that proceeds from each sale of assets are properly treated in accordance with donor's restrictions, if any, or in absence of donor restrictions, in accordance with the organization's policy. (P)	______	______	______
F. Review repairs and maintenance, supplies, small tools, and other accounts for any assets that should be capitalized. (V)	______	______	______
G. Determine the carrying amount of assets pledged on notes or other indebtedness. (P)	______	______	______
H. 1. Determine the cost of any significant, fully depreciated assets being carried in the accounts if meaningful for disclosure purposes. (P)	______	______	______
2. Determine that any impairment of value of assets has been properly recognized. (V)	______	______	______
I. If the organization has adopted SFAS No. 121 and any events or changes in circumstances have occurred indicating that the carrying amount of a long-lived asset may not be recoverable:			
1. Determine if an impairment loss should be recognized. [An impairment loss should be recognized if the carrying amount of an asset exceeds estimated future cash flows (undiscounted and without interest charges).]	______	______	______
a. Review the estimate of future cash flows for mathematical accuracy and, through discussion with management and review of any supporting documentation, determine whether assumptions used are reasonable.	______	______	______
2. If an impairment loss should be recognized, test the calculation of the loss. [The impairment loss is measured as the amount by which the carrying amount of an asset exceeds its fair value.]	______	______	______

TESTS OF BALANCES PROGRAM

XI. FIXED ASSETS (Continued)

Procedures	Done By	Date	W/P Ref.
a. Test the fair value calculation by vouching to quoted market prices in active markets or by reviewing the valuation technique used.	______	______	______
b. If the fair value is based on the present value of estimated future cash flows, test for mathematical accuracy and ensure that the assumptions used in the present value calculation, including the discount rate, are reasonable.	______	______	______
J. Inquire as to any significant expansion plans. (P)	______	______	______
K. Review rental income and expense accounts to determine leased and subleased assets are properly recorded. (P)	______	______	______
L. Perform a reasonableness test of depreciation and amortization by using average rates and lives and one-half year for additions and disposals. (V)	______	______	______
M. Challenge reasonableness of assets' lives used for accounting and income tax purposes. (V)	______	______	______
N. Read client's depreciation schedules for consistency of methods and reasonableness. Test a selection of ______ computations. Agree schedule to general ledger. Consider deleting this step if step J results are acceptable. (V and P)	______	______	______
O. Review lease agreements to determine if leases meet criteria for capitalization and see that they are accounted for properly. (E, R, and V)	______	______	______
P. Gather and document information for report disclosure and tax return preparation. (P)	______	______	______
Q. Consider and compute any capitalized interest. (V)	______	______	______

TESTS OF BALANCES PROGRAM

XI. FIXED ASSETS (Continued)

Procedures	Done By	Date	W/P Ref.
R. Through discussion with management and review of any supporting documentation, determine whether the organization is subject to any environmental liability, including any liability arising from contributed assets (e.g., land or buildings). (P)	______	______	______
S. Additional procedures: ______ ______ ______ ______ ______	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XII. INTERFUND LOANS

(Complete this program for organizations that present disaggregated funds in their financial statements.)

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Interfund Loans exist — To determine that all interfund loans are recorded as receivables and payables in the proper funds. (Assertions E, C, and P)
- Restrictions honored — To determine that interfund loans do not violate any donor restrictions. (Assertions R and P)

Procedures	Done By	Date	W/P Ref.
A. Analyze interfund loan accounts for all transactions during the year. (E, C, and R)	______	______	______
B. Determine that all interfund transactions are in accordance with donor restrictions. (R and P)	______	______	______
C. Consider whether interest should be charged in accordance with donor stipulations, organization policy, or applicable laws. (V and P)	______	______	______
D. Test whether interest charged is properly calculated. (V)	______	______	______
E. Consider whether repayment and collateral terms of interfund loans are being met, and whether the loans are reasonably collectible. (E, C, and V)	______	______	______
F. Consider whether the existence of any doubtful loans violates donor stipulations, organization policy, or applicable laws. (E, R, and P)	______	______	______
G. Consider whether any doubtful loan results in a question about the organization's ability to continue as a going concern. (P)	______	______	______

TESTS OF BALANCES PROGRAM

XII. INTERFUND LOANS (Continued)

Procedures	Done By	Date	W/P Ref.
H. Additional procedures:			
______________________			
______________________			
______________________			
______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XIII. OTHER ASSETS

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Proper valuation — To determine that the fair value of other assets has been determined as objectively as practicable. (Assertion V)
- Income recognition — To determine that related income from other assets is properly recorded and received. (Assertions C, R, and V)
- Restrictions identified — To determine that restrictions, pledges or liens on any of other assets and related liabilities are identified and adequately disclosed in the financial statements. (Assertions E, C, R, and P)
- GAAP conformity — To determine that the financial statement presentation and disclosure of other assets is in conformity with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Obtain schedules of other assets and agree to general ledger. (E and C)	______	______	______
B. Confirm cash surrender value of life insurance. (V)	______	______	______
C. For life insurance, reconcile prepaid premiums at beginning of period, premiums paid and increase in cash surrender value with life insurance expense. (V)	______	______	______
D. Review ______ calculations of investment earnings and related accruals for reasonableness. (V)	______	______	______
E. Examine documentation supporting investment transactions during the year. (E, R, and V)	______	______	______

TESTS OF BALANCES PROGRAM

XIII. OTHER ASSETS (Continued)

Procedures	Done By	Date	W/P Ref.
F. Additional procedures:			
______________________			
______________________			
______________________			
______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XIV. DEFERRED CHARGES AND INTANGIBLES

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Properly recorded — To determine that the balances represent costs that are properly allocable to future periods in conformity with GAAP. (Assertions E, C, R, and V)
- Additions supported — To determine that additions are adequately supported. (Assertions E, C, R, and P)
- Amortization appropriate — To determine that amortization is determined by a rational and systematic method consistently applied. (Assertions V and P)
- Impairment recognized — To determine that any permanent impairment of balance is recognized by write-downs charged to operations. (Assertions E, C, V, and P)
- Proper classification — To determine that balances and related expenses are properly described and classified in the financial statements. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review results of the applicable section of the Analytical Proceduress Program and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. Obtain schedules of deferred charges and intangibles and agree to general ledger. (E, C, and V)	______	______	______
C. Examine documentation supporting major transactions during the year. (E, R, and V)	______	______	______
D. Review capitalization policies and amortization computations as considered necessary. (V)	______	______	______
E. Determine if there has been permanent impairment of carrying amounts. (V)	______	______	______
F. Determine any required disclosures. (P)	______	______	______

TESTS OF BALANCES PROGRAM

XIV. DEFERRED CHARGES AND INTANGIBLES (Continued)

Procedures	Done By	Date	W/P Ref.
G. Additional procedures:			
____________________			
____________________			
____________________			
____________________	______	______	______

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

TESTS OF BALANCES PROGRAM

XV. ACCOUNTS PAYABLE

Financial Statement Assertions:

1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Payables exist — To determine that accounts payable represent authorized current obligations. (Assertions E and C)
- Proper classification — To determine that amounts included in accounts payable are properly classified. (Assertion P)
- Obligations complete — To determine that accounts payable include all significant current obligations. (Assertions C, R, and V)

Procedures	Done By	Date	W/P Ref.
A. Review results of the applicable section of the Tests of Controls and Analytical Proceduress Programs and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. Obtain a list of accounts payable, foot, and agree to general ledger. (E and C)	______	______	______
C. Trace ______ balances to the accounts payable subledger. Trace ______ additional balances from the subledger to the list. If a subledger is not in use (System B or C), trace _____ balances to supporting vendor statements or unpaid invoices. (E, C, and V)	______	______	______
D. Segregate amounts due to officers, employees, affiliates, and other related parties. (P)	______	______	______
E. Send confirmation requests to ______ major suppliers and selected other accounts with zero balances. Reconcile and follow up on differences. (The number of requests can be reduced or eliminated for System A.) (E, C, and R)	______	______	______

TESTS OF BALANCES PROGRAM

XV. ACCOUNTS PAYABLE (Continued)

Procedures	Done By	Date	W/P Ref.
F. Review client reconciliations of available current vendors' statements to accounts payable subledger. Follow up on unresolved problems. (If a subledger is not in use, System B or C, step is not applicable.) (E, C, and R)	______	______	______
G. Obtain the purchases journal (Systems A and B) and trace all entries over $______ for a period of _____ days after the balance-sheet date to supporting documents to determine recording in the proper period. (Step is not applicable for a System C or for All Substantive Approach.) (C and R)	______	______	______
H. Obtain the cash disbursements journal and trace all entries over $________ for a period of _______ days after the balance-sheet date to supporting documents to determine recording in the proper period. (C and R)	______	______	______
I. Review the open receiving report, open purchase order and open purchase requisition files for ____ days after the balance-sheet date (Systems A and B) for unrecorded liabilities. (C and R)	______	______	______
J. Review the open vendor invoice files for _____ days after the balance-sheet date to determine recording in the proper period. (C and R)	______	______	______
K. Investigate any disputed items that have not been recorded. (C and R)	______	______	______
L. Determine that credit memos received ____ days after the balance-sheet date have been recorded in the proper period. (E and R)	______	______	______
M. Determine any payables due after one year and consider imputing interest. (V)	______	______	______
N. Consider reclassification and confirmation of material debit balances. (P)	______	______	______

TESTS OF BALANCES PROGRAM

XV. ACCOUNTS PAYABLE (Continued)

Procedures	Done By	Date	W/P Ref.
O. Additional procedures:			
____________________			
____________________			
____________________	______	______	_____

Prepared by: ____________________ Date: ____________________

Reviewed by: ____________________ Date: ____________________

TESTS OF BALANCES PROGRAM

XVI. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations (R).
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Liabilities complete — To determine that expense accounts include costs and expenses applicable to the period. (Assertions E, C, and P)
- Amount reasonable — To determine that the provision for income taxes is reasonable. (Assertions E, C, R, and V)
- Amount comparable to amount to be paid — To determine that the liability for accrued income taxes is adequate and not excessive in relation to amounts reasonably expected to be payable. (Assertions R and V)
- Temporary differences recognized — To determine that deferred income taxes represent the effect of temporary differences. (Assertions E, C, and V)
- Proper classification — To determine that income tax provisions, accruals and deferrals are properly described and classified in conformity with generally accepted accounting principles consistently applied. (Assertion P)
- GAAP conformity — To determine that all contingencies and estimated future expenses that should be accrued in the period have been accrued, classified, and described in accordance with GAAP consistently applied. (Assertions E, C, R, V, and P)

Procedures	Done By	Date	W/P Ref.
A. Obtain a schedule of all accrued expenses and other liabilities and agree to general ledger. (E and C)	______	______	______
B. Examine subsequent payments and supporting documents such as tax returns, depository receipts, tax receipts, etc. (E, C, and R)	______	______	______
C. Test calculations of accrued expenses and examine support as considered necessary. (V)	______	______	______

TESTS OF BALANCES PROGRAM

XVI. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done By	Date	W/P Ref.
D. Discuss with management any accrued expenses or liabilities at the balance-sheet date not provided for currently. Be alert for unrecorded liabilities such as warranty costs, legal fees, compensated absences, etc. (C and R)	______	______	______
E. (Reserved)	______	______	______
F. Review deferred compensation agreements and the method of accounting:			
1. Determine whether the method of accounting recognizes deferred compensation costs in accordance with SFAS No. 106.	______	______	______
2. Consider whether individual contracts, if taken together, constitute a pension plan. (P)	______	______	______
G. Obtain an analysis of deferred compensation and proceed as follows:			
1. Test the clerical accuracy of the analysis and compare balances to the general ledger.	______	______	______
2. Verify the computations by reference to provisions of the agreements.	______	______	______
3. Test current payments by examining appropriate supporting data.	______	______	______
4. *Consider the advisability* of confirming unpaid balances and the terms of payment. (E, C, R, and V)	______	______	______
H. Obtain and verify disclosure information for multi-employer plans and vouch expense for the period.	______	______	______

TESTS OF BALANCES PROGRAM

XVI. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done By	Date	W/P Ref.
I. For defined contribution plans:			
1. If applicable, obtain copy of trustee's fund report. Consider confirming contents of report with trustee. (E, C, and R)	______	______	______
2. Ascertain if there have been any adoptions or amendments of plans during the period and obtain copies. Note for financial statement disclosures and: (E, C, R, V, and P)	______	______	______
(a) Agree expense to minutes, when applicable. (R and V)	______	______	______
(b) Verify computations, where applicable. (E and C)	______	______	______
3. Where applicable, test employee data. Test should consist of analytical review, and additional procedures as considered necessary. (E, C, R, and V)	______	______	______
J. For defined benefit plans, obtain the following, where applicable:			
1. Copy of actuarial report as of a date no earlier than 3 months prior to balance-sheet date.	______	______	______
2. If applicable, copy of trustee's report.	______	______	______
3. Form 5500 for prior year and for current year, if already prepared.	______	______	______
4. Actuary's certificate on Schedule B for Form 5500 for prior year and for current year if already prepared.	______	______	______
5. Plan document(s).	______	______	______
6. Census and plan asset date given to actuary. (E, C, and R)	______	______	______

TESTS OF BALANCES PROGRAM

XVI. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done By	Date	W/P Ref.
K. Consider confirming contents of Trustee report with Trustee. (E, R, and V)	______	______	______
L. Reconcile aggregate census data, such as number of employees covered, compensation, to amounts shown in the actuarial valuation report or if not in the report, consider obtaining confirmation of such data from the actuary. (E and C)	______	______	______
M. For selected employees, check census data (age, sex, marital status, current pay, term of employment, benefit election, etc.) to payroll records. [Check only those data important to the valuation. If analytical review of data and valuation report appear reasonable, a sample of 15 will generally be acceptable. If not, a sample up to 40 may be required.] (E, C, R, and V)	______	______	______
N. Based on plan documents, make appropriate tests to determine whether all eligible employees are included in the census data provided to the actuary. (E and C)	______	______	______
O. Reconcile plan assets per the trustee's report to amounts shown in the actuarial valuation report. (E and C)	______	______	______
P. Ascertain that actuary is professionally qualified. (Membership in the Society of Actuaries, the Conference of Actuaries in Public Practice, American Academy of Actuaries is usually sufficient to indicate that actuary is qualified.) (V)	______	______	______
Q. Inquire as to any relationships between the actuary and the client that would impair independence. (V)	______	______	______
R. Review the actuary's most recent certificate on Schedule B, Form 5500, and determine the reasons for qualifications expressed, if any. (V)	______	______	______
S. Ascertain if there have been any adoptions or amendments of plans during the period. Obtain copies of any and note for financial statement disclosure. (E, C, V, and P)	______	______	______

TESTS OF BALANCES PROGRAM

XVI. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done By	Date	W/P Ref.
T. Review the latest plan document and compare with key provisions included in the actuarial valuation report. If the report does not include a description of key plan provisions, it may be necessary to confirm the actuary's understanding of such provisions. (E and C)	______	______	______
U. Vouch the payment of the prior year's accrual to determine that it was paid prior to the filing of the year tax return. (If not paid at the tax return due date, or extended due date, the organization loses its tax deduction, if applicable.) (E and C)	______	______	______
V. Trace the authorization for the contribution to the plan to the company's minutes, or obtain the management representation in the representation letter. (R)	______	______	______
W. Inquire of the client as to any intent to terminate the plan. (E)	______	______	______
X. Obtain and check disclosure information. (See Financial Disclosure Checklist — Supplement.) (P)	______	______	______
Y. If not previously audited, obtain net transition obligation computations and agree amounts to actuarial report, trustees report, or other evidential sources. Recheck compensation. (V and P)	______	______	______
Z. Obtain calculation of pension cost for the current period and agree components to actuarial report or trustee's report. (V and P)	______	______	______
AA. Determine that a liability is recorded for unfunded accrued pension cost whenever the company's contribution is less than its related expense or that prepaid pension costs is recorded when the amount funded exceeds the related expenses. (V and P)	______	______	______

TESTS OF BALANCES PROGRAM

XVI. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures	Done By	Date	W/P Ref.
BB. Determine that an additional liability is recorded equal to the excess, if any, of the accumulated benefit obligation over the fair value of plan assets. (Similar assets are not recorded except when the excess follows a business combination treated as a purchase.) (V and P)	______	______	______
CC. Prepare conclusion memo as to whether or not audit objectives have been met and accordingly whether or not the pension and related accounts are fairly stated for inclusion in the (consolidated, if applicable) financial statements in accordance with generally accepted accounting principles. (If not, document details of exception.) (E, C, R, V, and P)	______	______	______
DD. If the work of a specialist is used in performing the audit, has the auditor documented his or her satisfaction concerning the following:			
1. Review the professional certification, license, or other recognition of the competence of the specialist. (E)	______	______	______
2. The reputation and standing of the specialist in view of those familiar with his or her capability or performance. (E)	______	______	______
3. The specialist's experience in the type of work under consideration.	______	______	______
4. Review the relationship, if any, of the specialist to the client. (E, P)	______	______	______
EE. If the work of a specialist is used in performing the audit, obtain and document the auditor's understanding of the nature of the work to be performed.	______	______	______
FF. Determine that the organization has not violated any of the tax regulations that would invalidate the organization's tax-exempt status.	______	______	______

TESTS OF BALANCES PROGRAM

XVI. ACCRUED EXPENSES, INCOME TAXES AND OTHER LIABILITIES (Continued)

Procedures		Done By	Date	W/P Ref.
GG.	If applicable, have taxes been accounted and disclosed in accordance with SFAS No. 109.	______	______	______
HH.	Additional procedures: ______ ______ ______ ______	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XVII. DEFERRED REVENUE

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Deferred Revenue complete — To determine that revenue accounts exclude revenue not applicable to the period. (Assertions E, C, and P)
- Proper classification — To determine that deferred revenue is properly described and classified in accordance with donor restrictions, if any. (Assertions R, V, and P)
- GAAP conformity — To determine that deferred revenue is described and classified in accordance with GAAP consistently applied. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Obtain a list of all deferred revenue, separated by type of income and by type of restriction, if any, imposed by donors. (E, C, and R)	______	______	______
B. For deferred revenue related to reciprocal revenue, determine that amounts recorded are for future services or goods, and test the calculation of deferred amounts. (E, R, and V)	______	______	______
C. For organizations following SOP 78-10, for any deferred revenue related to nonreciprocal revenue:			
1. Review documentation of donor restrictions.	______	______	______
2. Discuss with management progress through the balance sheet date toward satisfying donor restrictions and consider whether reported expenses justify the recognition of additional revenue. (E, R, and P)	______	______	______
D. For organizations following SOP 78-10, consider whether revenue may have been recognized which should be deferred due to restricted expenses not having been incurred through the balance sheet date. (V and P)	______	______	______

TESTS OF BALANCES PROGRAM

XVII. DEFERRED REVENUE (Continued)

Procedures	Done By	Date	W/P Ref.
E. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XVIII. NOTES PAYABLE AND LONG-TERM DEBT

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Payables exist — To determine that notes payable and long-term debt are authorized, properly classified, and described in the financial statements. (Assertions R and P)
- Period recorded proper — To determine that liabilities are recorded in the proper period at the correct amounts. (Assertions E, C, and V)
- Expense recognized — To determine that related interest expense (including discount or premium) is accounted for in conformity with GAAP consistently applied. (Assertions C and P)
- Adequate disclosure — To determine that the financial statements include adequate disclosure of restrictive covenants of loan agreements, pledged assets, etc. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the applicable sections of the Analytical Proceduress Program and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. Obtain a schedule of notes and related interest expense showing beginning balance, additions, payments, ending balances and all terms of borrowing and payment. Recompute the mathematical accuracy of the schedule and agree to the general ledger. (E and C)	______	______	______
C. Obtain copies of all notes and related agreements for the permanent file. (E, R, and V)	______	______	______
D. Examine notes canceled during the period or related evidence of payment. (C and R)	______	______	______
E. Confirm significant balances outstanding at any time during the period. (E, R, and V)	______	______	______
F. Examine current notes and review compliance with restrictive loan covenants. (P)	______	______	______

TESTS OF BALANCES PROGRAM

XVIII. NOTES PAYABLE AND LONG-TERM DEBT (Continued)

Procedures	Done By	Date	W/P Ref.
G. Determine if any assets are subject to lien and obtain carrying amounts for disclosure. (P)	______	______	______
H. Examine notes for any guarantees. Be alert for related-party guarantees. All guarantee relationships should be disclosed. (P)	______	______	______
I. Separate short-term notes and the current portion of long-term debt for report classification. Categorize by type of lender (related party, banks, loan company, etc.). Determine five-year maturities for all long-term obligations. (P)	______	______	______
J. Perform a reasonableness test of interest expense by multiplying average balances outstanding by average interest rates. (C)	______	______	______
K. Consider need to impute interest on noninterest-bearing notes. (V)	______	______	______
L. Review or recompute the computation of balances in capitalized lease obligations accounts. Gather information for report disclosure. (V and P)	______	______	______
M. Additional procedures: ______ ______ ______ ______	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XIX. CONTINGENT LIABILITIES, CONTRACTS AND COMMITMENTS

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Contingencies exist — Identify the existence of any contingencies arising from litigation, claims, and assessments; when the underlying cause occurred; the likelihood of an unfavorable outcome; and the amount or range of possible loss. (Assertions E, C, R, and V)
- Proper recording and disclosure — The financial statements include proper accruals and/or disclosure of the contingencies. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Discuss with management its description and evaluation of possible and existing litigation, claims and assessments, including violations of laws. (E, C, R, V, and P)	______	______	______
B. Examine all available documents concerning these matters. (E, C, R, V, and P)	______	______	______
C. Request letter from client's attorneys regarding contingencies and commitments and other matters. Investigate reasons for any changes in legal counsel. (C, R, V, and P)	______	______	______
D. Review minutes of governing board meetings and discuss all pertinent items with management. Make excerpts and agree to applicable working papers. (C, R, V, and P)	______	______	______
E. Analyze legal expense for any undisclosed matters. (C, R, V, and P)	______	______	______
F. Obtain a schedule of any purchase contracts or commitments. (C, R, V, and P)	______	______	______
G. Investigate any product warranties. (V and P)	______	______	______
H. Obtain or prepare a schedule of open letters of credit. (P)	______	______	______

TESTS OF BALANCES PROGRAM

XIX. CONTINGENT LIABILITIES, CONTRACTS AND COMMITMENTS (Continued)

Procedures	Done By	Date	W/P Ref.
I. If considered necessary, obtain UCC information and agree to notes payable and debt working papers. (P)	_______	_______	_____
J. Additional procedures:			
_______________________________________			
_______________________________________			
_______________________________________			
_______________________________________	_______	_______	_____

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XX. NET ASSETS (EQUITY)

Financial Statement Assertions:

1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Proper authorization and classification — To determine that all transactions, including transfers, reclassifications, designations and prior period adjustments are properly authorized and classified. (Assertions E, C and R)

- Proper recognition and cutoff — To determine that all transactions and designations are recorded at correct amounts in the proper period. (Assertions E, C, and P)

- GAAP conformity — To determine that all transactions and balances are presented in the financial statements in conformity with GAAP consistently applied and accompanied by adequate disclosures. (Assertion P)

- Appropriate composition of assets — To determine that liquidity is sufficient to meet donor restrictions which are reflected in balances of the classes of net assets. (Assertions R and V)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Procedures Programs. (E, C, and V)	______	______	______
B. Obtain or prepare a schedule of changes in each class of net assets (unrestricted, temporarily restricted and permanently restricted). Such changes are represented by revenues, expenses, gains and losses for the year, reclassifications between classes of net assets, and prior-period adjustments.			
1. Agree changes in each class of net assets represented by revenues, expenses, gains and losses to audit work-papers documenting tests of proper classification of these items. (E and C)	______	______	______

TESTS OF BALANCES PROGRAM

XX. NET ASSETS (EQUITY) (Continued)

Procedures	Done By	Date	W/P Ref.
2. Obtain a detailed listing of all reclassifications between classes of net assets. Determine that significant transfers are appropriate by reference to other audit workpapers or other documentation supporting the fulfillment of temporary restrictions or removal of permanent restrictions. [Note: permanent restrictions are generally removed only by court action.] (E and C)	______	______	______
3. Ensure that any prior-period adjustments are properly classified, that they meet the criteria of SFAS No. 16, and that they are properly disclosed in the financial statements. (E and C)	______	______	______
C. For significant changes in designations of unrestricted net assets, trace the transaction to minutes of governing board meetings. (E, C, and P)			
D. Ensure that the financial statement presentation and disclosure requirements of SFAS No. 117 are met. (See the Financial Disclosure Checklist in Chapter 9, section 9.400.) (P)	______	______	______
E. For the initial year of adoption of SFAS No. 117, ensure that net assets for prior year-end fund balances are allocated to beginning balances of appropriate classes of net assets for all periods presented. Determine the propriety of the allocation by reference to prior year's audit workpapers or other supporting documentation, such as grant agreements, donor correspondence, and court actions. (E, C and P)	______	______	______
F. If the organization has significant restricted contributions in which the restrictions require the use of liquid assets and you have reason to believe that the organization may have inadequate liquidity to fulfill donor restrictions, determine whether the organization has maintained an appropriate composition of assets by performing the following procedures:			
1. Compare a) year-end liquid assets, to b) cash flows required to satisfy donor restrictions and to meet other operating and debt service needs. (R and V)	______	______	______

TESTS OF BALANCES PROGRAM

XX. NET ASSETS (EQUITY) (Continued)

Procedures	Done By	Date	W/P Ref.
2. Inquire of management as to anticipated future cash flows which, along with year-end liquid assets, would be available to satisfy donor restrictions and to meet other operating and debt service needs. Consider the adequacy of support for significant assumptions underlying management's cash flow projections. (R and V)	______	______	______
3. Review board minutes for any indications of prior liquidity or cash flow problems in satisfying donor restrictions. (R and V)	______	______	______
4. If available liquidity and anticipated cash flows appear inadequate to satisfy donor restrictions and to meet other needs, the organization may have an inappropriate composition of assets. Ensure that any resultant contingent liability or going-concern issue is properly reflected in the financial statements. (P)	______	______	______
G. For organizations that include disaggregated fund information in their financial statement presentation:			
1. Agree disaggregated fund information included in the financial statement presentation to underlying accounting records. (P)	______	______	______
2. Review disaggregated fund information for reasonableness based on your knowledge of the organization and by reference to other current year and prior year workpapers. (P)	______	______	______
H. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XXI. RELATED-PARTY TRANSACTIONS

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- To identify related parties and related-party transactions. (Assertions E and C)
- To determine the substance of such transactions is reflected in the accounts. (Assertions C, R and V)
- To obtain all information necessary for footnote and/or report disclosure. (Assertions C and P)

Procedures	Done By	Date	W/P Ref.
A. Make inquiries of management about related parties, obtain related-party confirmation if applicable, and inquire about any recorded or unrecorded transactions during the year. (E, C, R, V, and P)	______	______	______
B. Obtain names of governing board members, and the entities they control for evidence of related-party transactions. (E and C)	______	______	______
C. Review last year's working papers for evidence of related-party transactions. (E and C)	______	______	______
D. Inquire of predecessor auditors about related parties. (E and C)	______	______	______
E. Investigate transactions with major customers, suppliers and lenders for undisclosed relationships. (E and C)	______	______	______
F. Review minutes of governing board meetings for evidence of related-party transactions. (E and C)	______	______	______
G. Be alert for potential related-party transactions while examining confirmations of receivables and payables, large unusual transactions and attorneys' letters. (E and C)	______	______	______

TESTS OF BALANCES PROGRAM

XXI. RELATED-PARTY TRANSACTIONS (Continued)

Procedures	Done By	Date	W/P Ref.
H. Obtain a list of major customers, amounts of sales during the year and amounts of receivables at year end. Agree to detail client records. Consider disclosure. (E, C, and P)	______	______	______
I. Examine supporting documents of significant related-party transactions to determine:			
1. Business purpose. (V and P)	______	______	______
2. Governing board approval. (P)	______	______	______
3. Reasonableness and consistency of amounts to be disclosed. (V and P)	______	______	______
4. Financial capabilities of related parties. (V)	______	______	______
J. Inquire of management regarding the collectibility of related-party receivables. (V)	______	______	______
K. Separately classify related-party receivables. (P)	______	______	______
L. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XXII. CONTRIBUTIONS AND GRANTS

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Proper recognition — To determine that contribution and grant revenue represents the amount that should be recognized in accordance with GAAP. (Assertions E, C, R, V, and P)
- Proper classification — To determine that contribution and grant revenue is properly classified and that donor restrictions are adequately disclosed. (Assertions C, V, and P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Proceduress Programs and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. For contributions and grants received:			
1. Randomly select ____ receipts from the cash receipts journal and trace them to the contributions subsidiary journal.	______	______	______
2. Randomly select ______ entries in the contributions subsidiary journal and trace them to the cash receipts journal.	______	______	______
3. Agree the totals of the contributions journal to the general ledger.	______	______	______
4. If lists of contributions are published or distributed to board members, compare each item selected in Steps 1 and 2 above to the lists.	______	______	______
5. If lists of contributions are published or distributed to board members, select ____ items from the lists, and trace them to the cash receipts journal.	______	______	______

TESTS OF BALANCES PROGRAM

XXII. CONTRIBUTIONS AND GRANTS (Continued)

Procedures	Done By	Date	W/P Ref.
6. If correspondence files are maintained for acknowledgement or thank-you letters to donors, select ___ contributions from the file and trace them to the cash receipts journal.	______	______	_____
7. For each item selected in Steps 1, 2 and 5, review documentation and verify that any donor restrictions are noted and that revenue recognition properly reflects the restrictions.	______	______	_____
8. Consider direct confirmation of a sample on contributions (with attention to restrictions or their absence). (E, C, R, and V)	______	______	_____
C. For donated materials received:			
1. Obtain a list of materials received.	______	______	_____
2. For a sample of _____ contributions, determine the valuation method and examine documentation and calculation of the value recognized. Consider whether each contribution selected meets the policy adopted by the organization.	______	______	_____
3. Consider direct confirmation of contribution, value and restrictions, if any.	______	______	_____
4. Determine the propriety of the asset or expense accounts debited. (E, C, R, V, and P)	______	______	_____
D. For donated services received:			
1. Analyze donated services recognized.	______	______	_____
2. For a sample of ______ contributions, determine the valuation method and examine documentation and calculation of the value recognized. Consider whether each contribution selected meets the policy adopted by the organization.	______	______	_____

TESTS OF BALANCES PROGRAM

XXII. CONTRIBUTIONS AND GRANTS (Continued)

Procedures	Done By	Date	W/P Ref.
3. Consider direct confirmation of the contribution and value.	______	______	______
4. Determine the propriety of the asset or expense accounts debited. (E, C, R, and V)	______	______	______
E. For reimbursement-type grants:			
1. Consider whether the grant is properly classified as nonreciprocal.	______	______	______
2. Review grant documents to determine basis for reimbursements.	______	______	______
3. Review the types of expenses charged and allocated to the grant, including data upon which allocations are based, and determine whether they meet reimbursement requirements.	______	______	______
4. Test cutoff of expenses charged to the grant.	______	______	______
5. Test cutoff of reimbursement receivables recorded.	______	______	______
6. Examine subsequent receipts and correspondence for evidence of receivable collectibility.	______	______	______
7. Consider the possibility of subsequent grantor review or audit of expense records and any repayment contingencies which should be recorded or disclosed. (E, C, R, V, and P)	______	______	______
F. For membership dues with no significant economic benefits to members, determine that revenue is recognized as nonreciprocal when received. (E, R, and P)	______	______	______

TESTS OF BALANCES PROGRAM

XXII. CONTRIBUTIONS AND GRANTS (Continued)

Procedures	Done By	Date	W/P Ref.
G. Additional procedures:			
____________________			
____________________			
____________________			
____________________	______	______	______

Prepared by: ________________ Date: ________________

Reviewed by: ________________ Date: ________________

TESTS OF BALANCES PROGRAM

XXIII. SALES

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations.(R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Proper recognition — To determine that revenue transactions represent consideration applicable to goods shipped and/or completed services rendered to customers (or clients) in the normal course of business during the year. (Assertions E, R, V, and P)
- Revenue realized — To determine that revenue transactions have resulted in collections or bona fide receivables. (Assertions E and C)
- Revenue recorded — To determine that all revenues earned during the year are recorded and included in the financial statements. (Assertions E, C, and P)
- Proper classification — To determine that revenues are properly classified and described in the financial statements and accompanied by adequate disclosure. (Assertions V and P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Proceduress Programs and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. Scan source journals for the period for unusual transactions. Determine that they are accounted for properly. Follow up on any unusual or related-party transactions. (E, V, and P)	______	______	______
C. Randomly select ______ invoices from the sales journal from various times during the year.	______	______	______
1. Check the mathematical accuracy of sales invoice. (E, C, and V)	______	______	______
2. Compare invoice to sales order and determine the following:			
a. Approval of sales order by responsible person.	______	______	______

TESTS OF BALANCES PROGRAM

XXIII. SALES (Continued)

Procedures	Done By	Date	W/P Ref.
b. Prices on invoice agree with terms of sales order. (E, C, and V)	______	______	______
3. Examine shipping records for shipment of goods. (E, C, and V)	______	______	______
4. Trace sales to perpetual inventory, if applicable. (E and C)	______	______	______
D. Randomly select ______ shipping orders prepared at various times during the year. Obtain related sales invoice and trace to the sales journal. (C)	______	______	______
E. Obtain or prepare a schedule of monthly sales by financial statement classification.* (E, C, R, and V)	______	______	______
F. Compare schedule to prior periods and investigate large or unusual fluctuations.* (E, C, R, and V)	______	______	______
G. Additional procedures:**			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

* If results from tests of controls for Systems A and B are satisfactory, these steps may not be necessary.

** If no controls tests are performed, predictive analytical procedures, or other special procedures, may be necessary to verify the completeness assertion for revenues.

TESTS OF BALANCES PROGRAM

XXIV. COSTS OF GOODS SOLD

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Properly recorded — To determine that other costs of goods sold are properly allocable to the year. (Assertions E, C, and V)
- Proper recognition — To determine that recognition has been given to all costs. (Assertions E, C, R, and V)
- GAAP conformity — To determine that the costs of goods sold are in conformity with GAAP consistently applied. (Assertion P)
- Proper classification — To determine that costs of goods sold are appropriately classified and described in the statement of activity. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Proceduress Programs and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. If major, unexplained variances exist, scan entries in source journals and investigate timing, size and method of recording unusual items. Discuss findings with management. (E, C, V, and P)	______	______	______
C. Randomly select ______ invoices from the purchase journal from various times during the year.	______	______	______
1. Check the mathematical accuracy of each purchase invoice.	______	______	______
2. Compare the purchase order to the purchase invoice and determine the following:			
a. The purchase order was properly approved.	______	______	______
b. The quantities on the purchase order agree with the quantities on the invoice.	______	______	______

TESTS OF BALANCES PROGRAM

XXIV. COSTS OF GOODS SOLD (Continued)

Procedures	Done By	Date	W/P Ref.
c. The unit price on the purchase order agrees to the invoice price. (E, C, R, and V)	______	______	______
3. Examine the receiving report to determine the following:			
a. The report has been initialed by the receiving agent and the date received has been recorded.	______	______	______
b. The quantities on the receiving report agree with the quantities on the invoice.	______	______	______
c. The quantities on the receiving report have been posted to perpetual inventory, if applicable. (E, C, R, and V)	______	______	______
D. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XXV. OTHER REVENUES AND EXPENSES

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Properly recorded — To determine that other revenues and expenses are properly allocable to the year. (Assertions E, C, and V)
- Proper recognition — To determine that recognition has been given to other revenue and expenses. (Assertions E, C, R, and V)
- GAAP conformity — To determine that the statement of activity is prepared in conformity with GAAP consistently applied. (Assertion P)
- Proper classification — to determine that other revenues and expenses are appropriately classified and described in the statement of activity. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Proceduress Programs and assess impact on tests of balances. (E, C, R, and V)	______	______	______

Practice Tip:

Be alert to potential mispostings in other revenue and expense accounts. Organizations often post tax payments to miscellaneous expense accounts because there is no general ledger account set up for the payments.

B. Obtain a schedule of other revenues and expenses and investigate large or unusual items. (E, C, and V)	______	______	______
C. Vouch as considered necessary. (E, C, and V)	______	______	______

TESTS OF BALANCES PROGRAM

XXV. OTHER REVENUES AND EXPENSES (Continued)

Procedures	Done By	Date	W/P Ref.
D. Scan the source journals for major transactions omitted from the schedule. (E, C, V, and P)	______	______	______
E. Additional procedures:			
______________________________			
______________________________			
______________________________			
______________________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XXVI. EXPENSE ACCOUNT ANALYSIS AND VOUCHING

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:
- Properly recorded — To determine that reported expenses include costs that are properly allocable to the year and are properly matched with revenues. (Assertions E, C, and V)
- Proper recognition — To determine that recognition has been given to all costs and expenses (including losses) that should be recognized. (Assertions E, C, R and V)
- Proper classification — To determine that extraordinary items have been properly classified and disclosed. (Assertions E and P)
- GAAP conformity — To determine that the statement of activity is prepared in conformity with GAAP consistently applied. (Assertion P)
- Proper classification — To determine that costs and expenses are appropriately classified and described in the statement of activity. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Proceduress Programs and assess impact on tests of balances. (E, C, R, and V)	______	______	_____
B. Scan source journals for the period for large or unusual transactions and determine they are properly recorded.* (E, C, R, V, and P)	______	______	_____
C. Obtain a detailed analysis of charges and credits to expense accounts with unusual fluctuations from prior years, and the following:*			
1. Officers' salaries and bonuses. Determine governing board authorization.	______	______	_____

* Satisfactory results from tests of controls will allow examination of less detail. Stronger controls, Systems A and B, may permit omission of detailed analysis except for analytical procedures follow-up and certain accounts affecting financial statement disclosures or income tax return preparation.

TESTS OF BALANCES PROGRAM

XXVI. EXPENSE ACCOUNT ANALYSIS AND VOUCHING (Continued)

Procedures	Done By	Date	W/P Ref.
2. Officers' expenses (for tax return).	______	______	______
3. Rents (look for potential capitalizable leases).	______	______	______
4. Legal and professional services (look for any payments that may represent undisclosed legal matters).	______	______	______
5. Taxes (for tax return).	______	______	______
6. Repairs and maintenance (look for capitalizable items).	______	______	______
7. Supplies and small tools (look for capitalizable items).	______	______	______
8. Travel and entertainment expenses (look for adequate documentation).	______	______	______
9. Miscellaneous expense.	______	______	______
10. Property tax expense (for unrecorded property).	______	______	______
11. Other accounts: ________________________ ________________________ ________________________			
(E, C, R, V, and P)	______	______	______
D. If the organization has entered into an operating lease that contains rent escalations, determine that rent expense has been accounted for using the straight-line method as required by SFAS No. 13.	______	______	______

TESTS OF BALANCES PROGRAM

XXVI. EXPENSE ACCOUNT ANALYSIS AND VOUCHING (Continued)

Procedures	Done By	Date	W/P Ref.
E. As considered necessary, obtain supporting vendor invoices or other documentation to determine that charges or credits to the accounts above apply to the organization and are recorded at the proper amount in the proper period (primarily System C and All Substantive Approach). Documentation for immaterial account balances need not be examined. (E, C, R, and V)	______	______	______
F. Additional procedures: ______ ______ ______	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

TESTS OF BALANCES PROGRAM

XXVII. PAYROLL TESTS

Financial Statement Assertions:
1. Existence or occurrence. (E)
2. Completeness. (C)
3. Rights and obligations. (R)
4. Valuation or allocation. (V)
5. Presentation and disclosure. (P)

Objectives:

- Properly recorded — To determine that reported payroll expenses include costs that are properly allocable to the year. (Assertions E, C, and V)
- Proper recognition — To determine that payroll expenses have been properly recognized. (Assertions E, C, R, and V)
- GAAP conformity — To determine that the statement of activity is prepared in conformity with GAAP consistently applied. (Assertion P)
- Proper classification — To determine that payroll expenses are appropriately classified and described in the statement of activity. (Assertion P)

Procedures	Done By	Date	W/P Ref.
A. Review the results of the applicable sections of the Tests of Controls and Analytical Proceduress Programs and assess impact on tests of balances. (E, C, R, and V)	______	______	______
B. Scan source journals for _____ periods for unusual transactions to determine they are recorded properly. (E, C, R, and V)	______	______	______
C. Prepare a schedule of monthly payroll costs by department or function.* (E, C, R, V, and P)	______	______	______

* If results from tests of controls for Systems A and B are satisfactory, these steps may not be necessary.

TESTS OF BALANCES PROGRAM

XXVII. PAYROLL TESTS (Continued)

Procedures	Done By	Date	W/P Ref.
Practice Tip: If the organization has offices in different states, be sure to itemize payroll expense to aid in allocation for income tax calculations and returns.			
D. Compare schedules to prior periods, budget and production records and investigate significant fluctuations.* (E, C, R, and V)	______	______	______
E. Reconcile gross wages on payroll tax returns to general ledger.* (E, C, R, and V)	______	______	______
F. Additional procedures: ______ ______ ______ ______	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

* If results from tests of controls for Systems A and B are satisfactory, these steps may not be necessary.

TESTS OF BALANCES PROGRAM

XXVIII. GENERAL

Procedures	Done By	Date	W/P Ref.
A. Management letter matters (those not meeting criteria as reportable conditions and not being communicated as a SAS 61 matter):			
1. List suggested communications in the workpapers (or list with cross-reference to location of details).	______	______	______
2. If applicable, draft management letter.	______	______	______
3. If applicable, document oral communication.	______	______	______
B. If it appears the client may have engaged in any questionable or illegal acts or irregularities, obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. Procedures are to include inquiry of management at a level above those involved, if possible.	______	______	______
C. If management does not provide satisfactory information that there has been no illegal acts or irregularities, consult with the client's legal counsel or other specialists about the application of relevant laws and regulations. Arrangements for such consultation with client's legal counsel should be made by the client.	______	______	______
Parts of an Audit Performed by Other Independent Auditors			
D. Obtain satisfaction as to the firm's professional reputation.	______	______	______
E. Obtain standard independence confirmation.	______	______	______
F. Consider whether to make reference to the other auditor in our report on the financial statements.	______	______	______

TESTS OF BALANCES PROGRAM

XXVIII. GENERAL (Continued)

Procedures	Done By	Date	W/P Ref.
G. If a decision is made not to make reference to the other auditor, consider performing some or all of the following procedures:			
1. Visit the other auditor and discuss the procedures followed and the results obtained.	______	______	______
2. Review the other auditor's audit programs and instruct the other auditor as to the scope of his work, if appropriate.	______	______	______
3. Review the other auditor's workpapers, including the conclusions on all significant aspects of the engagement.	______	______	______
4. Perform any other procedures considered necessary in the circumstances, including participating in discussions with officials of the component being audited by the other auditor.	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

Completing the Audit

CHAPTER 8

COMPLETING THE AUDIT

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CHAPTER 8

COMPLETING THE AUDIT

8.000 INTRODUCTION

8.001 Completing the audit is often the most critical, yet most underestimated, phase of the audit in terms of the amount of time required and its importance to meeting the audit objectives. Good engagement "wrap-up" involves more than just the administrative tasks that first come to mind; it requires summarizing and evaluating audit findings, determining that the proper opinion and other reports are issued, performing a final review of the financial statements, and ensuring that the audit procedures and working papers conform with authoritative standards, as well as the firm's quality control policies and procedures.

8.002 The procedures involved in completing the audit should include:

- Performing final analytical procedures.
- Obtaining legal letters.
- Performing subsequent events procedures.
- Summarizing and evaluating possible journal entries.
- Obtaining written management representations.
- Communicating to the organization:
  - reportable conditions.
  - errors and irregularities.
  - illegal acts.
  - certain other matters (if Statement on Auditing Standards (SAS) No. 61 applies to the organization).
- Preparing financial statements and auditor's reports.
- Completing the review of assistants' work.
- Consulting with others in resolving certain issues.
- Completing performance appraisals and final time summary.

8.003 Except for completing performance appraisals and final time summary, these procedures should be performed before engagement personnel leave the client's offices. The procedures and the applicable authoritative literature are discussed in the following sections.

8.100 ANALYTICAL PROCEDURES

8.101 As discussed in Chapter 3, analytical procedures are required to be performed in planning the nature, timing, and extent of auditing procedures. Chapter 7 discusses how analytical procedures are used as substantive tests to obtain evidential matter about particular assertions related to account balances and classes of transactions.

8.102 SAS No. 56, *Analytical Procedures* (AU 329.04), also requires the use of analytical procedures "as an overall review of the financial information in the final review stage of the audit." Paragraph 22 of SAS No. 56 (AU 329.22) states:

> The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation.

8.103 Overall review procedures generally include reading the financial statements and notes and considering:

- Whether evidence gathered during the audit as to unusual or unexpected balances was adequate, and
- Whether there are any unusual or unexpected balances or relationships not identified during the audit.

The results of these procedures may require the auditor to perform additional tests.

8.104 Documentation of the overall review need not be elaborate. In fact, signing a program step indicating that the review was performed, with a conclusion as to the results of the review, may be sufficient. However, if the results of the overall review indicate that additional procedures must be performed, the authors recommend that such procedures be documented in a separate memo or working paper.

8.105 The review should be performed by someone familiar with all aspects of the engagement; generally they are performed by the in-charge. However, the engagement partner may be in a better position to provide a critical and objective review of the financial presentation.

8.106 The Engagement Performance Review Checklist at section 8.910 contains a step that requires performance of the overall review.

8.200 OBTAINING LEGAL LETTERS

8.201 SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU 337), provides guidance to the auditor in (1) identifying litigation, claims, and assessments, (2) determining that such matters are appropriately reflected in the financial statements, and (3) issuing the appropriate auditor's report.

8.202 The auditor's procedures for identifying litigation, claims, and assessments should include:

- Inquiring of and discussing with management the policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the balance-sheet date and up to the date the information is furnished (which should be the auditor's report date), including matters referred to legal counsel, and assurance from management that all matters required to be disclosed by Statement of Financial Accounting Standards (SFAS) No. 5, *Accounting for Contingencies*, have been disclosed.
- Examining the client's documents concerning litigation, claims, and assessments.
- Obtaining assurance from management that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with SFAS No. 5. (This assurance is generally stated in the client's letter of inquiry to the lawyers.)

8.203 The auditor should be aware that certain other procedures performed for different purposes may also uncover litigation, claims, and assessments, including:

- Reading minutes of meetings of the governing board, directors, and appropriate committees held during and subsequent to the period being audited.
- Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents.
- Obtaining information concerning guarantees from bank confirmation forms.
- Inspecting other documents for possible guarantees by the client.

8.204 A letter of inquiry to the client's legal counsel is the auditor's primary means of obtaining corroborating evidence of the information provided by management about litigation, claims, and assessments. This letter of inquiry and the lawyers' responses are so important that the client's refusal to send the letter or the lawyer's refusal to respond fully would be considered a limitation on the scope of the audit.

8.205 Letters should be sent to all lawyers who devoted substantive attention on behalf of the client to pending or threatened litigation and asserted or unasserted claims and assessments in the form of legal consultation or representation. A review of the client's correspondence with its lawyers, the lawyers' billings for services, and prior year's working papers are good sources of information for identifying the lawyers to whom letters of inquiry should be sent.

8.206 SAS No. 12 (AU 337.09) lists the following matters that should be covered in the letter of inquiry:

a. Identification of the organization and the date of the audit.

b. A list prepared by management (or a request that the lawyer prepare the list) that describes and evaluates pending or threatened litigation, claims, and assessments that the lawyer has been engaged to handle, and to which the lawyer has devoted substantial attention on behalf of the organization.

c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome to which the lawyer has devoted substantial attention on behalf of the organization.

d. As to each matter in item b., a request that the lawyer either furnish the following or comment on matters as to which his or her views may differ from those stated by management:

   (1) A description of the nature of the matter, the progress of the case to date, and the action the organization intends to take.

   (2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if possible, of the amount or range of potential loss.

   (3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

e. As to each matter in item c., a request that the lawyer comment on those matters to which his or her views about the description or evaluation of the matter differ from those stated by management.

f. A statement by management that they understand that whenever, in the course of performing legal services regarding a matter recognized to involve an unasserted possible claim or assessment that may require financial statement disclosure, the lawyer has formed a professional conclusion that management should disclose or consider disclosing the possible claim or assessment, the lawyer will so advise management and consult with management about the disclosure and applicable requirements of SFAS No. 5.

g. A request that the lawyer confirm whether the understanding described in item f. is correct.

h. A request that the lawyer specifically identify the nature of and reasons for any limitations on his or her response.

Other Considerations in the Letter

8.207 **Immaterial Matters.** To avoid requiring the lawyer to respond to clearly immaterial matters, many auditors will have the client include in the letter of inquiry an instruction that the lawyer need address only matters exceeding a specified dollar amount. This amount should be mutually agreed upon by the client and the auditor.

8.208 Timing of Letter and Response. Generally, letters of inquiry are sent at the beginning of year-end field work to give the lawyers adequate time to respond. Many auditors have the client specify the date of the lawyer's response, because AU Section 560, *Subsequent Events*, requires the auditor to inquire of the client's lawyer about litigation, claims, and assessments for the period from the balance-sheet date through the date of the auditor's report, which is generally the date of completion of field work. The specified date is generally slightly before the completion of field work to allow the auditor adequate time to evaluate the responses. As a practical matter, if the lawyer's response is dated more than two weeks before the completion of field work, the auditor may decide to obtain an oral update directly from the lawyer. The results of this oral response should be documented.

8.209 Request for Unpaid and Unbilled Fees. To obtain information about unrecorded liabilities, many auditors have the client include a request that the lawyer indicate the amount of any unpaid or unbilled fees as of the balance-sheet date.

8.210 If the auditor becomes aware that the client's lawyers have resigned or have been changed either during the year or subsequent to year-end, the auditor should inquire as to the reasons for the resignation.

8.211 The in-charge and partner should carefully read and evaluate responses to determine that all significant litigation, claims, and assessments have been properly accounted for and disclosed, and to identify any limitations of the response, either expressly or by omission. Conclusions should be documented by the in-charge and reviewed by the partner. Illustrative inquiry letters to legal counsel are included in sections 8.901 and 8.902.

8.300 SUBSEQUENT EVENTS

8.301 Completing the audit includes performing certain procedures to identify whether any events have occurred since the balance-sheet date that would require adjustment to or disclosure in the financial statements. AU Section 560, *Subsequent Events*, (AU 560.12) states:

> The independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements. . . . These procedures should be performed at or near the completion of the field work.

8.302 Procedures the auditor should perform to identify and evaluate subsequent events include:

- Read the latest available interim financial statements, compare them with the financial statements being reported upon, and make any other comparisons considered necessary. The auditor should determine whether the interim statements have been prepared on the same basis as that used for the audited financial statements.
- Inquire of and discuss with management and board members having responsibility for financial and accounting matters as to:
  - The existence of any substantial contingent liabilities or commitments at the balance-sheet date or at the date of inquiry.

- — Any significant changes in long-term debt or working capital that have occurred up to the date of inquiry.
- — The current status of items that were accounted for on the basis of tentative, preliminary, or inconclusive data.
- — Any unusual adjustments made during the period from the balance-sheet date to the date of inquiry.

- Read the available minutes of meetings of the governing board and committees.
- Inquire of the organization's legal counsel concerning litigation, claims, and assessments.
- Obtain a representation letter from the client that includes a statement about whether any events have occurred subsequent to the balance-sheet date that, in the client's opinion, would require adjustment to or disclosure in the financial statements.
- Make any other inquiries or perform other procedures considered necessary to dispose of questions that arise in carrying out the above procedures.

8.303 To document performance of these procedures, the Subsequent Events Review Program included in section 8.903 should be completed.

8.400 SUMMARY OF POSSIBLE JOURNAL ENTRIES

8.401 SAS No. 22, *Planning and Supervision* (AU 311), requires the consideration of an overall materiality limit during planning. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU 312), requires the subsequent evaluation of misstatements by comparing the known, but unadjusted, and the estimated or projected misstatements, to the overall materiality limit.

8.402 The Summary of Possible Journal Entries Form in section 8.904 should be used to evaluate the effect of unadjusted misstatements on the financial statements.

8.403 The following types of misstatements should be included in the Summary of Possible Journal Entries Form:

- Known but unadjusted misstatements.
- Projected misstatements from sampling applications.
- Estimated misstatements from predictive analytical procedures.

Misstatements From the Prior Year

8.404 Often overlooked is the consideration of misstatements detected in the prior year that affect the current year. For example, assume last year's Summary of Possible Journal Entries Form included an item representing a $500 overstatement of prepaid insurance and an understatement of insurance expense. This item should also be posted to the current year's form because it affects the current year's insurance expense. Therefore, the prior year's Summary of Possible Journal Entries Form should be reviewed for any items that may have an effect on the current year's financial statements, and such items should be posted to the current year's form.

8.405 In considering the effects of prior year's possible journal entries on the current year's financial statements, be alert for items that carry over and accumulate from year to year, such as an understatement of the prior year's allowance for bad debts of $10,000 that has increased to $15,000 in the current year. Even though such misstatements may be immaterial to the current and prior year's income statements and balance sheets, the authors recommend that you urge your clients to correct such misstatements before they become material.

Establishing Thresholds for Posting Unadjusted Misstatements

8.406 Some firms establish a predetermined dollar threshold above which misstatements should be recorded as adjusting entries, and below which misstatements should be posted to the Summary of Possible Journal Entries Form as unadjusted misstatements. Often such a threshold results from the client's desire to record all misstatements detected during the audit that exceed a certain dollar amount. Other firms prefer to not establish such a threshold because they believe this decision should be based on the nature or sensitivity of the accounts affected by the misstatement.

8.407 To avoid posting clearly inconsequential misstatements, many firms also establish a threshold below which items are not to be posted to the Summary of Possible Journal Entries Form. In other words, they establish a minimum dollar amount that a misstatement must exceed to qualify for posting to the Summary. For example, if this minimum amount were $10.00, and a $9.00 misstatement is detected in cash, the misstatement would be noted in the cash workpapers, but not posted to the Summary of Possible Journal Entries Form. This process can often save valuable engagement time.

Using the Summary

8.408 The Summary of Possible Journal Entries Form should be prepared for all audit engagements by the in-charge and reviewed by the engagement partner.

Practice Tip:

In determining whether misstatements have a material effect on the financial statements, the auditor should consider qualitative as well as quantitative factors. A misstatement that is considered immaterial in amount may in fact have a material impact on a qualitative factor. For example, a misstatement in contributions may be immaterial in its dollar amount, but the misstatement may cause the organization to meet (or not meet) a certain matching level required by the donor.

Because professional judgment is needed to assess materiality and the effects that misstatements have on the financial statements, it is very important that the engagement partner participate in completing the Form. The partner therefore, should review each possible journal entry, as well as the final conclusion.

8.409 The overall materiality limit obtained from the Materiality Computation Form (Chapter 3, section 3.509) should be indicated in the space provided. Also, the dollar value over which misstatements should be posted to the Form should be indicated in the space provided.

8.410 The Summary of Possible Journal Entries Form has been designed to permit the evaluation of the effect of unrecorded misstatements on both the financial statements taken as a whole and on key components of the financial statements (i.e., current assets, noncurrent assets, etc.).

8.411 The Form is designed to permit easy evaluation of misstatements by key components of the financial statements, such as current and noncurrent assets, current and noncurrent liabilities, net assets, and the income statement. Misstatements should be posted to the Form in the appropriate columns (for Lotus 1-2-3 formulas, debits should be positive amounts and credits should be negative amounts).

8.412 Misstatements affecting the statement of activities are further broken down into three categories: known, estimated, and projected. "Known" misstatements are those for which the amount of the error is relatively certain. Such misstatements are often supported by highly reliable evidence, such as third-party documents. An example of a known misstatement would be a failure to record an invoice for repairs expense. Such an item would be posted to the Form as a debit (positive amount) in the "Known Misstatements" column and a credit (negative amount) in the "Current Liabilities" column.

8.413 As the term implies, "estimated" misstatements, are items for which the amount of the misstatement must be estimated. For example, if the auditor believes, based on prior collection history, that the client's reserve for bad debts is understated, the auditor would determine (with the client's assistance and input) the additional reserve needed, and would post this estimate to the Form as a debit (positive amount) in the "Estimated Misstatements" column and a credit (negative amount) in the "Current Liabilities" column.

8.414 "Projected" misstatements arise from projecting sampling errors to the sampling population (see the Audit Sampling Evaluation Form — Tests of Balances Sampling, section 5.707). For example, if a $1,000 accounts receivable misstatement is found in a sample of 10% of the population, the projected misstatement would be $10,000 (posted as a debit to the "Current Assets" column and a credit to the "Projected Misstatements" column). It is important to distinguish between the different types of income statement misstatements to aid in assessing the overall impact the unrecorded misstatements have on the financial statements. The "Total" column in the income statement section represents the sum of the known, estimated, and projected misstatements in the income statement columns.

8.415 After all possible journal entries have been posted to the Form and reviewed by the engagement partner, they should be discussed with the client. All entries subsequently recorded by the client should be removed from this Form and recorded on the trial balance so that only **unrecorded** entries remain on the Form. The columns for each key component should be totaled and then compared to the corresponding financial statement amounts. The total unrecorded income statement misstatements should be tax effected using the client's effective tax rate (if applicable) and compared to net income. The total unrecorded misstatements should be compared to the financial statement totals as a whole and by key component.

8.416 Concluding on the effect of misstatements on the financial statements is a matter of judgement and generally involves considering the nature of the misstatements (known, estimated or projected), overall materiality, and their impact on the financial statements taken as a whole. In instances when net income approaches zero, other factors may be considered, such as the effect of the misstatements, on net assets, whether recording the adjustment to correct the misstatements would cause net income to become a loss, and historical earnings trends of the entity.

8.417 Adjustments would be proposed after considering the aggregate effects of all of the misstatements. If there are no known, projected, or estimated misstatements, this fact should be documented on the Summary of Possible Journal Entries Form.

8.500 CLIENT REPRESENTATIONS

8.501 The purpose of a client representation letter is to document oral and written representations made by the client to firm personnel during the course of the engagement, including representations made through the financial statements. While representations are not a substitute for applying necessary auditing procedures, they are considered an important part of the evidential matter an auditor must obtain. Further, the auditor should discuss the letter with the client since the client needs to understand the significance of the letter rather than making the letter a mere formality. Management's refusal to sign the representation letter constitutes a scope limitation.

8.502 SAS No. 19, *Client Representations* (AU 333), establishes a requirement that the independent auditor obtain written representations from management on all audit engagements. It does not specify the form and content of a client representation letter; however, AU 333.04 provides a detailed listing of representations the auditor should consider obtaining. Those that apply to most not-for-profit engagements include:

- Management's acknowledgement of its responsibility for the fair presentation of the financial statements.
- Availability of all financial records and related data.
- Completeness and availability of all minutes of meetings of the governing board, board of directors, and committees
- Absence of errors in the financial statements and unrecorded transactions.
- Information about related-party transactions.
- Noncompliance with aspects of contractual agreements, including awards and grants, that may affect the financial statements.
- Information about subsequent events.
- Irregularities involving management or employees.
- Communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.
- Plans or intentions that may affect the carrying value or classification of assets or liabilities.
- Disclosure of compensating balance or other arrangements involving restrictions on cash balances, and disclosure of line-of-credit or similar arrangements.

- Satisfactory title to assets, liens on assets, and assets pledged as collateral.
- Agreements to repurchase assets previously sold.
- Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
- Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by SFAS No. 5.

8.503 Management and the auditor may reach an understanding to limit management's representations to matters that are considered either individually or collectively material to the financial statements. These limitations would apply only to items that have a direct affect on financial statement amounts. One example where this limitation would not be applicable would involve related party transactions. These limitations never relate to irregularities involving management or employees.

8.504 In addition to these representations, Chapter 7 of the AICPA Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*, indicates that the auditor should consider obtaining representations concerning the following:

- Compliance with restrictions on resources.
- Taxation and tax-exemption status.
- Reasonableness of bases for allocation of functional expenses.
- Propriety of interfund transfers and collectibility of interfund loans
- Inclusion of all funds under the entity's control in the financial statements.

Entities that Receive Governmental Funds

8.505 The auditor should consider obtaining additional management representations if the not-for-profit organization is subject to the compliance testing and reporting requirements of the Yellow Book, including:

a. Management is responsible for the entity's compliance with laws and regulations applicable to it.

b. Management has identified and disclosed to the auditor all laws and regulations that have a direct and material effect on the determination of financial statement amounts and all irregularities and illegal acts not clearly inconsequential.

8.506 In an audit in accordance with OMB Circular A-133 the auditor ordinarily obtains the following representations:

a. Management has identified in the schedule of federal financial assistance all assistance provided by federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations.

b. Management has identified the requirements governing political activity, the Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, federal financial reports, allowable costs/cost principles, drug-free workplace, and administrative requirements over federal financial assistance.

c. Management has identified the requirements governing types of services allowed or disallowed; eligibility; matching, level of effort, or earmarking; reporting; [*include any special provisions*]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the schedule of federal financial assistance.

d. Management has complied with reporting requirements in connection with federal financial assistance.

e. Information presented in federal financial reports and claims for advances and reimbursements is supported by the books and records from which the basic financial statements have been prepared.

f. Amounts claimed or used for matching were determined in accordance with OMB Circular A-122, "Cost Principles for Nonprofit Organizations," and the OMB's "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments."

g. Management has monitored subrecipients to determine that the subrecipients expend financial assistance in accordance with applicable laws and regulations and have met the requirements of OMB Circular A-128 or OMB Circular A-133, whichever is applicable.

h. Management has taken appropriate corrective action on a timely basis after receipt of a subrecipient's auditor's report that identifies noncompliance with federal laws and regulations.

i. Management has considered the results of subrecipients' audits and made any necessary adjustments to the entity's own books and records.

j. Management has identified and disclosed to the auditor all amounts questioned and known noncompliance with requirements that could have a material effect on a major federal financial assistance program.

8.507 The client representation letter should be dated as of the date of the auditor's report and signed by at least the chief financial officer of the organization. A sample client representation letter is shown in section 8.905. This letter should be tailored to fit the circumstances of each engagement.

8.600 REQUIRED COMMUNICATIONS

Overview

8.601 Several SASs require that certain matters be communicated to clients. The following is a summary of these requirements for audits conducted in accordance with Generally Accepted Auditing Standards (GAAS):

- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325), requires that auditors communicate deficiencies in the design and operation of the entity's control structure (referred to as "reportable conditions") that could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with management's financial statement assertions regarding existence or occurrence, completeness, rights and obligations, valuation or allocation, and presentation and disclosure.

- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU 316), and SAS No. 54, *Illegal Acts by Clients* (AU 317), require auditors to report any irregularities and illegal acts (unless they are clearly inconsequential) the auditor becomes aware of during the course of the audit.

- SAS No. 61, *Communications with Audit Committees* (AU 380), specifies certain audit-related matters that auditors should communicate to their clients.

8.602 Although the title of SAS No. 61 seems to indicate that it only applies to organizations that have audit committees, it in fact applies to any organization that has formally designated oversight of the financial reporting process to a group equivalent to an audit committee, such as a finance or budget committee. As a result, if the not-for-profit organization has an audit committee or a formally designated oversight group, the auditor would be required to communicate the matters discussed in SAS No. 61 (see section 8.620). If the organization does **not** have an audit committee or formally designated group that oversees the financial reporting process, auditors may choose to communicate the matters discussed in SAS No. 61 if they believe management or members of the board would benefit from such communication.

8.603 Persons to Whom Communications Should be Directed. Communications under the four SASs listed above should be directed to the audit committee, or if there is no audit committee, to the individuals with equivalent authority, such as the governing board or board of trustees. As mentioned above, the SAS No. 61 communication is not required if there is no formally designated group responsible for overseeing the financial reporting process; however, communications of internal control structure related matters and irregularities and illegal acts is required even if the organization does not have an audit committee.

8.604 Required Communications for Entities that Receive Governmental Funds. If the not-for-profit entity receives federal financial assistance, it may be subject to additional communication requirements set forth in the Yellow Book and OMB Circular A-133. These requirements are discussed in Chapter 4, "Compliance Auditing."

8.605 Must the Communications be in Writing? The communications required under SAS Nos. 53, 54, 60, and 61 may be either oral or written. Oral communications should be documented in the working papers. Written communications should indicate that they are solely for the use of the governing board, board of trustees, audit committee, or, if appropriate, management.

8.606 The required communications are generally made at the end of the audit. However, if the matter is significant or requires immediate corrective action, the auditor may want to communicate the matter before the end of the audit. The Engagement Performance Review Checklist in section 8.910 contains a step to remind engagement personnel that these communications must be made.

Internal Control Structure Related Matters

8.607 As mentioned in section 8.601, as a part of an audit in accordance with GAAS, an auditor must communicate to the client reportable conditions noted in an audit. SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325.02), explains that reportable conditions:

> . . . are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may involve aspects of the internal control structure elements of (a) the control environment, (b) the accounting system, or (c) control procedures.

8.608 SAS No. 60 establishes two categories of reportable conditions: deficiencies in the design of the internal control structure, and deficiencies in the operation of the internal control structure. Design deficiencies relate to inadequate or absent control structure policies and procedures that could adversely affect the entity's ability to record and report financial information. For example, a design deficiency could exist in a not-for-profit organization if it does not have policies and procedures that require that two persons open mail receipts of contributions. A deficiency in the operation of the control structure occurs when the entity has designed appropriate control policies and procedures, but they are not being followed or they are ineffective. Using the example above, an operational deficiency would occur if the organization's policies and procedures require that two persons open mail receipts, but in fact only one person does so.

8.609 Material Weaknesses. Some reportable conditions may be of such a magnitude that a material error or irregularity could occur and not be detected timely by employees in performing their normal assigned functions. These reportable conditions are considered material weaknesses. Many auditors separately identify material weaknesses from other reportable conditions in their written communications, either because the client asks them to do so or because they want to emphasize the conditions; however SAS No. 60 does not require that an auditor separately identify material weaknesses in the report on reportable conditions.

8.610 Operations and Management-Related Matters. SAS No. 60 also recognizes that an auditor may identify other matters during the course of the audit that would benefit management or the audit committee that are not reportable conditions. For example, the auditor may want to communicate to management suggestions for improving internal control deficiencies that are not considered significant enough to be considered reportable conditions or operational and administrative efficiencies. The auditor is not required to communicate such matters and authoritative literature provides no required format for such letters. However, SAS No. 60, par. 14 states that, in communications that contain both reportable conditions (see section 8.607) and other matters, each should be clearly identified.

Refer to section 8.908 for a sample report on reportable conditions that also identifies other recommendations and see section 8.909 for a management letter with internal control recommendations (other than reportable conditions).

8.611 Reporting Requirements. The report on reportable conditions in accordance with GAAS should:

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.
- Include the definition of reportable conditions.
- Include the restriction on distribution that states that the communication is intended solely for the information and use of the audit committee, management, and others within the organization. In the case of audits under the Yellow Book and OMB Circular A-133, the distribution may include the oversight agencies.

To avoid misunderstandings, a written communication indicating that no reportable conditions were noted during the audit performed in accordance with GAAS should *not* be issued. The report examples in the following sections should only be used in connection with audits performed in accordance with GAAS. Reporting requirements under the Yellow Book are discussed in Chapter 4, sections 4.311-4.328, with a sample report on the internal control structure based on an audit of the financial statements found in section 4.603a and b.

8.612 The following is a sample report on reportable conditions based on the guidance in SAS No. 60 (AU 325.12):

> In planning and performing our audit of the financial statements of the ABC Organization for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
>
> (Describe the reportable conditions noted.)
>
> This report is intended solely for the information and use of the audit committee (governing board or board of trustees), management, and others within the organization (or specified regulatory agency or other specified third party).

A sample report on reportable conditions is shown at section 8.906.

8.613 When reportable conditions have been identified but none is deemed a material weakness, the auditor may use the following format for a written communication:

> (Include the first paragraph of the report illustrated in section 8.612.)

(Describe the reportable conditions noted.)

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.

(Include the final paragraph from section 8.612 above.)

A sample report on reportable conditions that also identifies material weaknesses is shown at section 8.907.

8.614 The Internal Control Structure Reportable Conditions Form included in section 6.500, Chapter 6 is provided to accumulate the reportable conditions identified during the course of an audit. The Engagement Performance Review Checklist in section 8.910 contains a reminder to perform this communication before the engagement is completed.

Errors, Irregularities, and Illegal Acts

8.615 Audit planning involves assessing the risk that errors, irregularities, and illegal acts having a direct effect on financial statement amounts may occur and cause the financial statements to contain a material misstatement. The auditor's responsibility to assess this risk and design appropriate auditing procedures to reduce this risk to an acceptable level is discussed in sections 3.322–3.339 of Chapter 3.

8.616 Communication of Irregularities and Illegal Acts. SAS Nos. 53 and 54 require the auditor to ensure that the organization's audit committee, or others of equivalent authority, is adequately informed of any irregularities and illegal acts having direct and indirect effects on the financial statements, unless they are clearly inconsequential. If senior management participates in the illegal act, the auditor must directly inform the audit committee. With respect to illegal acts, the communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements.

8.617 Organizations that receive governmental financial assistance are governed by specific laws and regulations that, if violated, could have a direct effect on the financial statements in that the organization could be subject to loss of further funding, fines, penalties, etc. The Yellow Book and OMB Circular A-133 set forth the auditor's responsibility to communicate violations of such laws and regulations. See Chapter 4, "Compliance Auditing," for a discussion of these requirements.

8.618 Communication of Errors. SAS No. 53 does not specifically require that errors be communicated; however, if the organization is subject to SAS No. 61 (that is, it has an audit committee or other formally designated group responsible for oversight of the financial reporting process), then the auditor must communicate information about errors in the financial statements. See section 8.620 for a discussion of the communication requirements under SAS No. 61.

8.619 The Engagement Performance Review Checklist in section 8.910 contains a step to remind the auditor of the requirements to communicate irregularities and illegal acts.

Other Matters

8.620 SAS No. 61, *Communication With Audit Committees* (AU 380), requires the auditor to communicate certain matters about the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process. As mentioned in section 8.602, this communication is required only for organizations that have an audit committee or formally designated group responsible for the oversight of the financial reporting process; however, auditors of not-for-profit organizations that do not have such groups may find such communications beneficial. SAS No. 61 (AU 380.06–.14) requires communication of the following matters:

- The level of responsibility assumed by the auditor in an audit performed in accordance with GAAS concerning matters of interest to an audit committee, such as the internal control structure and whether the financial statements are free of material misstatement.
- The initial selection of and changes in significant accounting policies or their application, including methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is no authoritative guidance or consensus.
- The process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions about the reasonableness of those estimates.
- Adjustments arising from the audit that could, in the auditor's judgment, either individually or in the aggregate, have a significant effect on the organization's financial reporting process.
- The auditor's responsibility for other information in documents containing audited financial statements, any procedures performed, and the results.
- Disagreements with management, whether or not satisfactorily resolved, if they relate to matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report. These disagreements may relate to:
  - the application of accounting principles to specific transactions and events,
  - the basis for management's judgments about accounting estimates,
  - the scope of the audit or the wording of the auditor's report, or
  - disclosures to be included in the entity's financial statements.
- The auditor's views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters.
- Any major issues discussed with management in connection with the initial or recurring retention of the auditor including, any discussion about the application of accounting principles and auditing standards.
- Any serious difficulties encountered in dealing with management during the audit, such as unreasonable delays by management in permitting the commencement of the audit or in providing needed information, whether the timetable set by management was unreasonable under

the circumstances, the unavailability of client personnel, or the failure of client personnel to complete client-prepared schedules on a timely basis.

8.621 The Engagement Performance Review Checklist in section 8.910 contains a step to remind the auditor of this required communication.

8.700 SUPERVISION AND REVIEW AND PREPARING FINANCIAL STATEMENTS AND AUDITOR'S REPORTS

Supervision and Review

8.701 Effective supervision, one of the nine elements of a system of quality control for CPA firms outlined in Statement of Quality Control Standards (SQCS) No. 1, *Statement of Quality Control for a CPA Firm*, is an essential element of quality, efficient engagements. This Statement requires firms to establish policies and procedures for conducting and supervising work at all organizational levels in order to provide reasonable assurance that the work performed meets professional standards. The sample quality control policies and procedures found in QC 90.16 provide the following three basic objectives for designing a quality control system for supervision:

- Provide procedures for planning engagements.
- Provide procedures for maintaining the firm's standards of quality for the work performed.
- Provide procedures for reviewing engagement working papers and reports.

Each firm should design quality control policies and procedures for supervision and review that fit its unique organizational and operating characteristics.

8.702 The requirement to supervise engagement personnel is also found in SAS No. 22, *Planning and Supervision* (AU 311.13), which states:

> The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report.

8.703 Proper supervision should include, among others things, the following:

- Helping assistants design procedures to resolve engagement problems early.
- Making sure assistants thoroughly understand the objectives and procedures of an assignment before beginning.
- Helping assistants to prioritize, organize, and control the approach to assigned work areas.
- Periodically checking on the assistants' progress.
- Keeping assistants informed of other engagement matters affecting the assigned work area.

- Rotating work assignments and offering assistants opportunities to work in new areas.
- Motivating assistants to maximum performance levels.
- Supervising paraprofessionals and temporary help.
- Appraising staff performance.

Review of Working Papers

8.704 The firm's quality control system for supervision should address procedures for reviewing working papers, including who performs these reviews and how the reviews are documented. In most firms the in-charge performs a detailed review of the work of all assistants to determine that sufficient evidence has been gathered to accomplish the engagement objectives and that the engagement procedures and documentation are in accordance with the firm's quality control standards. Also, the in-charge initials and dates each working paper to indicate that he or she is satisfied with the work performed.

8.705 The engagement partner is responsible for reviewing work performed by the in-charge and the results of the in-charge's review of assistants' working papers. The objectives of his or her review are to determine that sufficient evidence has been gathered to accomplish engagement objectives and that the engagement procedures and documentation are in accordance with the firm's quality control standards. The engagement partner generally reviews all of the working papers, and documents this review by initialling and dating each working paper.

8.706 The engagement partner's review should determine that all firm quality control standards have been met. Depending on the complexity of the engagement, and the experience of staff, the partner may review all engagement working papers, or may choose to review only the working papers supporting material or unusual audit areas. Working paper reviews by the partner may be documented by initials on the applicable lines of the working trial balance or lead sheets, or on the individual working papers. Checklists reviewed should be signed in the space provided for the partner.

8.707 The In-charge Review. The in-charge's detailed review of assistant's work should be performed as frequently as possible, as each audit area is completed. Immediate feedback is often difficult to give under the time constraints of an audit, but is essential to providing effective on-the-job training. The in-charge's review procedures should include at least the following:

- Review applicable section of last year's working papers.
- Review the applicable section of the work program.
- Compare current and prior period trial balance accounts related to the work area and note variations.
- Briefly review the contents of the working papers.
- Read the conclusions.
- Review the working papers in detail for:
  - Mathematical accuracy.

— Accomplishment of the purposes of the documentation, i.e., engagement objectives.

— Proper performance of procedures.

— Reasonableness of judgments.

— Identification and follow-up of exceptions.

— Resolution of problems and questions.

— Projection of sample results to the population

- Determine that all work program procedures have been completed correctly.

8.708 **The Partner Review.** The engagement partner or his or her designee should review the work of engagement personnel as frequently as practical. Acceptable reasons for reviewing the engagement only after its final completion are rare.

8.709 The magnitude of the engagement partner's review may vary depending on the complexity and size of the engagement and on the experience of engagement personnel. The partner's review should be conducted in the field whenever possible. Field reviews allow problem resolution while staff is working on the engagement, prevent typical office interruptions, enable the partner or the designee to schedule review time, and allow the partner or the designee to be seen by client personnel. Except for periodic discussions with engagement personnel, the partner's review will normally occur during the final stages of the engagement.

8.710 Completion of the Engagement Performance Review Checklist included in section 8.910 documents that the in-charge and engagement partner are satisfied that engagement personnel have been properly supervised and the work performed has been properly reviewed.

8.711 **The Technical Review.** As part of their quality control system for the supervision element, many firms require preissuance, technical reviews of reports and related financial statements, and often the engagement working papers, by persons not involved with the engagement. Such reviews are performed to give the firm assurance that the auditor's report, related financial statements, and the engagement working papers comply with professional standards and the firm's quality control system.

8.712 As with all quality control policies and procedures, each firm should develop policies and procedures for technical reviews that are appropriate for its practice. Many firms require these technical reviews only for certain types of engagements and special reporting situations. The authors recommend that firms carefully identify the situations in which an independent technical review is required and identify the firm personnel who have the qualifications and authority to perform such reviews. One example when it may be appropriate to conduct a technical review would be for audits of not-for-profit organizations in accordance with *Government Auditing Standards*.

8.713 Included in section 8.911 is a Technical Review Checklist that can be used to document technical reviews of reports, financial statements and, if necessary, the engagement working papers.

Preparing Financial Statements and Auditor's Reports

8.714 Chapter 9 contains guidance for the in-charge when drafting financial statements, notes and reports. It also contains a disclosure and reporting checklist that should be completed on all not-for-profit engagements. Completion of the Engagement Performance Review Checklist in section 8.910 documents the engagement partner's approval that the financial statements and auditor's reports conform with authoritative and professional standards.

8.800 CONSULTATION ON ENGAGEMENTS, PERFORMANCE APPRAISALS, AND FINAL TIME SUMMARIZATION

Consultation on Engagements

8.801 An important part of ensuring that firms provide high-quality engagements is encouraging staff to seek assistance when needed from the appropriate individuals. They should also be advised of the individuals within or outside the firm designated as specialists in not-for-profit organizations and other relevant areas.

8.802 SQCS No. 1 (QC 90.13) states:

> Policies and procedures for consultation should be established to provide the firm with reasonable assurance that personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation will depend on a number of factors, including the size of the firm and the level of knowledge, competence, and judgment possessed by the persons performing the work.

8.803 All firms that are members of the AICPA Division for CPA Firms are obligated to follow the quality control standards. However, because all AICPA members could be called upon to justify departures from these standards, every firm should establish and maintain a quality control system appropriate for its particular operational and organizational structure.

8.804 The following are three basic objectives (found in QC 90.14) for consultation that a firm should consider in developing its policies and procedures:

1. Identify areas and specialized situations where consultation is required, and encourage personnel to consult with or use authoritative sources on other complex or unusual matters.

2. Designate individuals as specialists to serve as authoritative sources, and define their authority in consultative situations. Provide procedures for resolving differences of opinion between engagement personnel and specialists.

3. Specify the extent of documentation to be provided for the results of consultation in those areas and specialized situations where consultation is required. Specify documentation, as appropriate, for other consultations.

8.805 Each firm should carefully design quality control policies and procedures over consultation that fit its unique operating and organizational characteristics. These policies and procedures should be communicated to all professional staff, preferably in a written quality control document, so that they are aware of the situations that require consultation and of the individuals from whom they should seek advice or assistance.

8.806 Examples of situations that may require consultation include:

- Going-concern problems.
- Identification of errors, irregularities and illegal acts, including significant instances of noncompliance with regulations governing federal awards.
- Information that raises doubt about management's integrity.
- Unresolved disagreements among engagement personnel.

8.807 Because of the high risk associated with many not-for-profit engagements, particularly with organizations that receive federal awards, firms may consider requiring that a specialist review all reports, or certain specified reports (such as all Circular A-133 reports), issued on not-for-profit engagements.

8.808 All consultations should be documented in a memorandum to the working papers that includes a description of the issue, relevant authoritative literature, and the resolution. The memo should be signed by the individual who prepared the memo, the consultant or specialist, and the engagement partner.

Performance Appraisals

8.809 Performance appraisals should be completed by the in-charge for all staff working on an engagement. Similarly, the engagement partner should perform an appraisal for the in-charge. To achieve maximum benefits from these feedback mechanisms, appraisal forms should be prepared and reviewed with the staff immediately after the engagement's completion.

Final Time Summarization

8.810 The in-charge is responsible for the final time summarization, its reconciliation to client time charges in the firm's billing records, and its final comparison to budget. Reasons for budget overruns should be documented. Suggestions for next year's possible time savings should also be included. These documents should be discussed with the engagement partner prior to preparing the final client billing. Finally, a tentative budget should be prepared for next year's engagement. Chapter 3, "Pre-Engagement Considerations and Audit Planning," includes budget and time control forms to collect the engagement staff's time and suggestions for modifying procedures on the next year's engagement.

8.900 DOCUMENTATION ASSISTANCE

8.901 INQUIRY LETTER TO LEGAL COUNSEL

[Client's Letterhead]

[Date]

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____
____

In connection with an audit of our financial statements at ________ [balance-sheet date] and for the ________ [period] then ended, management of the Organization has prepared, and furnished to our auditors __________________________________ [name and address of auditors], a description and evaluation of certain contingencies, including those set forth below, involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Organization in the form of legal consultation or representation. These contingencies are regarded by management of the Organization as material for this purpose [management may indicate a materiality limit if an understanding has been reached with the auditor]. Your response should include matters that existed at ________ [balance-sheet date] and during the period from that date to the date of your response.

Pending or Threatened Litigation (excluding unasserted claims and assessments)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at lease a reasonable possibility of an unfavorable outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.]

Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosure concerning such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the organization, such as guarantees of indebtedness of others.]

Very truly yours,

____

[Client's Authorized Signature]

Notes to User:

(1) Auditors should carefully consider the provisions of Statement on Auditing Standards No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU 337), in drafting this letter.

(2) Sending of this letter should be timed so that the lawyer's response is dated within two weeks of the auditor's report date. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

(3) If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained. In these circumstances, a written representation should be obtained from the Organization that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation (see AICPA *Technical Practice Aids*, section 8340.10).

8.902 INQUIRY LETTER TO LEGAL COUNSEL IF MANAGEMENT HAS NOT PROVIDED DETAILS ABOUT PENDING OR THREATENED LITIGATION

[Client's Letterhead]

[Date]

____
____
____

In connection with an audit of our financial statements as of _________ [balance-sheet date], and for the ___________[period] then ended, please furnish our auditors ________________________ [name and address of auditors] with information requested below for which you have been engaged and to which you have devoted substantive attention on behalf of the Organization in the form of legal consultation or representation.

1. Pending or threatened litigation, claims and assessments (excluding unasserted claims and assessments):

   Please furnish a list of all pending or threatened litigation, claims or assessments your firm is handling on our behalf, including the following: (1) the nature of the litigation (including the amount of monetary or other damages sought); (2) progress of the case to date; (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement); and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.

2. Unasserted claims and assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome):

   We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosing such possible claim or assessment, as a matter of professional responsibility to us, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Statement of Financial Accounting Standards No. 5. Please specifically confirm to our auditors that our understanding is correct.

   We have represented to ___________ [name of auditors] that there are no unasserted claims, which are not specifically identified in this letter, that you have advised us are probable of assertion and must be disclosed in accordance with SFAS No. 5.

   (If unasserted claims exist, management's listed information should include the following: (1) the nature of the matter; (2) how management intends to respond if the claim is asserted; and

(3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.)

Please furnish our auditors any explanation you consider necessary to supplement the foregoing information, including an explanation of these matters as to which your views may differ from those stated.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the organization, such as guarantees of indebtedness of others.]

Very truly yours,

____

[Client's Authorized Signature]

Notes to User:

(1) Auditors should carefully consider the provisions of Statement on Auditing Standards No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU 337), in drafting this letter.

(2) Sending of this letter should be timed so that the lawyer's response is dated within two weeks of the auditor's report date. However, the auditor and client should consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

(3) If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained. In these circumstances, a written representation should be obtained from the Organization that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation (see AICPA *Technical Practice Aids*, section 8340.10).

8.903

Subsequent Events Review Program

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS:

This program has been developed for use on all audit engagements. It is not a substitute for professional judgment.

Each step should be initialed and dated by the engagement personnel who performed the work. References to supporting workpapers should be placed in the "W/P Ref." column. Also, "N/A" should be placed in the "W/P Ref." column for any steps that are not applicable.

Procedure	Done By	Date	W/P Ref.
A. If available, review financial statements and schedules or general ledger and source journals of the organization for the period subsequent to the balance-sheet date to ______ (last day of field work).	______	______	______
B. Refer to latest reconciliations of major bank accounts and inquire into any unusual items.	______	______	______
C. Refer to latest aging of grants and accounts receivable and compare with aging totals at the balance-sheet date. Inquire into material or troublesome accounts.	______	______	______
D. Discuss with the organization's management and investigate the following matters for the period from balance-sheet date to ______ (last day of field work). (Names of management should be recorded in working papers.)			
1. Organization's operations.	______	______	______
2. Trends in the organization's contributions as compared to budget and trends in the industry.	______	______	______
3. Subsequent cancellations of grants or pledges receivable, or sales orders.	______	______	______

SUBSEQUENT EVENTS REVIEW PROGRAM
(Continued)

Procedure	Done By	Date	W/P Ref.
4. Status of items accounted for at the balance-sheet date based on tentative data.			
5. Commitments or plans for major purchases of capital additions or materials, and consideration of possible losses due to price trends.			
6. Federal taxes—changes in tax-exempt status, changes in law, agents' reports, deficiency assessments, etc.			
7. Renegotiation and price redetermination under government contracts—possible effect and proceedings, if any.			
8. Litigation, claims, and assessments.			
9. Liabilities in dispute or being contested, such as customers' claims, creditors' invoices or claims, warranties, guarantees, state and local tax assessments.			
10. Losses of important contributors, grantors or customers, exceptional bad debt losses, or pledging of receivables.			
11. Changes in accounting and financial policies.			
12. New pension plans and other employee benefit plans.			
13. New borrowings or other financing.			
14. Potential losses on marketable securities, carrying amounts of equity investments, receivables, inventory or other assets not already considered.			
15. Regulatory commissions, governmental body requirements, or laws that could adversely affect the organization.			
16. Purchase or sale of major property and equipment; destructions or abandonments of plant, etc.			
17. Status and impact of wage negotiations in progress.			

SUBSEQUENT EVENTS REVIEW PROGRAM
(Continued)

Procedure	Done By	Date	W/P Ref.
18. Effect of changes in management, development of substitute programs, etc.	______	______	______
19. Related-party transactions.	______	______	______
E. Read and evaluate the lawyers' responses to the letters of inquiry. (Letters should be requested from legal counsel so that replies will cover the status of litigation, etc., to a date as close as possible to the date of the auditor's report.)	______	______	______
F. Read and excerpt the available minutes of meetings of the governing board and committees of the board. Inquire as to matters discussed at meetings for which minutes are not available and obtain a letter from management confirming the subject matters discussed and any decisions reached.	______	______	______
G. Consider adjustment of year-end financial statements or disclosure of any items resulting from the above procedures.	______	______	______
H. Consider the possible effects on financial statements and disclosures of any matters causing substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.	______	______	______
I. Discuss contents of representation letter and obtain appropriate signatures.	______	______	______
J. Additional procedures: ______________________ ______________________ ______________________ ______________________	______	______	______

Prepared by: ______________________ Date: ______________________

Reviewed by: ______________________ Date: ______________________

8.904

Summary of Possible Journal Entries Form

Client: ____________________

Financial Statement Date: ____________________

INSTRUCTIONS:

This Form should be prepared on all audit engagements by the in-charge and reviewed by the engagement partner. (This Form is provided on the complementary disk in Lotus 1-2-3 — release 3.1 with wysiwyg or release 3.4 and higher. The schedule includes formulas to calculate totals and percentages.)

Indicate in the space provided the overall materiality limit (obtained from the Materiality Computation Form, Chapter 3, section 3.509). Also, indicate the threshold amount for posting items to this Form; items below this amount need not be posted.

This Form should be used to record all proposed journal entries, starting with the effect of unrecorded misstatements from prior years that should be carried forward (posted either individually or as one item) and continuing with current year entries. After all misstatements are posted, they should be reviewed by the engagement partner and discussed with the client. Any misstatements subsequently recorded by the client should be removed from this Form and included on the trial balance.

At the completion of the engagement, the columns should be totaled and compared to the corresponding financial statement amounts. Misstatements that affect the income statement should be reduced by any related tax effect using the client's effective tax rate, if applicable.

Concluding on the effect of misstatements on the financial statements is a matter of judgment and generally involves considering the nature of the misstatement (known, estimated, or projected), overall materiality, and their impact on the financial statements taken as a whole. In instances when net income approaches zero, other factors may be considered, such as the effect of misstatements on net assets and historical earnings trends of the company.

SUMMARY OF POSSIBLE JOURNAL ENTRIES FORM
(Continued)

Summary of Possible Journal Entries Form

Client:

Financial Statement Date:

Overall materiality limit: $ ________

Amount over which misstatements should be posted to this form: $ ________

page ____

W/P Ref	Journal Entry Debit (Credit)	BALANCE SHEET					INCOME STATEMENT			
		Current Assets	Noncurrent Assets	Current Liabilities	Noncurrent Liabilities	Net Assets	Known misstatements	Estimated misstatements	Projected misstatements	TOTAL*
	Total effect of unrecorded misstatements from prior years									
Total Unrecorded Misstatements (Page ____)										

* Total of known, estimated and projected misstatements columns.

SUMMARY OF POSSIBLE JOURNAL ENTRIES FORM
(Continued)

page ____

W/P Ref	Journal Entry Debit (Credit)	BALANCE SHEET Current Assets	Noncurrent Assets	Current Liabilities	Noncurrent Liabilities	Net Assets	INCOME STATEMENT Known misstatements	Estimated misstatements	Projected misstatements	TOTAL*
	Totals from previous page									
Total Unrecorded Misstatements										
Corresponding Financial Statement Amounts										
% of Total Unrecorded Misstatements to Corresponding Financial Statement Amounts										

Tax effect on total unrecorded misstatements (income statement)** ______

Tax effected unrecorded misstatements ______

Net income ______

% of tax effected unrecorded misstatements to net income ______

* Total of known, estimated and projected misstatements columns.

** Apply the client's effective tax rate, if applicable, to the total unrecorded misstatements (income statement). Subtract the tax amount from the total unrecorded misstatement amount for the tax effected amount.

Conclusion: The above misstatements do not ______ do ______ materially affect the financial statements

Prepared by: ______________________ Date: ______
(In-charge)

Reviewed by: ______________________ Date: ______
(Engagement Partner)

8.905 SAMPLE CLIENT REPRESENTATION LETTER

[Client Letterhead]

[Auditor's Report Date]

____
____
____

In connection with your audit of the financial statements of __________________________ [name of organization] as of _____________ [financial statement date] and for the _____________ [period] then ended, for the purpose of expressing an opinion as to whether the financial statements present fairly in all material respects, the financial position, results of activity, and cash flows[1] of _________________ _____________ [name of organization] in conformity with generally accepted accounting principles, we confirm, to the best of our knowledge and belief, the following representations made to you during your audit:

1. We are responsible for the fair presentation in the financial statements of financial position, results of activity, and cash flows[1] in conformity with generally accepted accounting principles. In addition, the financial statements include all funds under the organization's control.

2. We have made available to you—

    a. All financial records and related data.

    b. All minutes of meetings of the governing board and committees of the board, or summaries of actions of recent meetings for which minutes have not yet been prepared.

    c. Information relating to all statutes, laws, or regulations that have a direct effect on our financial statements.

3. There have been no—

    a. Irregularities involving management or employees who have significant roles in the internal control structure.

    b. Irregularities involving other employees that could have a material effect on the financial statements.

    c. Communications from regulators or funding agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements.

---

[1] This wording reflects the financial statement presentation under SFAS No. 117. If SFAS No. 117 has not been adopted "results of activity, and cash flows" should be replaced by "results of operations, and changes in financial position."

   d. Communications from donors or funding agencies concerning noncompliance with restrictions on resources.

4. We have no plans or intentions that may materially affect the carrying value or classification of assets or liabilities.

5. The following have been properly recorded or disclosed in the financial statements:

   a. Related-party transactions and related amounts of receivable or payable, including sales, purchases, loans, transfers, leasing arrangements, and guarantees.

   b. Arrangements with financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line of credit or similar arrangements.

   c. Agreements to repurchase assets previously sold.

   d. Security agreements under the Uniform Commercial Code.

   e. Contractual obligations for purchases of assets.

   f. Asset reversion clauses, liens, encumbrances, or subordination of assets pledged as collateral in any way.

   g. Subordination of any liabilities.

   h. All lease or rental obligations under long-term leases.

6. There are no—

   a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

   b. Other material liabilities or gain or loss contingencies that are required to be accrued or disclosed by Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

7. There are no unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with SFAS No. 5.

8. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

9. Provision, when material, has been made to—

   a. Reduce excess or obsolete inventories to their estimated net realizable value.

   b. Reduce all investments for permanent declines in value.

10. The organization has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged.

11. The organization is a tax-exempt organization under Section ______ of the Internal Revenue Code and we have disclosed to you those activities that would jeopardize the organization's tax-exempt status.

12. Provision has been made for any material loss to be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices.

13. We have complied with all restrictions on resources and with all aspects of contracts and grant agreements that would have a material effect on the financial statements in the event of noncompliance.

14. No events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statements.

Very truly yours,

____

[Chief Financial Officer]

Notes to User:

(1) The auditor should also consider obtaining representations regarding the following:

- Reasonableness of bases for allocation of functional expenses.
- Propriety of interfund transfers and collectibility of interfund loans.

(2) If the audit is conducted in accordance with OMB Circular A-133, the following additional written representations should be obtained:

a. We have identified in the schedule of federal financial assistance all assistance provided by federal agencies in the form of grants, contracts, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, or direct appropriations.

b. We have identified and disclosed to you all laws and regulations that have a direct and material effect on the determination of financial statement amounts and all irregularities and illegal acts not clearly inconsequential.

c. We have identified the requirements governing political activity, the Davis-Bacon Act, civil rights, cash management, relocation assistance and real property management, federal financial reports, allowable costs/cost principles, drug-free workplace, and administrative requirements over federal financial assistance.

d. We have identified the requirements governing types of services allowed or disallowed; eligibility; matching, level of effort, or earmarking; reporting; [*include any special provisions*]; claims for advances and reimbursements; and amounts claimed or used for matching that are applicable to its major federal financial assistance programs, which are identified in the schedule of federal financial assistance.

e. We are responsible for the entity's compliance with laws and regulations applicable to it.

f. We have complied with reporting requirements in connection with federal financial assistance.

g. Information presented in federal financial reports and claims for advances and reimbursements is supported by the books and records from which the basic financial statements have been prepared.

h. Amounts claimed or used for matching were determined in accordance with guidelines in OMB Circular A-122, "Cost Principles for Nonprofit Organizations," and Attachment E, "Cost Sharing and Matching," of OMB Circular A-110, "Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Organizations."

i. We have monitored subrecipients to determine that the subrecipients expend financial assistance in accordance with applicable laws and regulations and have met the requirements of OMB Circular A-133.

j. We have taken appropriate corrective action on a timely basis after receipt of a subrecipient's auditor's report that identifies noncompliance with federal laws and regulations.

k. We have considered the results of subrecipients' audits and made any necessary adjustments to the entity's own books and records.

l. We have identified and disclosed all amounts questioned and known noncompliance with requirements that could have a material effect on a major federal financial assistance program.

8.906 SAMPLE REPORT ON REPORTABLE CONDITIONS

[CPA Firm Letterhead]

[Date of Auditor's Report on the Financial Statements]

The Governing Board
XYZ Not-for-Profit Organization
City, State

In planning and performing our audit of the financial statements of the XYZ Organization for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Bank Reconciliations

Bank reconciliations have been prepared for the operating cash account, but they have not been in agreement with the general ledger, often by as much as $20,000. At June 30, 19X1, the general ledger balance varied from the bank reconciliation by $12,852.

In prior years, the bank reconciliations did not reconcile exactly to the general ledger; however, the variances were not as significant as in 19X1. To maintain effective internal controls over cash, it is critical that bank accounts be reconciled to the general ledger monthly with differences identified and resolved immediately. At the present time, an adjusting journal entry should be made to bring the general ledger balance into agreement with the reconciled balance.

Accounts Payable

A listing of accounts payable as of June 30, 19X1 could not be produced to support the general ledger amount. We were able to reconcile accounts payable to the general ledger amount by reviewing computer-generated accounts payable listings dated June 28 and 29 and July 9 and 10, 19X1, along with examining unpaid invoices at the time of our field work, July 25, 19X1.

As indicated in previous letters to the Governing Board, accounts payable has been an ongoing problem due to the fact that the accounts payable listing is not reconciled to the general ledger monthly. Proper recording of accounts payable is key to maintaining adequate financial statements. Whether computer-generated or manually prepared, a detailed accounts payable listing should be reconciled monthly to the general ledger balance. All reconciliations should be reviewed and approved by someone other than the preparer, with the reviewer being responsible for ensuring that all differences are resolved.

Property and Equipment

Documentation provided to support the changes in property and equipment was not in agreement with the changes in the general ledger balances, for some categories, by as much as $32,000. Also, the computer-generated list of property and equipment was not in agreement with the total property and equipment recorded in the general ledger; therefore, this listing was not a useful resource.

The property and equipment computer listing should be reviewed, revised, and reconciled to the general ledger. Changes in property and equipment should be recorded timely and the detailed property and equipment listing should be reconciled to the general ledger balances monthly.

The procedures for recording fixed asset additions and deletions should be reviewed to determine their adequacy. Adjusting journal entries with regard to trade-ins, sales and other retirements of fixed assets should be reviewed by the Treasurer or someone other than the person preparing the entry. Examples of problems encountered include improper capitalization of assets when a like kind exchange or trade-in is involved and improper recording of gain or loss on sale of assets.

An annual or biannual physical inventory of equipment is an effective management tool to help maintain detail property and equipment records and strengthen controls of safeguarding equipment. The Governing Board should consider making a physical inventory a standard procedure.

This report is intended solely for the information and use of the Governing Board, management, and others within the organization.

Very truly yours,

____

[Firm's Signature]

8.907 SAMPLE REPORT ON REPORTABLE CONDITIONS THAT ALSO IDENTIFIES A MATERIAL WEAKNESS

[CPA Firm Letterhead]

[Date of Auditor's Report on the Financial Statements]

The Governing Board
XYZ Not-for-Profit Organization
City, State

In planning and performing our audit of the financial statements of the XYZ Organization for the year ended June 30,19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

Accrued Vacation

Although accrued vacation has not been recorded on the financial statements, the amount of accrued vacation must be considered in determining the fair presentation of the financial statements. The June 30, 19X1 analysis of accrued vacation had a balance significantly lower than the prior year's balance. The details of the analysis were traced to the "attendance control cards." We found (1) the number of days earned on the listing did not agree to that recorded in the cards, (2) individuals were reported in the cards with earned vacation but were not on the listing, and (3) some of the cards appeared to not have been maintained.

Detailed records of vacation days earned and used by employees should be timely and accurately maintained. At least annually, these days should be converted to dollar amounts. Management should review the conversion and consider reporting this liability on the financial statements for complete recognition of liabilities.

Discussions with the office manager revealed that not all employees are required to notify her when they use vacation days. All employees should be required to inform the office manager of all vacation days taken. Employees should also be asked to periodically review their vacation records with the office manager and to indicate their agreement by signing the records.

Bad Debts

During 19X1, the Governing Board approved the write-off of accounts receivable of about $10,000. The write-off was charged to revenue rather than to bad debt expense.

Procedures for recording bad debt write-offs should be reviewed for adequacy. All adjusting entries should be reviewed by the Treasurer or a member of management other than the person preparing the journal entry.

A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, we believe that the following reportable condition is a material weakness.

Blank Checks

Blank checks are maintained in an unlocked cabinet along with the check signing machine.

Blank checks and the check signing machine should be locked in separate locations so as to prevent the embezzlement of funds.

This report is intended solely for the information and use of the Governing Board, management, and others within the organization.

Very truly yours,

____

[Firm's Signature]

8.908 SAMPLE REPORT ON REPORTABLE CONDITIONS THAT ALSO IDENTIFIES OTHER RECOMMENDATIONS[1]

[CPA Firm Letterhead]

[Date of Auditor's Report on the Financial Statements]

The Governing Board
XYZ Not-for-Profit Organization
City, State

In planning and performing our audit of the financial statements of the XYZ Organization for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, we noted the following matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. We have also included other recommendations to enhance internal controls and administrative efficiency.

I. *Reportable Conditions*

Bank Reconciliations

Bank reconciliations have been prepared for the operating cash account, but they have not been in agreement with the general ledger, often by as much as $20,000. At June 30, 19X1, the general ledger balance varied from the bank reconciliation by $12,852.

In prior years, the bank reconciliations did not reconcile exactly to the general ledger; however, the variances were not as significant as in 19X1. To maintain effective internal controls over cash, it is critical that bank accounts be reconciled to the general ledger monthly with differences identified and resolved immediately. At the present time, an adjusting journal entry should be made to bring the general ledger balance into agreement with the reconciled balance.

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[1] SAS No. 60, par. 17 precludes auditors from issuing a written report representing that no reportable conditions were noted. Therefore, if no reportable conditions were identified, but the auditor wishes to communicate other recommendations, the report should not refer to reportable conditions. See section 8.909 for a sample management letter with internal control recommendations not considered to be reportable conditions.

Accounts Payable

A listing of accounts payable as of June 30, 19X1 could not be produced to support the general ledger amount. We were able to reconcile accounts payable to the general ledger amount by reviewing computer-generated accounts payable listings dated June 28 and 29 and July 9 and 10, 19X1, along with examining unpaid invoices at the time of our field work, July 25, 19X1.

As indicated in previous letters to the Governing Board, accounts payable has been an ongoing problem due to the fact that the accounts payable listing is not reconciled to the general ledger monthly. Proper recording of accounts payable is key to maintaining adequate financial statements. Whether computer-generated or manually prepared, a detailed accounts payable listing should be reconciled monthly to the general ledger balance. All reconciliations should be reviewed and approved by someone other than the preparer, with the reviewer being responsible for ensuring that all differences are resolved.

Property and Equipment

Documentation provided to support the changes in property and equipment was not in agreement with the changes in the general ledger balances, for some categories, by as much as $32,000. Also, the computer-generated list of property and equipment was not in agreement with the total property and equipment recorded in the general ledger; therefore, this listing was not a useful resource.

The property and equipment computer listing should be reviewed, revised, and reconciled to the general ledger. Changes in property and equipment should be recorded timely and the detailed property and equipment listing should be reconciled to the general ledger balances monthly.

The procedures for recording fixed asset additions and deletions should be reviewed to determine their adequacy. Adjusting journal entries with regard to trade-ins, sales and other retirements of fixed assets should be reviewed by the Treasurer or someone other than the person preparing the entry. Examples of problems encountered include improper capitalization of assets when a like kind exchange or trade-in is involved and improper recording of gain or loss on sale of assets.

An annual or biannual physical inventory of equipment is an effective management tool to help maintain detail property and equipment records and strengthen controls of safeguarding equipment. The Governing Board should consider making a physical inventory a standard procedure.

II. *Other Recommendations*

[Refer to section 8.909 for a listing of sample internal control and administrative efficiency recommendations for not-for-profit organizations.]

This report is intended solely for the information and use of the Governing Board, management, and others within the organization.

Very truly yours,

____

[Firm's Signature]

8.909 SAMPLE MANAGEMENT LETTER WITH INTERNAL CONTROL RECOMMENDATIONS (OTHER THAN REPORTABLE CONDITIONS)

[CPA Firm Letterhead]

[Date][2]

The Governing Board
XYZ Not-for-Profit Organization
City, State

In planning and performing our audit of the financial statements of XYZ Organzation for the year ended June 30, 19X1, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control structure. However, during the course of our audit, the following internal control matters came to our attention. We present our recommendations for your consideration and we would be happy to discuss these comments in further detail.

Board Minutes

Minutes of the meetings of the Governing Board represent a formal record of the Board's decisions and actions. As such, they should be prepared on a timely basis and signed by two officers. Furthermore, the minutes should include a detailed account of the Board's discussion of financial matters. For instance, the minutes should address the formal approval of the operating budget, major investment decisions, and approval of restricted gifts and grants.

Bank Accounts

Currently, restricted cash contributions are deposited in separate bank accounts. Most donors require that their restricted cash contributions be accounted for separately from other cash balances but do not require their contributions to be deposited in separate bank accounts. In the absence of specific donor requirements, the Organization should consolidate its restricted cash balances with other cash balances. Closing unnecessary bank accounts should minimize administrative costs and maximize interest income.

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Cash receipts are currently mailed to the Organization, then recorded and deposited into the general checking account. To reduce the time between receipt and deposit and improve control over cash receipts, the Organization should establish a lockbox account.

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[2] The auditor may communicate these recommendations at any time. However, it is common practice to date the report the same as the date of the auditor's report on the financial statements if this report is issued after conclusion of the audit or as of the date of completion of interim field work if issued earlier.

Cash Flow Projections

To facilitate effective use of the Organization's cash, a projection of monthly receipts and disbursements should be prepared in conjunction with the annual budget process and updated on a monthly basis.

Appraisals for Non-Cash Contributions

During the course of our audit, we noted that independent appraisals were obtained to value various non-cash contributions. However, in several instances, the appraisal forms could not be located. To provide a proper audit trail for the valuation of such contributions, documentation from independent appraisers should be maintained along with other documentation supporting contributions. Consider attaching the appraisal forms to the file copies of the contribution acknowledgement letters.

Cash Disbursements

The Organization often pays vendor invoices prior to the due date. To maximize the Organization's interest income and to reduce costs, the Organization should pay vendor invoices on the last possible day to meet the due date. For invoices offering cash discounts for early payment, the Organization should pay on the last possible day to take advantage of the discount. To achieve this, the Organization should establish accounts payable files by discount or due date.

Expense Allocation

The basis for allocating certain general expenses, such as rent, insurance, utilities, and depreciation, between programs is not clearly documented. To ensure proper and consistent allocation, the basis should be properly documented. In addition, the assumptions used in the methodology should be reviewed on a periodic basis to ensure that they remain valid.

Employee Expense Accounts

The Organization's policy and procedures for employee and director expense accounts are not documented. To ensure proper and consistent application, the policy and procedures should be properly documented in the Organization's Accounting Policies and Procedures Handbook.

Grants

During the course of our audit we noted that documentation supporting various federal grants (i.e., agreements, explanatory documents, and guidelines) was not always readily available. To facilitate efficient review by management, external auditors, and other third parties, all documentation supporting grants should be maintained in an organized manner along with the applicable grant documents.

Currently, grantors are not billed for reimbursable expenditures on a timely basis. To improve cash flow, the Organization should develop procedures to bill grantors on a timely basis.

***

This report is intended solely for the information and use of the Governing Board, management, and others within the Organization.

Very truly yours,

____

[Firm's signature]

8.910

Engagement Performance Review Checklist

Client: ______________________

Financial Statement Date: ______________________

INSTRUCTIONS:

This checklist documents the in-charge and engagement partner review responsibilities, as required by the firm's quality control policies and procedures.

Part I of the checklist should be completed by the in-charge at the completion of the engagement. Part II should be completed by the engagement partner.

Part I	Yes	No	See Additional Comments
Administrative Considerations			
1. Have all required engagement programs, forms, and checklists been completed, signed, and dated?	____	____	____
2. Have all working papers been reviewed for:			
a. Initials and dates of preparation and review?	____	____	____
b. Proper format, that is, headings, tickmark explanations, indexing, and cross-referencing?	____	____	____
c. Footing and testing of schedules prepared by the client?	____	____	____
d. Posting of adjustments and cross-referencing to trial balance?	____	____	____
e. Agreeing beginning balances to prior year's working papers?	____	____	____
3. Do financial statements agree with the trial balance?	____	____	____

ENGAGEMENT PERFORMANCE REVIEW CHECKLIST
(Continued)

	Yes	No	See Additional Comments
4. Has the Time Summary Form been completed, and significant variances between budget and actual been explained?			
5. Have the following letters been obtained and reviewed for proper dating and propriety?			
a. Management representations (dated as of the auditor's report date).			
b. Lawyers' letters (dated within two weeks of the auditor's report date).			
Other Considerations			
1. Have you reviewed all work done by assistants and cleared all review points?			
2. Does the work performed accomplish the objectives of the engagement?			
3. Do the conclusions in the working papers support the type of report issued?			
4. Has the engagement been completed in accordance with firm policy and authoritative standards?			
5. Have all problems been adequately resolved?			
6. If a situation has been encountered that impairs the firm's independence, has a disclaimer of opinion been issued for public companies or a step-down to a compilation with lack of independence noted for nonpublic companies?			
7. Were any transactions or events encountered that, according to the firm's policy, require consultation?			
• If yes, was consultation obtained and properly documented?			

ENGAGEMENT PERFORMANCE REVIEW CHECKLIST
(Continued)

	Yes	No	See Additional Comments
• If applicable, were the resolutions of differences of opinion among the firm personnel documented?			
8. Has a final review of the overall financial presentation been performed? (If necessary, attach supporting working papers.)	______	______	______
9. Has the Subsequent Events Review Program been completed?	______	______	______
10. Have all communications been made as required by SAS Nos. 53, 54, and 60 for:			
a. Internal control structure related matters?	______	______	______
b. Irregularities?	______	______	______
c. Illegal acts?	______	______	______
11. If the organization has an audit committee or other formally designated group responsible for oversight of the financial reporting process, have the other matters required by SAS No. 61 been communicated?	______	______	______
12. If the organization is a recipient of governmental financial assistance, have the communication requirements of the Yellow Book and OMB Circular A-133 been met as to:			
a. Internal control structure related matters?	______	______	______
b. Irregularities?	______	______	______
c. Illegal acts?	______	______	______

13. Additional comments:

____

____

Prepared by: ______________________________ Date: ______________________
(In-Charge)

Reviewed by: ______________________________ Date: ______________________
(Engagement Partner)

ENGAGEMENT PERFORMANCE REVIEW CHECKLIST
(Continued)

Part II (To be completed by engagement partner) Initials

1. I have reviewed the engagement working papers, work programs, checklists, etc. to the extent required by firm policy. ________

2. I have reviewed the financial statements for appropriate form and conformity with professional standards. ________

3. I have reviewed the following reports for conformity with professional standards, and have determined that the conclusions reached in the working papers support these reports:

    a. Report on the financial statements. ________

    b. Report on Organization's internal control structure. ________

    c. Report on Organization's compliance with laws and regulations. ________

    d. Report on Schedule of Federal Awards. ________

    e. Report on Organization's internal control structure over federal awards. ________

    f. Report on Organization's compliance with laws and regulations governing federal awards. ________

4. I authorize issuance of the financial statements and the report(s). ________

Prepared by: ______________________ Date: ______________________
(Engagement Partner)

8.911

Technical Review Checklist

Client: ______________________________

Financial Statement Date: ______________________________

Technical Reviewer: ______________________ Date: ______________

INSTRUCTIONS:

This checklist should be completed by the technical reviewer on those engagements in which a technical review is required by the firm's quality control policies and procedures.

	Initials
1. Review the financial statements for appropriate form and content. Consider the appropriateness of:	
a. Titles.	______
b. Captions.	______
c. Classifications within captions.	______
d. Descriptions.	______
e. Reference to auditor's report and financial statement notes.	______
2. Compare the financial statements and related notes to the Financial Statement Disclosure Checklist. Determine whether the financial statement presentation and disclosures are complete and in accordance with GAAP.	______
3. Review the financial statements for any obvious departures from GAAP or OCBOA.	______
4. Read the auditor's report (including reports issued to comply with Government Auditing Standards or OMB Circular A-133) for appropriateness and conformity with professional standards.	______

TECHNICAL REVIEW CHECKLIST
(Continued)

Initials

5. If applicable, review the engagement checklists:

   a. To determine that they support the conclusions reached in the engagement. ________

   b. For potential problems. ________

6. Describe any problems noted and the way they were resolved. ________

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____

____

Illustrative Audit Reports
& Financial Statements

CHAPTER 9

ILLUSTRATIVE AUDITOR'S REPORTS AND FINANCIAL STATEMENTS

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CHAPTER 9

ILLUSTRATIVE AUDITOR'S REPORTS AND FINANCIAL STATEMENTS

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CHAPTER 9

ILLUSTRATIVE AUDITOR'S REPORTS AND FINANCIAL STATEMENTS

9.000 INTRODUCTION

9.001 This chapter discusses matters the auditor needs to consider in preparing or reporting on financial statements, including:

- Procedures for drafting and approving issuance of reports and financial statements (section 9.002)
- Discussion of various reporting situations and recommendations on formatting auditor's reports (section 9.100)
- Examples of auditor's reports (section 9.200)
- Sample financial statements (section 9.300)
- Financial statement disclosure checklist, including a checklist for the auditor's report (section 9.400)
- Financial Statement Control Form (section 9.500)

Drafting and Approving Issuance of Reports and Financial Statements

9.002 Auditors should establish policies and procedures that would define responsibility regarding the preparation and review of the auditor's report, the financial statements and the notes to the financial statements. Firms should identify situations when the auditor's report, financial statements, and engagement working papers should be reviewed by someone not associated with the engagement. This review is discussed in Chapter 8, sections 8.711-8.713, and this review is documented on the Technical Review Checklist in section 8.911.

9.003 The Financial Statement Control Form, located in section 9.500, will help the auditor document his or her compliance with the firm's policies regarding the review process. It should be completed when the first draft of the report and financial statements is prepared, and should be signed by all individuals performing the required procedures. It also documents the engagement partner's final approval to release the report to the client.

Financial Statements Included in this Manual

9.004 Sample financial statements are presented in sections 9.301–9.306 to assist you in preparing financial statements for your clients. The sample financial statements in sections 9.301–9.303 have been prepared for organizations that have adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 116, *Accounting for Contributions Received and Contributions Made*, and SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*. The sample financial statements in sections 9.304–9.306 have been prepared for organizations that have not adopted SFAS No. 116 and No. 117.

9.100 REPORTING ON AUDITED FINANCIAL STATEMENTS

Association With Financial Statements

9.101 Auditors are associated with financial statements when:

- They consent to the use of their name in documents containing financial statements they have audited.
- They submit financial statements they prepared or assisted in preparing to clients or others, even though the firm's name is not included with the statements.

9.102 It is important to note that this definition applies to situations in which the auditor has been engaged to *audit* the financial statements. It does not apply to compilation and review engagements.

Report Preparation

9.103 Firms should develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies:

- **Letterhead.** The report should be presented on firm letterhead.
- **Addressee.** The report should be addressed to the governing board or board of trustees of the organization whose financial statements are being audited as follows:

  The Board of Trustees
  XYZ Not-for-Profit Organization
  City, State Zip Code

- **Salutation.** A salutation should not be included on the report.
- **Report Signing.** The firm name should be manually signed by the engagement partner after completing the Financial Statement Control Form in section 9.500. The words "Certified Public Accountants" should be excluded from the signature if they are a normal part of the firm's letterhead.
- **Report Dating.** Audit reports should be dated as of the last day of field work.

  The date should be presented at the bottom of the page along with the city and state, if not included in firm letterhead, as follows:

  City, State
  April 5, 199Y

If significant subsequent events are discovered before the report is issued, but after the completion of field work, the report should be dual-dated for the subsequent event. Subsequent events affecting previously issued reports that are being reissued will also cause the report to be dual-dated. The following illustrates dual-dating:

> City, State
> February 26, 199Y, except for Note X as to which the date is
> April 5, 199Y

- **Level of Service.** The level of service performed and the nature of the report are outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, i.e., in the event of a step-up or step-down in the level of service.

  The partner should approve any step-up or step-down in level of service. A step-up in level of service may occur after a revised understanding with the client. A step-down in level of service should occur only after carefully evaluating the reasons for change because the reasons for the change may also affect the report on lower levels of service. Limitations on the scope of an audit, for example, may also preclude issuing a review or compilation report.

  If more than one level of service is performed for financial statements of the same period, e.g., compilation and audit, the financial statements should be accompanied only by the report on the highest level of service performed.

Reports on Audited Financial Statements

9.104 Generally accepted auditing standards (GAAS) establish reporting responsibilities. The four standards of reporting stated in AU 150.02 are:

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP).

2. The report shall identify those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall contain either an expression of opinion regarding the financial statements taken as a whole, or a statement that an opinion cannot be expressed. When an opinion cannot be expressed, the reasons should be stated. In all cases, the report should contain a clear-cut indication of the degree of responsibility, if any, the auditor is taking.

Standard Report

9.105 The standard auditor's report prescribed by Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AU 508), should be used when the auditor has formed an opinion, based on the application of GAAS, that the financial statements present fairly, in all material respects, an entity's financial position, results of activities, and cash flows in accordance with GAAP. It should address all financial statements presented. A standard auditor's report for the presentation of comparative financial statements is illustrated in section 9.201.

Report When Only a "Total" Column for the Prior Year is Presented

9.106 Although not-for-profit organizations are not required to use fund accounting, many do so in order to properly segregate restricted from unrestricted funds. Some organizations use a multi-column financial statement format to show the statements of financial position, activities, and cash flows classified by unrestricted, temporarily, and permanently restricted. If comparative financial statements for the prior year are to be presented, this multi-column format can be cumbersome for preparers and confusing for the users of the financial statements. As a result, many organizations present only the total of all classes of net assets for the prior year.

9.107 Many not-for-profit organizations frequently present information in total of all classes of net assets for the prior period(s) in an effort to save space and avoid cumbersome or confusing formats. AU 508.74 footnote 27 indicates that a continuing auditor need not report on the prior-period financial statements whenever only summarized comparative financial information of the prior period(s) is presented. If the client requests the auditor to express an opinion on the prior period(s) as well as the current period, the auditor must determine if the presentation contains sufficient detail to constitute a fair presentation in conformity with GAAP and express an opinion on it. If the auditor determines that the information does not constitute a fair presentation in conformity with GAAP, he or she would be required to issue a qualified or adverse opinion on the prior year's information.

Modifications of the Standard Auditor's Report

9.108 SAS No. 58 describes situations that may require auditors to modify the standard report, and also provides illustrations of the appropriate modifying language. These modifications, which are discussed in greater depth in the following sections, are:

> *Explanatory Language*. A wide variety of situations may arise that require a modification of the standard auditor's report, without affecting the expression of an unqualified opinion. Some of the more common of such situations are uncertainties, going-concern problems, part of the financial statements have been audited by another auditor, or a significant change in accounting principles. The explanatory paragraph for situations that do not affect the auditor's opinion should be placed after the opinion paragraph.
>
> *Qualified Opinion*. Qualified opinions result from two general categories of situations: scope limitations and departures from GAAP. A scope limitation arises when the auditor has been unable to perform all of the auditing procedures he or she believes are necessary to express an unqualified opinion on the financial statements. Financial statements containing a material departure from GAAP, including inadequate disclosures in the financial statements, may lead the auditor to qualify his or her opinion. Both situations require that an explanatory paragraph, preceding the opinion paragraph, be included that describes the nature of the scope limitation or the departure from GAAP.

Disclaimer of Opinion. A disclaimer of opinion may be required when:

- The scope of the audit has been restricted so significantly that the auditor does not have a basis for forming an opinion on the financial statements. In this case, an explanatory paragraph, preceding the disclaimer paragraph, should be included in the auditor's report to explain all significant reasons for the disclaimer.

- The auditor is not independent, in which case a one-paragraph disclaimer is issued (applies for publicly held entities only). A compilation report with a lack of independence noted should be issued for nonpublic entities.

Adverse Opinion. An adverse opinion should be expressed on financial statements that do not present fairly the entity's financial position, results of operations, or cash flows in conformity with GAAP. In other words, the auditor concludes that the financial statements are *not* fairly presented in accordance with GAAP. Issuance of an adverse opinion requires inclusion of an explanatory paragraph, preceding the opinion paragraph, that explains all of the reasons for the adverse opinion and, if practicable, the effects of the subject matter of the adverse opinion on the financial statements.

Scope Limitations

9.109 Restrictions on the scope of an audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient, competent evidential matter, or an inadequacy in the client's accounting records, may require a qualified opinion or a disclaimer of opinion. Deciding whether to qualify or disclaim is a matter of judgment, and generally the primary factor in this decision is the materiality of the financial statement items affected. However, other factors should be considered, such as the pervasiveness of the effects of the omitted auditing procedures and the nature of the financial statement items affected.

Departures From GAAP

9.110 Unacceptable Principles. Significant departures from GAAP require that the auditor issue either a qualified or adverse opinion. Choosing between a qualified or adverse opinion depends on the magnitude of the departure. While the materiality of the effects of the departure is a primary consideration, the auditor should also consider the pervasiveness of the departure, such as the number of financial statement items affected, the importance of the departure to the organization's activities and its ability to obtain funding, and the dollar effect of the departure on individual financial statement items as well as the statements as a whole.

9.111 For both qualified and adverse opinions, an explanatory paragraph should be included, preceding the opinion paragraph, that describes all of the substantive reasons for the auditor's opinion, and the effects on the financial statements, if readily determinable. If it is not practical to determine the effects of the departure, the explanatory paragraph should contain a statement to that effect. If information about the effects of the departure are described in the notes, the explanatory paragraph can be shortened by referring to the note.

9.112 Inadequate Disclosure. Departures from GAAP include not just inappropriate application of accounting principles, but also omitted or inadequate disclosures in the financial statements. Such situations require the auditor to add an explanatory paragraph, preceding the opinion paragraph, that describes the nature of the inadequate or omitted disclosure and, if practical, the information that should have been disclosed. The significance of the omitted or inadequate disclosure will determine whether a qualified or adverse opinion is appropriate.

9.113 Report Modification. The opinion paragraph for a qualified opinion due to a departure from GAAP should include the words "except" or "exception" and a reference to the explanatory paragraph that describes that departure. Adverse opinions should include language such as "do not present fairly" and should also include a reference to the explanatory paragraph.

Errors, Irregularities, and Illegal Acts

9.114 If the financial statements are materially affected by an error, irregularity or illegal act that has not been properly accounted for and disclosed, a qualified or adverse opinion should be considered. If the auditor is precluded from applying necessary procedures or from obtaining sufficient information to conclude whether an error, irregularity or illegal act that could be material to the financial statements has occurred, a qualified or disclaimer of opinion should be issued. All such matters should be discussed immediately with the engagement partner.

9.115 If a client will not accept modification of the report under the circumstances above, the firm should consider withdrawing from the engagement and consulting with legal counsel.

Consistency Exceptions

9.116 Accounting changes affecting consistency include:

- A change from one generally accepted accounting principle to another method, practice or principle that is different from the one previously used
- A change from an unacceptable to an acceptable principle (correction of an error)
- A change in financial statement classification that significantly affects financial position or results of operations (e.g., classification of an item in earnings from operations as other income or expense)
- A change in reporting entity.

9.117 Accounting changes not normally affecting consistency include:

- Initial adoption of an existing accounting principle for a new event or transaction
- Insignificant reclassification
- Correction of errors not involving a principle
- Changes in accounting estimates.

9.118 The nature of the accounting change will determine whether prior periods should be restated or a cumulative adjustment should be included in current activities. In either event, the change should be disclosed in the notes to the financial statements and in the auditor's report in a separate paragraph following the opinion paragraph. The auditor's concurrence with a change is implicit unless he or she takes exception to the change. The opinion paragraph would be standard unless the change is to an unacceptable principle or method, the change is not justified, or a prospective change of a principle requiring retroactive adjustment is not discussed. In such situations, either a qualified or adverse opinion should be issued.

9.119 Uncertainties. Uncertainties are significant circumstances, events, or transactions affecting the financial statements, the outcome of which cannot be reasonably estimated. Uncertainties are a particularly complex area because they can result in a qualified or adverse opinion due to a departure from GAAP, a qualified opinion or disclaimer due to a scope limitation, or merely an explanatory paragraph that does not affect the auditor's opinion. SFAS No. 5, *Accounting for Contingencies* (AC C59), and SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, (effective for fiscal years ending after December 15, 1995; early application encouraged) are the primary authoritative pronouncements for financial statement presentation and disclosure of uncertainties.

9.120 Uncertainties Not Requiring Modification of the Opinion. Paragraph 23 of SAS No. 58 (AU 508.23) states that when the auditor has concluded that an uncertainty exists, he or she should consider whether the matter warrants disclosure in the notes to the financial statements and inclusion of an explanatory paragraph in the auditor's report. This assessment is based on the likelihood that the resolution of the uncertainty will result in a material loss. If management and the auditor believe the likelihood of a material loss is "remote," no explanatory paragraph or disclosure would be required. If the likelihood of a material loss is "probable" and, in some instances "reasonably possible," the uncertainty should be disclosed in the notes to the financial statements and the auditor should include an explanatory paragraph in the report. The explanatory paragraph should describe the uncertainty and indicate that the outcome cannot presently be determined. This paragraph may be shortened by referring to information in the notes to the financial statements. Because this situation does not result in a modified opinion, no mention should be made of the uncertainty in the introductory, scope, or opinion paragraphs of the report.

9.121 Scope Limitation. A qualified opinion or disclaimer of opinion may be required if the auditor is unable to obtain sufficient information to support management's assertions about the uncertainty. In some ways, information about uncertainties may always be considered insufficient because it is dependent on future, unknown events. However, if the auditor determines that information did or does exist, but it is unavailable to him or her (e.g., because the information was destroyed or management will not allow the auditor to have access to it), the auditor should consider modifying the report for a scope limitation.

9.122 Departures From GAAP. SAS No. 58, paragraph 19 (AU 508.19) describes three categories of departures from GAAP involving uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

9.123 As mentioned in section 9.119, SFAS No. 5 and SOP 94-6 set forth the disclosure requirements for uncertainties. A qualified or adverse opinion due to a departure from GAAP may be necessary if the auditor concludes that the uncertainty has not been appropriately disclosed.

9.124 Also, a departure from GAAP may exist if management has made inappropriate estimates of future events in applying accounting principles (such as the use of unreasonable expected lives of depreciable assets for calculating depreciation) or in making other accounting estimates.

9.125 **Resolution of the Uncertainty.** When an auditor has issued a report for a previous period that includes a paragraph for an uncertainty, and this uncertainty is resolved in the current period, the explanatory paragraph should be removed when issuing comparative financial statements that includes the previous period, and any effects of the uncertainty should be recorded in the period of resolution.

9.126 An example of an explanatory paragraph (following the opinion paragraph) describing an uncertainty follows:

> As discussed in Note X to the financial statements, the Department of Health and Human Services has claimed that $_____ of costs charged to research grants were not allowable under the terms of the grants. As a result, the Organization could become liable to the Federal Government for such costs. The ultimate liability, if any, cannot presently be determined. Accordingly, no provision for any liability that may result has been made in the accompanying financial statements.

Going-Concern Uncertainties

9.127 If the auditor concludes that there is substantial doubt about the organization's ability to continue as a going concern, the situation should be described in an explanatory paragraph, following the opinion paragraph. The explanatory paragraph should describe the principal events and conditions related to the going concern, their possible effects on the financial statements, management's plans for corrective actions, and the auditor's conclusion that substantial doubt exists. SAS No. 64, *Omnibus Statement on Auditing Standards*, imposes the additional requirement that the explanatory paragraph include the terms "substantial doubt" and "going concern."

9.128 If financial statement disclosures about the uncertainty are inadequate, a departure from GAAP exists, and either a qualified or adverse opinion may be necessary. An opinion indicating a going-concern uncertainty that is adequately disclosed in the notes to the financial statements is presented in section 9.203.

Reporting on Supplementary Information

9.129 Supplementary information includes detailed schedules of other data that are not necessary for a fair presentation of the basic financial statements. Whenever supplementary information is included in an auditor-submitted document, the auditor must indicate the degree of responsibility, if any, taken for this information. A separate report on the supplementary information or a separate paragraph in the report on the basic financial statements may be used to report on supplementary information. If a separate report is issued, it should be on the firm's letterhead and be signed. The report date should be the same as for the report on the basic financial statements.

9.130 Reports on supplementary information should express or disclaim audit assurance. The extent and results of testing of supplementary information will determine the firm's responsibility in each circumstance. Illustrated in sections 9.204–9.206 are sample auditor's reports on the basic financial statements, including supplementary information. If a separate report on the supplemental information is issued, the first sentence of that report should refer to the report on the basic financial statements.

Reporting on a Single Statement

9.131 In certain circumstances, an engagement to audit a single financial statement may be accepted. Generally these engagements, called "limited reporting engagements," are a result of the client needing a single financial statement to fulfill a contractual requirement, such as an organization that must provide its landlord with an audited income statement for purposes of calculating rent. Also, entities that have never been audited often request an audit of the statement of financial position only for the first year, with the intention of having audits of the entire financial statements in the future. Generally such engagements are accepted as long as there is a legitimate reason for the limited engagement, and provided there are no restrictions on access to information underlying the financial statements or on the scope of the procedures the auditor needs to perform. In such engagements, an unqualified opinion can be expressed on the financial statement the auditor was engaged to audit. If the other financial statements are presented, a disclaimer of opinion should be issued on those statements.

Relying on the Work of a Specialist

9.132 The firm may engage specialists to perform certain work supporting representations in the financial statements. SAS No. 73, *Using the Work of a Specialist*, states that if a review of the specialist's work finds it satisfactory, and if no report modification is necessary because of the specialist's findings, there is no need to refer to the specialist's work.

9.133 If the specialist's work is not adequate to support the financial statement representations, a qualification or disclaimer of opinion because of a scope limitation may be required. Findings of the specialist that indicate the financial statements are not in accordance with GAAP may require a qualified or adverse opinion.

Lack of Independence

9.134 For public entities, whenever the auditor is not independent with respect to a client whose financial statements have been audited, a disclaimer of opinion should be issued. For nonpublic entities, the firm must issue a compilation report that includes a statement that the firm is not independent. Most not-for-profit organizations would be nonpublic entities, and accordingly, the compilation report with the statement that the firm is not independent would be appropriate in this circumstance. An illustration of a compilation report indicating the firm is not independent is provided in section 9.207.

Reissuance of Audit Reports as Predecessors

9.135 If the auditor is asked by a former client to reissue its report on prior-period financial statements, he or she should inform the client of the procedures necessary to comply with that request. If the client agrees to perform these procedures, and pay the fee for these services, the auditor would ordinarily agree to reissue the report.

9.136 Before reissuing a report, the auditor should consider whether the previous opinion on those prior-period statements is still appropriate. Differences in the current form and presentation of the financial statements for the prior period, or the possibility of material subsequent events affecting those financial statements, could make the previous opinion inappropriate. The auditor should perform at least the following procedures:

1. Read the financial statements of the current period.

2. Compare the prior-period financial statements with the financial statements to be presented in comparative format by the successor.

3. Obtain a letter of representation from the successor auditor. The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior-period financial statements.

9.137 If the firm reissues its report without change, the previous report date should be used. If the financial statements or the report of the prior period are revised, the report should be dual-dated as to the event or matter causing the revision. There should be no reference to the report or the work of the successor auditor.

Reissuance of the Audit Report Subsequent to the Date of Original Issue

9.138 Occasionally the firm may be requested by a client to furnish additional copies of a previously issued report. Approval of the engagement partner is necessary to reissue a previously issued report. In such situations the authors recommend that the engagement partner prepare a memo stating the reasons for the reissuance and that he or she is not aware of any circumstances occurring since the original report date that would require adjustment to or disclosure in the financial statements.

9.139 Use of the original report date removes any implication that records, transactions, or events after that date have been audited or reviewed. Although the auditor has no responsibility to make further investigation or inquiry as to subsequent events, the engagement partner should consider a brief discussion with the client's chief financial or executive officer before reissuing his or her report.

Subsequent Discovery of Facts Existing at Report Date

9.140 Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuing his or her report, the auditor may become aware of information that affects the financial statements upon which he or she has previously reported. When becoming aware of such information, the auditor should determine the reliability of the information and whether such information existed at the date of the report. The engagement partner should make inquiries of client management in this regard.

9.141 If the information is reliable and did exist at the date of the report, if the report would have been affected if the information had been known at the report date, and if there are persons relying on the financial statements who would attach importance to the information, the auditor should take action to prevent future reliance on the report. If the engagement partner concludes that action should be taken to prevent future reliance on the report, he or she should advise the client to make appropriate disclosure of the newly discovered facts and their impact on the financial statements to the persons known to be, or likely to be, relying on the financial statements and related report. Disclosures should be made in one of the following ways:

- If the effects of subsequent facts can be promptly determined, disclosure should include reissuing revised financial statements and a revised report. The reasons for the revision usually should be described in a note to the financial statements and referred to in the auditor's report.
- If the current financial statements have not been released, appropriate disclosure of the revision of the prior-period financial statements can be included therein.
- When the effects of subsequent facts cannot be readily determined, revisions of financial statements and reports may be delayed. In this case, persons known to be, or likely to be, relying on the financial statements should be notified by the client that the financial statements and related reports should not be relied on, and that revised financial statements and report will be forthcoming.

9.142 If the client refuses to make the disclosures discussed above, the auditor should contact legal counsel. He or she should also notify all members of the board of directors of such refusal and that the firm will take the following steps to prevent future reliance on its report:

- Notify the client that the auditor's report must no longer be associated with the financial statements.
- Notify any applicable regulatory agencies that the report should no longer be relied upon.
- Notify each person known to be relying on the financial statements that the report should no longer be relied upon.

9.143 If the auditor's investigation of the subsequently discovered information is satisfactory, and he or she has determined that the information is reliable, the notifications in section 9.142 should include a description of the effects of the information on the financial statements. If the client has not cooperated and, as a result, the auditor has been unable to conduct a satisfactory investigation, the auditor does not need to indicate the details of the information. Instead, he or she should indicate that the auditor's report must no longer be relied upon nor should the auditor be associated with the financial statements.

Special Reports

9.144 Special reports are those issued in connection with:

- Financial statements that are prepared in accordance with an other comprehensive basis of accounting (OCBOA) other than GAAP (e.g., cash, modified-cash, or tax-basis).
- Specified elements, accounts, or items of a financial statement.
- Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements.

- Financial presentations to comply with contractual agreements or regulatory provisions.
- Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's report.

9.145 SAS No. 62, *Special Reports*, requires that an auditor's report issued for financial statements presented on an other comprehensive basis of accounting differ from a report on GAAP financial statements in the following ways:

a. The financial statements described in the first and the opinion paragraphs will conform to the titles of the OCBOA financial statements. To avoid confusion OCBOA financial statements should not use unmodified GAAP titles such as "statement of financial position" and "statement of activities." Modified titles such as "statement of financial position— modified cash basis," "statement of assets and liabilities arising from cash transactions," and "statement of support and revenue collected and expenses paid" are common in practice.

b. An extra paragraph describing the basis of presentation is included immediately preceding the opinion paragraph.

c. The opinion paragraph makes reference to "presents fairly...*on the basis of accounting described in Note X.*" Note that a common error in practice is to make reference to "presents fairly...in conformity with GAAP."

An example of an auditor's report on a not-for-profit organization following the modified cash basis is shown in section 9.208.

Special-Purpose Presentation

9.146 Special-purpose financial presentations are those that are prepared in accordance with a contractual agreement or regulatory provision. They may represent a.) an incomplete presentation of an organization's assets, liabilities, revenues and support and expenses that is otherwise in conformity with GAAP or OCBOA, or b.) a complete set of financial statements or single financial statement prepared on a basis prescribed by an agreement that is not in accordance with GAAP or OCBOA. Of the two types of special-purpose presentations, incomplete presentations otherwise in accordance with GAAP or OCBOA are most common.

9.147 If a not-for-profit organizations receives funds from a regulatory agency or pursuant to a contractual agreement and the auditor is asked to report on an incomplete GAAP or OCBOA presentation specified by the agency or contract, SAS 62, par. 25 (AU 623.25) indicates that the auditor's report should include:

a. A paragraph explaining what the presentation is intended to present and a reference to a note in the financial statements that describes the basis of presentation.

b. If the basis of presentation is in conformity with GAAP,[1] that the presentation is not intended to be a complete presentation of the organization's assets, liabilities, revenues and support and expenses.

c. A paragraph expressing the auditor's opinion related to the fair presentation, in all material respects, of the information the presentation is intended to present in conformity with GAAP or OCBOA. If the auditor concludes that the information is not presented fairly, an explanatory paragraph preceding the opinion paragraph and a reference to the explanatory paragraph are required.

d. A paragraph restricting the report's distribution to those within the organization and to the knowledgeable parties (the regulatory agency or the contracting parties).

[1] If the basis is OCBOA, the paragraph should also state that the basis is a comprehensive basis of accounting other than GAAP and that it is not intended to be a complete presentation of the organization's assets, liabilities, revenues, and support and expenses on the basis described.

9.200 SAMPLE AUDITOR'S REPORTS

9.201 Standard Auditor's Report

Independent Auditor's Report

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We have audited the accompanying statements of financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the related statements of activities and cash flows[2] for the years then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the results of its activities and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

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[2] As discussed in Chapter 2, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*, in June 1993. This Statement changed the basic financial statements that are required to be presented in not-for-profit organization financial statements. The sample auditor's reports found in this section have been updated to reflect financial statements issued in accordance with SFAS No. 117. Auditors who are engaged to perform audits for not-for-profit organizations that have not yet adopted the provisions of this Statement should modify their reports accordingly.

9.202 Single Year With Comparative Totals

Independent Auditor's Report

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We have audited the accompanying statements of financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4 and the related statements of activities and cash flows[3] for the year ended December 31, 19X4.[4] These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the results of its activities and its cash flows for the year ended December 31, 19X4 in conformity with generally accepted accounting principles.

[Signature]

[Date]

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[3] See footnote 2, section 9.201.

[4] In this example, the December 31, 19X3 statement of financial position is presented in its entirety and the statements of activities and cash flows for the year ended December 31, 19X3 are presented on a summarized basis. Therefore the auditor is reporting on the December 31, 19X3 statement of financial position, but is not reporting on the summarized statements of activities and cash flows for 19X3. See sections 9.106–9.107 for additional information.

9.203 Going-Concern Uncertainty

Independent Auditor's Report

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We have audited the accompanying statements of financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the related statements of activities and cash flows[5] for the years then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the results of its activities and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that the Organization will continue as a going concern. As discussed in Note X to the financial statements, the Organization has been unable to raise the necessary matching funds to secure federal assistance that raises substantial doubt about the Organization's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[Signature]

[Date]

[5] See footnote 2, section 9.201.

9.204 Financial Statements Accompanied by Supplementary Information — Unqualified

Independent Auditor's Report

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We have audited the accompanying statements of financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the related statements of activities and cash flows[6] for the years then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the results of its activities and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplementary information presented on pages x through z is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature]

[Date]

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[6] See footnote 2, section 9.201.

9.205 Financial Statements Accompanied by Supplementary Information — Disclaimer on Part of Supplementary Information

Independent Auditor's Report

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We have audited the accompanying statements of financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the related statements of activities and cash flows[7] for the years then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the results of its activities and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented on pages x through z is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audits of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[Signature]

[Date]

[7] See footnote 2, section 9.201.

9.206 Financial Statements Accompanied by Supplementary Information — Disclaimer on All of Supplementary Information

Independent Auditor's Report

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We have audited the accompanying statements of financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the related statements of activities and cash flows[8] for the years then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Not-for-Profit Organization as of December 31, 19X3 and 19X4, and the results of its activities and its cash flows for the years then ended in conformity with generally accepted accounting principles.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information presented on pages x through z is presented for purposes of additional analysis and is not a required part of basic financial statements. Such information has not been subjected to the auditing procedures applied in the audits of the basic financial statements, and, accordingly, we express no opinion on it.

[Signature]

[Date]

[8] See footnote 2, section 9.201.

9.207 Compilation Report—Lack of Independence

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We have compiled the accompanying statement of financial position of XYZ Not-for-Profit Organization as of June 30, 19X4 and the related statements of activities and cash flows[9] for the year then ended, in accordance with Statements of Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management. We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

We are not independent with respect to XYZ Not-for-Profit Organization.

[Signature]

[Date]

[9] See footnote 2, section 9.201.

9.208 Other Comprehensive Basis of Accounting — Modified Cash Basis

Independent Auditor's Report

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We have audited the accompanying statement of financial position—modified cash basis of XYZ Not-for-Profit Organization as of December 31, 19X4, and the related statement of activities—modified cash basis[10] for the year then ended. These financial statements are the responsibility of the Organization's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As described in Note X, these financial statements were prepared on a modified cash basis, which is a comprehensive basis of accounting other than generally accepted accounting principles.

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities of XYZ Not-for-Profit Organization as of December 31, 19X4, and its support, revenue, and expenses for the year then ended, on the basis of accounting described in Note X.

[Signature]

[Date]

[10] See footnote 2, section 9.201.

9.300 SAMPLE FINANCIAL STATEMENTS

9.301 *SFAS 116 and 117 have been adopted.*

The illustrative financial statements do not include all disclosures and presentation items promulgated.

Sample Voluntary Health and Welfare Organization

Big Brothers of Any County, Inc.

Statement of Financial Position

December 31, 19X4

Assets	
Current assets	
Cash and cash equivalents	$ 36,450
Contributions receivable (Note 2)	42,100
Leasehold interest, current (Note 3)	34,500
Prepaid expenses	3,800
Deposit	2,000
Total current assets	118,850
Noncurrent assets	
Vehicles and office equipment (Note 4)	26,400
Leasehold interest, noncurrent (Note 3)	213,950
Investments (Note 5)	67,800
Total noncurrent assets	308,150
Total assets	$ 427,000
Liabilities and Net Assets	
Current liabilities	
Accounts payable and accrued expenses	$ 34,500
Net assets	
Unrestricted	68,150
Temporarily restricted (Note 9)	266,550
Permanently restricted (Note 10)	57,800
Total net assets	392,500
Total liabilities and net assets	$ 427,000

The accompanying notes are an integral part of these financial statements.

Sample Voluntary Health and Welfare Organization

Big Brothers of Any County, Inc.

Statement of Activities

Year Ended December 31, 19X4

Changes in Unrestricted Net Assets	
Revenues	
Contributions	$ 91,400
Program revenue	212,600
Special events, net of direct costs in the amount of $14,000	22,200
Donated goods and facilities	34,800
Donated services	4,500
Interest and dividends	3,050
Total unrestricted revenue	368,550
Net assets released from restrictions	
Expiration of time restrictions	27,000
Total unrestricted revenues and other support	395,550
Expenses	
Program expenses	335,300
Management and general	41,350
Fund-raising expenses	46,050
Total expenses	422,700
Decrease in unrestricted net assets	(27,150)
Changes in Temporarily Restricted Net Assets	
Contributions	18,100
Donated facilities	248,450
Net assets released from restrictions	(27,000)
Increase in temporarily restricted net assets	239,550
Changes in Permanently Restricted Net Assets	
Contributions to endowment fund	10,000
Interest income	500
Increase in permanently restricted net assets	10,500
Increase in Net Assets	222,900
Net Assets at Beginning of Year, Restated (Note 8)	169,600
Net Assets at End of Year	$ 392,500

The accompanying notes are an integral part of these financial statements.

Sample Voluntary Health and Welfare Organization

Big Brothers of Any County, Inc.

Statement of Cash Flows

Year Ended December 31, 19X4

Cash Flows From Operating Activities	
Increase in net assets	$ 222,900
Adjustments to reconcile change in net assets to net cash used by operating activities:	
Depreciation	8,500
Contributions restricted for long-term investment	(258,450)
Increase in contribution receivable	(3,100)
Increase in prepaid expenses	(2,000)
Increase in accounts payable and accrued expenses	7,800
Net cash used by operating activities	(24,350)
Cash Flows From Investing Activities	
Purchase of office equipment	(6,500)
Cash Flows From Financing Activities	
Proceeds from contributions restricted for building fund	10,000
Interest and dividends restricted for reinvestment	500
Net cash provided by financing activities	10,500
Net Decrease in Cash and Cash Equivalents	(20,350)
Cash and Cash Equivalents at Beginning of Year	56,800
Cash and Cash Equivalents at End of Year	$ 36,450
Supplemental data:	
Noncash investing and financing activities:	
Gift of leasehold rights	$ 248,450

The accompanying notes are an integral part of these financial statements.

Sample Voluntary Health and Welfare Organization

Big Brothers of Any County, Inc.
Statement of Functional Expenses
Year Ended December 31, 19X4

		Supporting Services		
	Program	Management and General	Fund-Raising	Total
Salaries	$ 197,000	$ 22,000	$ 22,000	$ 241,000
Rent	36,500	3,000	3,000	42,500
Insurance	22,000	2,300	2,300	26,600
Payroll taxes	17,200	1,900	1,900	21,000
Outside services	8,000	—	9,000	17,000
Telephone	9,500	1,500	1,500	12,500
Office supplies	8,500	2,000	1,500	12,000
Depreciation	6,000	1,250	1,250	8,500
Lease and maintenance	5,600	900	900	7,400
Dues	7,000	—	—	7,000
Accounting and legal	—	4,500	—	4,500
Postage	6,200	1,100	1,800	9,100
Advertising and recruitment	3,600	—	—	3,600
Mileage	2,000	300	300	2,600
Newsletter	2,500	—	—	2,500
Awards and recognition	2,500	—	—	2,500
Miscellaneous	1,200	600	600	2,400
	$ 335,300	$ 41,350	$ 46,050	$ 422,700

The accompanying notes are an integral part of these financial statements.

Sample Voluntary Health and Welfare Organization

Big Brothers of Any County, Inc.

Notes to Financial Statements

For the Year Ended December 31, 19X4

Note 1 — Nature of Organization and Significant Accounting Policies

Big Brothers of Any County, Inc. (the Organization) is a nonprofit organization dedicated to helping single-parent children by building friendships through a one-on-one matching program with screened a dult volunteers.

Support and Expenses

Contributions received and unconditional promises to give are measured at their fair values and are reported as an increase in net assets. The Organization reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets, or if they are designated as support for future periods. When a donor restriction expires, that is, when a stipulated time restriction ends or purpose restriction is accomplished, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activity as net assets released from restrictions. Donor-restricted contributions whose restrictions are met in the same reporting period are reported as unrestricted support.

The Organization reports gifts of goods and equipment as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the Organization reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service.

Expenses are recorded when incurred in accordance with the accrual basis of accounting.

Donated Services, Goods and Facilities

A substantial number of volunteers have donated approximately 20,000 hours to the Organization's program services and fund-raising campaigns during the year; however, these donated services are not reflected in the financial statements since the services do not require specialized skills. Donated professional services (which include accounting and legal services) are reflected in the statement of activities at their fair value.

Materials and other assets received as donations are recorded and reflected in the accompanying financial statements at their fair values at the date of receipt.

Conditional Promises to Give

As of December 31, 19X4, the Organization had received conditional promises to give aggregating $13,000 that are contingent upon the Organization's raising matching corporate gifts.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash held in checking and money market accounts and certificates of deposit with maturities of less than 90 days. At year-end and throughout the year, the Organization's cash balances were deposited in several banks. Management believes the Organization is not exposed to any significant credit risk on cash and cash equivalents.

Investments

Investments are stated at cost which approximates market value.

Vehicles and Office Equipment

Vehicles and office equipment are carried at cost. Depreciation is computed on the straight-line method.

Advertising Costs

Advertising costs are expensed as incurred.

Income Taxes

The Organization is a nonprofit corporation whose revenue is derived from contributions and other fund-raising activities and is not subject to federal or state income taxes.

Note 2 — Contributions Receivable

Contributions receivable (in less than one year)	$ 52,600
Less allowance for uncollectible contributions	(10,500)
	$ 42,100

Note 3 — Leasehold Interest

In December of 19X4, the Organization received a contribution of leasehold rights for 3,000 square feet of office space for a ten-year term. The Organization's monthly rent under a signed lease agreement is $1 per month. The present value of the fair market rent of $3,000 per month over the lease term, which was determined using an 8% discount rate, has been recognized as temporarily restricted support in the current year. The amounts are classified as follows:

Future leasehold rights	$ 248,450
Less current portion	(34,500)
Leasehold interest — noncurrent	$ 213,950

The expected time expirations on restrictions of leasehold interests are:

Year Ending December 31,	Amount
19X5	$ 34,500
19X6	31,900
19X7	29,500
19X8	27,200
19X9	25,100
Thereafter	100,250
	$ 248,450

Note 4 — Vehicles and Office Equipment

Office equipment	$ 29,500
Leasehold improvements	12,400
Vehicles	14,300
	56,200
Less accumulated depreciation	(29,800)
	$ 26,400

Note 5 — Investments

The Organization's investments at December 31, 19X4 included approximately $57,800 of equity securities and $10,000 of State of Israel Bonds.

Note 6 — Lease Commitments

The Organization leased its Any City office facilities under a noncancellable operating lease which expired December 31, 19X4. Rental expense for the year ended December 31, 19X4 including common area expenses was $42,500.

In December 19X4, the Organization signed a lease agreement for new office facilities for a term of ten years. The Organization may cancel the lease at any time with a 30-day notice. See also note 3.

Note 7 — Functional Allocation of Expenses

The costs of providing the various programs, fund-raising and other activities have been summarized on a functional basis in the statement of functional expenses. Accordingly, certain costs have been allocated among the programs and fund-raising activities benefited.

Note 8 — Change in Accounting Method

During 19X4, the Organization adopted the accounting treatment prescribed by Statement on Financial Accounting Standards (SFAS) No. 116, *Accounting for Contributions Received and Contributions Made,* and SFAS No. 117, *Financial Statements for Not-for-Profit Organizations*. In accordance with SFAS No. 116, contributions received are recorded as unrestricted support depending on the existence and/or nature of any donor restrictions. As permitted by SFAS No. 116, the Organization may retroactively apply the provisions of this new statement by restating the net assets as of December 31, 19X3. The adjustment of $27,000 made to net assets as of December 31, 19X3 represents contributions not previously reported.

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Net assets, beginning, as previously stated	$ 89,850	$ —	$ 52,750	$ 142,600
Adoption of SFAS No. 116	—	27,000	—	27,000
Net assets, beginning, restated	$ 89,850	$ 27,000	$ 52,750	$ 169,600

Note 9 — Temporarily Restricted Net Assets

Temporarily restricted net assets are available for the following specific program services:

Contributions receivable for the Combined Federal Campaign	$ 18,100
Donated facilities available for future years	248,450
	$ 266,550

Note 10 — Permanently Restricted Assets

Permanently restricted assets of $57,800 are restricted to investments in perpetuity, the income from which is expendable to support the Combined Federal Campaign.

9.302 *SFAS 116 and 117 have been adopted.*

> The illustrative financial statements do not include all disclosures and presentation items promulgated.

Sample Small Ministry
Statements of Financial Position
December 31, 19X3 and 19X2

Assets

	19X3	19X2
Current assets		
Cash and cash equivalents	$ 4,157	$ 5,737
Pledges receivable (Note 3)	—	4,000
Supplies	342	186
Total current assets	4,499	9,923
Equipment (Note 4)	8,000	—
Less accumulated depreciation	(800)	—
	7,200	—
Total assets	$11,699	$ 9,923

Liabilities and Net Assets

	19X3	19X2
Current liabilities		
Accounts payable	$ 242	$ —
Payroll taxes payable	703	658
Total current liabilities	945	658
Net Assets		
Temporarily restricted		
Time restricted	—	2,000
Restricted for equipment purchase	—	6,000
Total temporarily restricted	—	8,000
Unrestricted		
Undesignated	3,554	1,265
Represented by equipment	7,200	—
Total unrestricted	10,754	1,265
Total net assets	10,754	9,265
Total liabilities and net assets	$11,699	$ 9,923

See notes to financial statements.

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Sample Small Ministry

Statements of Activities

Years Ended December 31, 19X3 and 19X2

	19X3	19X2
Changes in Unrestricted Net Assets		
Revenues		
Contributions	$70,631	$35,401
Contributed services (Note 5)	8,640	—
Interest income	112	—
Total unrestricted revenues	79,383	35,401
Net assets released from restrictions		
Satisfaction of equipment acquisition restrictions	6,000	—
Satisfaction of time restrictions	2,000	—
Total net assets released from restrictions	8,000	—
Total revenues, gains, and other support	87,383	35,401
Expenses		
Program services		
Program A	49,436	26,031
Program services contributed	8,640	—
Supporting activities		
Management and general	11,397	4,695
Fund raising	8,421	3,410
Total expenses	77,894	34,136
Increase (decrease) in unrestricted net assets	9,489	1,265
Changes in temporarily restricted net assets		
Contributions	—	8,000
Net assets released from restrictions	(8,000)	—
Increase (decrease) in temporarily restricted net assets	(8,000)	8,000
Change in net assets	1,489	9,265
Net assets, beginning of year	9,265	—
Net assets, end of year	$10,754	$ 9,265

See notes to financial statements.

Sample Small Ministry

Statements of Cash Flows

Years Ended December 31, 19X3 and 19X2

	19X3	19X2
Cash Flows from Operating Activities		
Cash received from donors	$70,631	$37,401
Interest received	112	—
Cash paid to employees and suppliers	(68,323)	(33,664)
Net cash provided (used) by operating activities	2,420	3,737
Cash Flows from Investing Activities		
Cash paid for equipment	(8,000)	—
Net cash used by investing activities	(8,000)	—
Cash Flows from Financing Activities		
Proceeds from contributions restricted for:		
Purchase of equipment	4,000	2,000
Net cash provided by financing activities	4,000	2,000
Net Increase (Decrease) in Cash and Cash Equivalents	(1,580)	5,737
Cash and Cash Equivalents		
Beginning of Year	5,737	—
End of Year	$ 4,157	$ 5,737
Reconciliation of Change in Net Assets to Net Cash from Operating Activities		
Change in net assets	$ 1,489	$ 9,265
Adjustments to reconcile change in net assets to net cash provided (used) by operating activities		
Increase in accounts payable	287	658
Depreciation	800	—
Decrease (increase) in pledges receivable	4,000	(4,000)
Contributions restricted for the purchase of equipment	(4,000)	(2,000)
Increase in supplies inventory	(156)	(186)
Net Cash Provided (Used) by Operating Activities	$ 2,420	$ 3,737

See notes to financial statements.

Sample Small Ministry

Notes to Financial Statements

December 31, 19X3

Note 1—Nature of Organization

Sample Small Ministry is an organization committed to presenting the Gospel of Jesus Christ to children.

Note 2—Significant Accounting Policies

The financial statements of Sample Small Ministry have been prepared on the accrual basis. The significant accounting policies followed are described below to enhance the usefulness of the financial statements to the reader.

Classes of Net Assets

The financial statements report amounts separately by class of net assets.

a) **Unrestricted** amounts of those currently available at the discretion of the board for use in the organization's operations and those resources invested in equipment.

b) **Temporarily restricted** amounts are those which are stipulated by donors for specific operating purposes or for the acquisition of equipment.

All contributions are considered available for unrestricted use, unless specifically restricted by the donor or subject to other legal restrictions.

Cash and Cash Equivalents

Cash and cash equivalents consist of cash held in checking, savings, and money market accounts and certificates of deposit with original maturities of less than 90 days.

Equipment and Depreciation

Expenditures for equipment are capitalized at cost. Donated assets are capitalized at their fair market value on the date of the gift. Depreciation is computed on the straight-line method over the estimated useful lives of the assets (10 years for furniture and equipment, 5 years for computer equipment, and 3 years for vehicles).

Revenues and Expenses

Unrestricted contributions are recognized when cash or ownership of donated assets is unconditionally promised to the organization.

Temporarily restricted contributions are recognized as contribution income in the statement of activities when cash or ownership of donated assets is unconditionally promised to the organization and subsequently released to the unrestricted fund when expenses have been incurred in satisfaction of those restrictions.

Other income is recognized when earned. Expenses are recognized when incurred in accordance with the accrual basis of accounting.

The organization reports gifts of land, buildings, and equipment as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support. Absent explicit donor stipulations about how long those long-lived assets must be maintained, the organization reports expirations of donor restrictions when the donated or acquired long-lived assets are placed in service.

Allocation of Expenses

The costs of providing the various programs and supporting activities of the organization have been summarized on a functional basis in the statement of activities. Accordingly, certain costs have been allocated among the program and supporting activities. Salaries and benefits are allocated 75% to program, 12.5% to management and general, and 12.5% to fund raising.

Note 3—Pledges Receivable

During 19X2, a donor pledged $8,000, of which $6,000 was for office furniture and computer equipment and $2,000 was for the 19X3 operating budget. $4,000 was donated in 19X2; the balance of $4,000 was donated in 19X3.

Note 4—Equipment

On June 30, 19X3, used office and computer equipment was purchased for $8,000. Straight-line depreciation has been used; the estimated life is five years.

Note 5—Contributed Services

A substantial number of unpaid volunteers have made significant contributions of their time to hold weekly children's Bible clubs. The value of this contributed time is not reflected in these statements since it is not susceptible to objective measurement or valuation.

In addition, the organization receives contributed services for a local child psychologist and a local seminary professor who prepares and reviews club curriculum. Both individuals donated between five to seven hours of their time monthly to the organization during 19X3. Support arising from these contributed services has been recognized in the financial statements at the fair value of the services received totalling $8,640 and $-0- for the years ended December 31, 19X3 and 19X2, respectively.

Sample Small Ministry

Schedule of Functional Expenses

For the Year Ended December 31, 19X3

	Program A	Contributed Program Services	Management and General	Fund Raising	Total
Salaries, wages, and benefits	$ 38,520	$ 8,640	$ 6,420	$ 6,420	$ 60,000
Travel	1,250	—	—	870	2,120
Supplies	1,881	—	—	—	1,881
Printing	2,866	—	207	191	3,264
Professional services	—	—	3,000	—	3,000
Occupancy	4,500	—	750	750	6,000
Depreciation	—	—	800	—	800
Interest	—	—	15	—	15
Telephone	419	—	205	190	814
Totals	$ 49,436	$ 8,640	$ 11,397	$ 8,421	$ 77,894

9.303 *SFAS 116 and 117 have been adopted.*

> The illustrative financial statements do not include all disclosures and presentation items promulgated.

Sample Private Research Foundation

Statements of Financial Position

June 30, 19X2 and 19X1

	19X2	19X1 (Restated)
Assets		
Cash and cash equivalents (Note A)	$ 641,946	$ 470,765
Accounts and interest receivable	12,451	10,210
Inventories and prepaid expenses	7,250	6,040
Contributions receivable	54,600	45,700
Short-term investments (Note D)	33,278	26,787
Office equipment (Note A)	25,449	20,178
Long-term investments (Note D)	357,025	261,507
Total assets	$ 1,131,999	$ 841,187
Liabilities and Net Assets		
Accounts payable	$ 20,715	$ 7,608
Total liabilities	20,715	7,608
Net Assets		
Unrestricted	903,450	684,740
Temporarily restricted (Note B)	80,647	71,984
Permanently restricted (Note B)	127,187	76,855
Total net assets	1,111,284	833,579
Total liabilities and net assets	$ 1,131,999	$ 841,187

The accompanying notes are an integral part of these financial statements.

Sample Private Research Foundation

Statements of Activities

Years Ended June 30, 19X2 and 19X1

	19X2	19X1 (Restated)
Changes in Unrestricted Net Assets		
Revenues and Gains		
Contributions	$ 695,045	$ 596,784
Income on long-term investments	1,453	2,145
Other investment income	645	506
Net unrealized and realized gains on long-term investment	1,055	1,083
Total Unrestricted Revenues and Gains	698,198	600,518
Net Assets Released from Restrictions (Note C)		
Satisfaction of program restrictions	151,620	124,411
Expiration of time restrictions	4,260	5,411
Total Net Assets Released from Restrictions	155,880	129,822
Total Unrestricted Revenues, Gains and Other Support	854,078	730,340
Expenses		
Research program	397,414	376,400
Academic support program	121,650	109,452
Management and general	96,200	90,100
Fund raising	20,104	18,254
Total Expenses	635,368	594,206
Increase in Unrestricted Net Assets	218,710	136,134
Changes in Temporarily Restricted Net Assets		
Contributions	161,631	123,526
Income on long-term investments	2,410	3,211
Net unrealized and realized gains on long-term investments	502	620
Net assets released from restrictions (Note C)	(155,880)	(129,822)
Increase (Decrease) in Temporarily Restricted Net Assets	8,663	(2,465)

The accompanying notes are an integral part of these financial statements.

Sample Private Research Foundation

Statements of Activities (Continued)

Years Ended June 30, 19X2 and 19X1

	19X2	19X1 (Restated)
Changes in Permanently Restricted Net Assets		
Contributions	$ 33,647	$ 29,442
Income on long-term investments	16,530	12,345
Net unrealized and realized gains on long-term investments	155	200
Increase in Permanently Restricted Net Assets	50,332	41,987
Increase in Net Assets	277,705	175,656
Net Assets at Beginning of Year	833,579	
Net Assets (Fund Balance) at July 1,19X0, as previously reported		614,713
Effect of Change in Accounting for Contributions Received (Note A)		43,210
Net Assets, at July 1, 19X0 as Restated		657,923
Net Assets at End of Year	$ 1,111,284	$ 833,579

The accompanying notes are an integral part of these financial statements.

Sample Private Research Foundation

Statements of Cash Flows

Years Ended June 30, 19X2 and 19X1

	19X2	19X1 (Restated)
Cash Flows from Operating Activities		
Change in net assets	$ 277,705	$ 175,656
Adjustments to reconcile change in net assets to net cash used by operating activities:		
Depreciation	8,422	6,530
Increase in accounts and interest receivable	(2,241)	(1,231)
Increase in contributions receivable	(8,900)	(6,000)
Increase in inventories and prepaid expenses	(1,210)	(890)
Increase in accounts payable	13,107	2,333
Contributions restricted for long-term investment	(29,971)	(24,545)
Interest and dividends restricted for long-term investments	(9,890)	(8,766)
Net unrealized and realized gains on long-term investments	(1,712)	(1,903)
Net Cash Provided by Operating Activities	245,310	141,184
Cash Flows from Investing Activities		
Purchase of equipment	(13,693)	(8,769)
Proceeds from sale of investments	45,333	28,900
Purchase of investments	(149,059)	(78,688)
Net Cash Used by Investing Activities	(117,419)	(58,557)
Cash Flows from Financing Activities		
Proceeds from contributions restricted for:		
Investment in endowment	30,400	28,900
Investment in term endowment	3,000	1,200
Interest and dividends restricted for reinvestment	9,890	8,766
Net Cash Used by Financing Activities	43,290	38,866
Net Increase in Cash and Cash Equivalents	171,181	121,493
Cash and Cash Equivalents at Beginning of Year	470,765	349,272
Cash and Cash Equivalents at End of Year	$ 641,946	$ 470,765
Supplemental data:		
Noncash investing and financing activities:		
Contribution of investments	$ 9,500	

The accompanying notes are an integral part of these financial statements.

SAMPLE PRIVATE RESEARCH FOUNDATION

Notes to Financial Statements
June 30, 19X2 and 19X1

NOTE A—ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

ORGANIZATION

Sample Private Research Foundation ("The Foundation") is a nonprofit organization formed to promote research and education. The Foundation provides grants for academic research and academic support programs.

BASIS OF PRESENTATION

For the year ended June 30, 19X2, The Foundation adopted Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*, issued by the Financial Accounting Standards Board (FASB). As such, the financial statements are presented on the basis of unrestricted, temporarily restricted, and permanently restricted net assets. The financial statements for 19X1 have been restated to be presented on a comparable basis.

CASH AND CASH EQUIVALENTS

For financial statement purposes, The Foundation considers all highly liquid investments with a maturity of three months or less when purchased to be cash equivalents.

REVENUE RECOGNITION

Effective July 1, 19X1, The Foundation has elected the early adoption of SFAS No. 116, *Accounting for Contributions Received and Contributions Made*. As such, contributions are recognized as revenue when they are received or unconditionally pledged. In prior years, unrestricted contributions were recognized as revenue when they were received, and restricted revenues were recognized to the extent that expenses had been incurred and restrictions specified by the donor had been met. This change in accounting principle has been accounted for by retroactive restatement of the financial statements for June 30, 19X1 and the net assets as of July 1, 19X0. The effect of this restatement was to increase the net assets (fund balances) as of July 1, 19X0 by $43,210, and increase the net assets in 19X1 by $10,432.

The Foundation reports gifts of cash and other assets as restricted support if they are received with donor stipulations that limit the use of the donated assets. When a donor restriction expires, temporarily restricted net assets are reclassified to unrestricted net assets and reported in the statement of activities as net assets released from restrictions.

The Foundation reports gifts of land, buildings, and equipment as unrestricted support unless explicit donor stipulations specify how the donated assets must be used. Gifts of long-lived assets with explicit restrictions that specify how the assets are to be used and gifts of cash or other assets that must be used to acquire long-lived assets are reported as restricted support.

Contributions receivable represent amounts committed by donors that have not been received by The Foundation.

NOTE A—ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

PROJECT EXPENSES AND ACADEMIC PROGRAMS

Because of the nature and purpose of The Foundation's research projects, all expenses related to these projects are expensed as incurred. Academic support programs include funds granted to selected schools for scholarships, curriculum support, endowed professorships, and doctoral dissertations.

OFFICE EQUIPMENT

Depreciation of office equipment is provided over the estimated useful lives of the respective assets on a straight line basis. Accumulated depreciation was $19,230 and $10,808 at June 30, 19X2 and 19X1, respectively.

INCOME TAX STATUS

The Foundation is a nonprofit organization and is exempt from Federal income taxes under Section 501(c)(3) of the U.S. Internal Revenue Code.

NOTE B—RESTRICTED NET ASSETS

Temporarily restricted net assets are available for the following purposes or periods:

	June 30, 19X2	June 30, 19X1
Academic Research Program activities:		
Publications	$ 10,416	$ 6,851
Research symposia	23,122	18,677
Academic Support Program activities:		
Endowed professorships	34,600	28,650
Scholarships	10,000	12,500
For future periods	2,509	5,306
	$ 80,647	$ 71,984

Permanently restricted assets are restricted to investments in perpetuity, the income from which is expendable to support:

	June 30, 19X2	June 30, 19X1
Academic Research Program activities	$ 91,545	$ 62,111
Academic Support Program activities	35,642	14,744
	$127,187	$ 76,855

Note C—NET ASSETS RELEASED FROM DONOR RESTRICTIONS

Net assets were released from donor restrictions by incurring expenses satisfying the restricted purposes or by the occurrence of other events specified by donors.

	June 30, 19X2	19X1
Purpose restrictions accomplished:		
Academic Research Program activities	$ 65,200	$ 54,300
Academic Support Program activities	86,420	70,130
Time restriction expired	4,260	5,392
Total restrictions released	$155,880	$129,822

NOTE D—INVESTMENTS

The Foundation's investments at June 30, 19X2 included approximately $229,000 of equity securities and $161,000 of U.S. government obligations. The Foundation's investments at June 30, 19X1 included approximately $184,000 of equity securities and $104,000 U.S. government obligations.

NOTE E—COMMITMENTS

The Foundation has entered into contracts and agreements with researchers and academic institutions for various projects. The remaining commitments under these contracts and agreements totaled $793,475 at June 30, 19X2.

9.304 *SFAS 116 and 117 have not been adopted.*

> The illustrative financial statements do not include all disclosures and presentation items promulgated.

Sample Independent School

Balance Sheet

June 30, 19X2

	Operating Funds	Plant Funds	Endowment Funds	Total All Funds
Assets				
Cash	$ 87,000	$ 15,000	$ 19,000	$ 121,000
Accounts receivable, less allowance for doubtful receivables of $3,000	34,000	—	—	34,000
Pledges receivable, less allowance for doubtful pledges of $10,000	—	75,000	—	75,000
Inventories at lower of cost (FIFO) or market	7,000	—	—	7,000
Investments (Note 2)	355,000	10,000	100,000	465,000
Land, buildings, equipment, and library books, at cost less accumulated depreciation of $980,000 (Note 3)	—	2,282,000	—	2,282,000
Other assets	17,000	—	—	17,000
Total assets	$ 500,000	$ 2,382,000	$ 119,000	$ 3,001,000
Liabilities and Fund Balances				
Accounts payable and accrued expenses	$ 13,000	—	—	$ 13,000
Deferred amounts (Note 6)				
Unrestricted	86,000	—	—	86,000
Restricted	27,000	$ 100,000	—	127,000
Long-term debt (Note 4)	—	131,000	—	131,000
Total liabilities	126,000	231,000	—	357,000
Fund balances				
Unrestricted				
Designated by the governing board for long-term investment	355,000	—	—	355,000
Undesignated	19,000	—	—	19,000
	374,000	—	—	374,000
Restricted—nonexpendable	—	—	$ 119,000	119,000
Net investment in plant	—	2,151,000	—	2,151,000
Total fund balances	374,000	2,151,000	119,000	2,644,000
Total liabilities and fund balances	$ 500,000	$ 2,382,000	$119,000	$ 3,001,000

The accompanying notes are an integral part of these financial statements.

Sample Independent School

Statement of Support and Revenue, Expenses, Capital Additions, and Changes in Fund Balances

Year Ended June 30, 19X2

	Operating Funds Unrestricted	Operating Funds Restricted	Total	Plant Funds	Endowment Funds	Total All Funds
Support and Revenue						
Tuition and fees	$ 910,000	—	$ 910,000	—	—	$ 910,000
Contributions	104,000	$ 80,500	184,500	—	—	184,500
Endowment and other investment income	23,000	1,500	24,500	—	—	24,500
Net loss on investment transactions	(8,000)	—	(8,000)	—	—	(8,000)
Auxiliary activities	25,000	—	25,000	—	—	25,000
Summer school and other programs	86,000	—	86,000	—	—	86,000
Other sources	26,000	—	26,000	—	—	26,000
Total support and revenue	1,166,000	82,000	1,248,000	—	—	1,248,000
Expenses						
Program services						
Instruction and student activities	798,000	43,000	841,000	$ 69,000	—	910,000
Auxiliary activities	24,000	—	24,000	—	—	24,000
Summer school and other programs	91,000	—	91,000	7,000	—	98,000
Financial aid	—	37,000	37,000	3,000	—	40,000
Total program services	913,000	80,000	993,000	79,000	—	1,072,000
Supporting services						
General administration	147,000	2,000	149,000	13,000	—	162,000
Fund raising	12,000	—	12,000	1,000	—	13,000
Total supporting services	159,000	2,000	161,000	14,000	—	175,000
Total expenses	1,072,000	82,000	1,154,000	93,000	—	1,247,000
Excess (deficiency) of support and revenue over expenses before capital additions	94,000	—	94,000	(93,000)	—	1,000
Capital Additions						
Contributions and bequests	—	—	—	80,000	$30,000	110,000
Investment income	—	—	—	5,000	—	5,000
Net gain on investment transactions	—	—	—	1,000	2,000	3,000
Total capital additions	—	—	—	86,000	32,000	118,000
Excess (deficiency) of support and revenue over expenses after capital additions	94,000	—	94,000	(7,000)	32,000	119,000
Fund Balances at Beginning of Year	387,000	—	387,000	2,047,000	91,000	2,525,000
Transfers						
Equipment acquisitions and principal debt service payments	(111,000)	—	(111,000)	111,000	—	—
Realized gains on endowment funds utilized	4,000	—	4,000	—	(4,000)	—
Fund Balances at End of Year	$ 374,000	$ —	$ 374,000	$ 2,151,000	$119,000	$ 2,644,000

The accompanying notes are an integral part of these financial statements.

Sample Independent School

Statement of Changes in Financial Position

Year Ended June 30, 19X2

	Operating Funds	Plant Funds	Endowment Funds	Total All Funds
Resources Provided				
Excess (deficiency) of support and revenue over expenses before capital additions	$ 94,000	$ (93,000)	—	$ 1,000
Capital additions				
Contributions and bequests	—	80,000	$ 30,000	110,000
Investment income	—	5,000	—	5,000
Net gain on investments	—	1,000	2,000	3,000
Excess (deficiency) of support and revenue over expenses after capital additions	94,000	(7,000)	32,000	119,000
Items not using (providing) resources				
Provision for depreciation	—	93,000	—	93,000
Net (gain) loss on investment transactions	8,000	(1,000)	(2,000)	5,000
Decrease in inventories	2,000	—	—	2,000
Increase in deferred amounts	3,000	75,000	—	78,000
Proceeds from sale of investments	160,000	2,000	47,000	209,000
Total resources provided	267,000	162,000	77,000	506,000
Resources Used				
Purchases of equipment	—	145,000	—	145,000
Reduction of long-term debt	—	52,000	—	52,000
Purchases of investments	210,000	6,000	136,000	352,000
Increase in other assets	1,000	—	—	1,000
Increase in accounts and pledges receivable	3,000	60,000	—	63,000
Decrease in accounts payable and accrued expenses	3,000	—	—	3,000
Total resources used	217,000	263,000	136,000	616,000
Transfers				
Equipment acquisitions and principal debt service payments	(111,000)	111,000	—	—
Realized gains on endowment funds utilized	4,000	—	(4,000)	—
Total transfers	(107,000)	111,000	(4,000)	—
Increase (decrease) in cash	$ (57,000)	$ 10,000	$ (63,000)	$ (110,000)

The accompanying notes are an integral part of these financial statements.

Sample Independent School

Notes to Financial Statements

Year Ended June 30, 19X2

Note 1—Summary of Significant Accounting Policies

The financial statements of Sample Independent School ("School") have been prepared on the accrual basis. The significant accounting policies followed are described below to enhance the usefulness of the financial statements to the reader.

Fund Accounting

To ensure observance of limitations and restrictions placed on the use of resources available to the School, the accounts of the School are maintained in accordance with the principles of fund accounting. This is the procedure by which resources for various purposes are classified for accounting and reporting purposes into funds established according to their nature and purposes. Separate accounts are maintained for each fund; however, in the accompanying financial statements, funds that have similar characteristics have been combined into fund groups. Accordingly, all financial transactions have been recorded and reported by fund group.

The assets, liabilities, and fund balances of the school are reported in three self-balancing fund groups as follows:

- Operating funds, which include unrestricted and restricted resources, represent the portion of expendable funds that is available for support of school operations.
- Plant funds represent resources restricted for plant acquisitions and funds expended for plant.
- Endowment funds represent funds that are subject to restrictions of gift instruments requiring in perpetuity that the principal be invested and the income only be used.

Expendable Restricted Resources

Operating and plant funds restricted by the donor, grantor, or other outside party for particular operating purposes or for plant acquisitions are deemed to be earned and reported as revenues of operating funds or as additions to plant funds, respectively, when the school has incurred expenditures in compliance with the specific restrictions. Such amounts received but not yet earned are reported as restricted deferred amounts.

Plant Assets and Depreciation

Uses of operating funds for plant acquisitions and principal debt service payments are accounted for as transfers to plant funds. Proceeds from the sale of plant assets, if unrestricted, are transferred to operating fund balances, or, if restricted, to deferred amounts restricted for plant acquisitions. Depreciation of buildings and equipment is provided over the estimated useful lives of the respective assets on a straight-line basis.

Other Matters

All gains and losses arising from the sale, collection, or other disposition of investments and other noncash assets are accounted for in the fund that owned the assets. Ordinary income from investments, receivables, and the like is accounted for in the fund owning the assets, except for income derived from investments of endowment funds. Such income is accounted for, if unrestricted, as revenue of the expendable operating fund or, if (a) restricted by purpose, as deferred revenue of the operating fund until the terms of the restriction have been met and (b) if required to be added to endowment principal, as capital additions.

Legally enforceable pledges, less an allowance for uncollectible amounts, are recorded as receivables in the year made. Pledges for support of current operations are recorded as operating fund support. Pledges for support of future operations and plant acquisitions are recorded as deferred amounts in the respective funds to which they apply.

Note 2—Investments

Investments are presented in the financial statements in the aggregate at the lower of cost (amortized, in the case of bonds) or fair market value.

	Cost	Market
Operating funds	$355,000	$365,000
Plant funds	10,000	11,000
Endowment funds	100,000	109,000
	$465,000	$485,000

Investments are composed of the following:

	Cost	Market
Corporate stocks and bonds	$318,000	$320,000
U.S. Government obligations	141,000	159,000
Municipal bonds	6,000	6,000
	$465,000	$485,000

The following tabulation summarizes the relationship between carrying values and market values of investment assets.

	Carrying Value	Market Value	Excess of Market Over Cost
Balance at the end of year	$465,000	$485,000	$ 20,000
Balance at beginning of year	$327,000	$335,000	8,000
Increase in unrealized appreciation			12,000
Realized net loss for year			(5,000)
Total net gain for year			$ 7,000

The average annual yield exclusive of net gains (losses) was 7% and the annual total return based on market value was 9% for the year ended June 30, 19X2.

Note 3—Plant Assets and Depreciation

A summary of plant assets as of June 30, 19X2 follows.

Land	$ 255,000
Buildings	2,552,000
Equipment	340,000
Library books	115,000
	3,262,000
Less accumulated depreciation	980,000
	$2,282,000

Note 4—Long-Term Debt

A summary of long-term debt as of June 30, 19X2 follows.

7½% unsecured notes payable to bank due in quarterly installments of $2,500	$ 29,000
8½% mortgage payable in semiannual installments of $3,500 through 20Y6	102,000
	$131,000

Aggregate maturities of long-term debt are summarized as follows:

19X3	$ 17,000
19X4	17,000
19X5	16,000
19X6	7,000
19X7	7,000
19X8 and after	67,000
	$131,000

Note 5—Pension and Other Postretirement Benefit Plans

The School has a defined benefit pension plan covering substantially all of its employees. The benefits are based on years of service and the employee's compensation during the last five years of employment. The School's funding policy is to contribute annually at a rate that is intended to remain a level percentage of compensation for the covered employees (presently 12%). Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

The following table sets forth the plan's funded status and amounts recognized in the School's financial statements at June 30, 19X2:

Funded status of plan:	
Actuarial present value of benefit obligations:	
Accumulated benefit obligation, including vested benefits of $250,000	$ 276,000
Projected benefit obligation for service rendered to date	$(347,000)
Assets available for benefits:	
Plan assets at fair value, primarily listed stocks and U.S. government securities	426,000
Plan assets in excess of projected benefit obligation	79,000
Unrecorded net gain from past experience different from that assumed and effects of changes in assumptions	(111,000)
Unrecognized net obligation at January 1, 19X1 being recognized over 15 years	40,000
Prepaid pension cost included in other assets	$ 8,000

Net pension expense for the year ended June 30, 19X2 included the following components:

Service cost — benefits earned during the year	$ 26,000
Interest cost on projected benefit obligation	39,000
Actual return on plan assets	(45,000)
Amortization of unrecognized net obligation	10,000
Net periodic pension expense	$ 30,000

The weighted average discount rate and rate of increase in future compensation levels in determining the actuarial present value of the projected benefit obligation were 6% and 5%, respectively. The expected long-term rate of return on assets was 8%.

The School also sponsors a defined contribution postretirement health care plan covering substantially all of its employees. The School's contributions and cost are determined annually as 2% of each covered employee's salary and totalled $31,000 in 19X2.

Note 6—Changes in Deferred Restricted Amounts

	Operating Funds	Plant Funds
Balances at beginning of year	$ 24,000	$ 25,000
Additions		
Contributions and bequests	79,000	158,000
Investment income	6,000	1,000
Net gain on investment transactions	—	2,000
	109,000	186,000
Deductions — funds expended during the year	(82,000)	(86,000)
Balances at end of year	$ 27,000	$100,000

Note 7—Functional Allocation of Expenses

The costs of providing the various programs and other activities have been summarized on a functional basis in the statement of support and revenue, expenses, capital additions, and changes in fund balances. Accordingly, certain costs have been allocated among the programs and supporting services benefited.

Note 8—Commitments

The School has entered into various agreements aggregating approximately $80,000 for the purchase of equipment to be received subsequent to June 30, 19X2.

Note 9—Contributed Services

A substantial number of unpaid volunteers have made significant contributions of their time to develop the School's programs, principally in instruction and student activities. The value of this contributed time is not reflected in these statements since it is not susceptible to objective measurement or valuation.

Note 10—Allocation of Joint Costs

In 19X2, the School incurred joint costs of $33,000 for informational materials and activities that included fund-raising appeals. Those costs were allocated as follows:

	19X2
Instruction and student activities	$ 26,000
Fund raising	7,000
	$ 33,000

Note 11—Income Taxes

The School is a tax-exempt organization under the Internal Revenue Code and similar provisions of the State Code. Therefore, no provision for income taxes has been made.

9.305 *SFAS 116 and 117 have not been adopted.*

> The illustrative financial statements do not include all disclosures and presentation items promulgated.

Sample Community Services Center

Balance Sheets

June 30, 19X2 and 19X1

Assets

	19X2	19X1
Current assets		
Cash	$ 3,904	$ 27,223
Accounts receivable (Notes 2 and 3)	150,149	136,669
Pledges receivable	396	12,179
Prepaid expenses	16,060	12,358
Total current assets	170,509	188,429
Property and Equipment (Notes 2, 3, and 4)		
Equipment and furniture	139,737	103,696
Leasehold improvements	1,049,857	1,014,368
	1,189,594	1,118,064
Less accumulated depreciation	202,548	140,921
	987,046	977,143
Total Assets	$1,157,555	$1,165,572

Liabilities and Fund Balances

	19X2	19X1
Current liabilities		
Notes payable (Note 2)	$ 61,450	$ 42,020
Current maturities of long-term debt (Note 3)	83,556	12,331
Accounts payable	26,449	35,110
Accrued expenses	76,959	64,624
Total current liabilities	248,414	154,085
Long-term debt (Note 3)	53,906	76,855
Fund balances		
Restricted for capital improvements (Note 6)	—	6,285
Unrestricted	855,235	928,347
	855,235	934,632
Total Liabilities and Fund Balances	$1,157,555	$1,165,572

The accompanying notes are an integral part of these financial statements.

Sample Community Services Center

Statements of Revenues, Expenses and Changes in Fund Balances

Years Ended June 30, 19X2 and 19X1

	19X2	19X1
Revenues		
Contract services	$1,035,346	$ 907,065
County marriage and dissolution fees	28,360	23,149
Third-party fees	23,599	46,284
Public support	143,095	156,424
In-kind contributions	16,365	10,267
Federal grants	125,307	272,958
Capital projects contributions and grants	—	251,854
Miscellaneous	14,568	6,440
Total revenues	1,386,640	1,674,441
Less unsupported client services	10,417	14,644
Net revenues	1,376,223	1,659,797
Expenses		
Personnel	1,095,681	888,775
Staff development	5,299	1,600
Professional services	23,041	6,680
Property services	145,732	107,338
Communications	14,364	14,103
Supplies	76,693	56,491
Travel	8,601	15,189
Direct client aid	25,359	12,027
Furnishings and small equipment	4,294	3,821
Fund raising	678	8,325
Interest	18,274	14,633
Bad debts	30,039	14,944
Loss on sale or disposition of property and equipment	—	10,324
Miscellaneous	7,565	14,150
Total expenses	1,455,620	1,168,400
Excess of revenues over (under) expenses	(79,397)	491,397
Fund balance, beginning of year	934,632	443,235
Fund balance, end of year	$ 855,235	$ 934,632

The accompanying notes are an integral part of these financial statements.

Sample Community Services Center

Statements of Cash Flows

Years Ended June 30, 19X2 and 19X1

	19X2	19X1
Cash flows from operating activities		
Excess of revenues over (under) expenses	$ (79,397)	$491,397
Items not requiring (providing) cash		
Depreciation and amortization	61,627	39,294
Loss on sale or disposition of property and equipment	—	10,324
Changes in:		
Accounts receivable	(13,480)	(67,067)
Pledges receivable	11,783	106,452
Prepaid expenses	(3,702)	(6,346)
Accounts payable	(8,661)	(25,607)
Accrued expenses	12,335	21,513
Deferred revenue — pledges	—	(77,627)
Deferred revenue — STEP project	—	(134,871)
Net cash provided by (used in) operating activities	(19,495)	357,462
Cash flows from investing activities		
Purchase of property and equipment	(50,162)	(512,813)
Proceeds from sale of property and equipment	—	325
Net cash used in investing activities	(50,162)	(512,488)
Cash flows from financing activities		
Proceeds from issuance of long-term debt	32,980	—
Payments made on long-term debt	(23,092)	(12,291)
Net borrowing under line of credit agreements	36,450	30,020
Net cash provided by financing activities	46,338	17,729
Increase (decrease) in cash	(23,319)	(137,297)
Cash, beginning of year	27,223	164,520
Cash, end of year	$ 3,904	$ 27,223

The accompanying notes are an integral part of these financial statements.

Sample Community Services Center

Notes to Financial Statements

June 30, 19X2 and 19X1

Note 1—Organization and Summary of Significant Accounting Policies

Nature of Business

Sample Community Services Center ("CSC") provides services to survivors of domestic violence and sexual assault; chemically dependent and codependent women; and at risk pregnant and parenting teens. These services include assessment, counseling, treatment and rehabilitation through both residential and non-residential services. Community services are provided through the promotion of public awareness and understanding and the prevention of these problems.

Accounts Receivable

CSC receivables consist primarily of state and federal contract receivables. Unsecured credit is extended to clients.

Property and Equipment

Property and equipment are stated at cost and depreciated or amortized over the estimated useful life of each asset. Depreciation and amortization are computed using the straight-line method.

Tax Status

CSC is a not-for-profit organization exempt from income taxes under the Internal Revenue Code and similar provisions of the State Code. Therefore, no provision for income taxes has been made.

Unsupported Client Services

Unsupported client services are those client fees for services not covered by contracted revenue and for which the client is financially unable to pay.

Reclassifications

Certain reclassifications have been made to the 19X1 amounts to conform to the 19X2 financial statement presentation. These reclassifications had no effect on previously reported 19X1 results of operations.

Note 2—Notes Payable

Short-term notes payable consist of:

	19X2	19X1
Bank (A)	$61,450	$25,000
Bank (B)	—	17,020
	$61,450	$42,020

(A) Line of credit due November 7, 19X2 in the maximum amount of $132,000; interest at the prime rate plus one percent per annum payable monthly; secured by accounts receivable, equipment, fixtures, inventory and leaseholds of CSC and the assets of Community Help Center, Inc. (CHCI), a related party.

(B) Revolving line of credit, due September 26, 19X1; maximum borrowings of $45,000; interest payable monthly at 11.25%; secured by equipment, furniture and accounts receivable; guaranteed by CHCI.

Note 3—Long-Term Debt

	19X2	19X1
Note payable, bank (A)	$ 48,507	$ —
Note payable, bank (B)	37,128	39,781
Note payable, bank (C)	37,585	49,405
Capital lease obligation (Note 4)	14,242	—
	137,462	89,186
Less current maturities	83,556	12,331
	$ 53,906	$76,855

Aggregate annual maturities of long-term debt at June 30, 19X2 are:

19X3	$ 83,556
19X4	8,736
19X5	45,170
	$137,462

(A) Due September 26, 19X4; payable $510 monthly, including interest at 1% over prime rate; secured by equipment, fixtures, inventory, accounts receivable and assets of CHCI.

(B) Due June 5, 19X3; payable $500 monthly, including interest at 1% over prime rate; secured by assets of CHCI.

(C) Due June 5, 19X3; payable $1,305 monthly, including interest at 1% over prime rate; secured by equipment, furniture and accounts receivable of CSC; guaranteed by CHCI.

Note 4—Leases

Operating

CSC leases its building facility from CHCI under an operating-type lease. The lease expires in October, 20Y5. CSC as lessee is responsible for maintenance. Rental payments are due monthly. Total rent expense for the years ended June 30, 19X2 and 19X1 was $29,500 and $17,000, respectively. The monthly rental amount may be adjusted annually.

Capital

The capital lease shown in long-term debt (Note 3) is a lease covering equipment for three years expiring in 19X4. Property and equipment include $22,863 under this capital lease.

Future minimum lease payments as of June 30, 19X2, were:

19X3	$ 9,014
19X4	7,512
Future minimum lease payments	16,526
Less amount representing interest	2,284
Present value of future minimum lease payments	14,242
Less current maturities	7,252
Noncurrent portion	$ 6,990

Note 5—Related-Party Transactions

During the year ended June 30, 19X1, CSC received a donation of $23,000 from CHCI.

CSC also received payment of a capital fund drive pledge of $55,000 from CHCI during 19X1.

CSC is a guarantor of a note payable for CHCI. The outstanding balance of this note at June 30, 19X2 and 19X1 was $42,816 and $43,200, respectively.

Note 6—Restricted for Capital Improvements

Restricted for capital improvements of $6,285 at June 30, 19X1 consists of contributions receivable and government grants receivable which came due when expenses were made for the grant purposes.

Note 7—Additional Cash Flow Information

	19X2	19X1
Noncash Financing Activities		
Capital lease obligation incurred for equipment	$21,368	—
Additional Cash Payment Information		
Interest paid	$18,493	$14,633

Note 8—Subsequent Event

On August 1, 19X2, a fire seriously damaged one floor of CSC's building facility.

Some client services have been temporarily suspended until reconstruction of the floor can be completed. Suspension of these client services have resulted in a monthly decrease in revenues of approximately $18,000. Insurance proceeds are expected to cover all construction costs and replacement of the majority of the contents. CSC is actively seeking community support to supplement insurance proceeds and any loss associated with the replacement of contents is undeterminable at this time. Completion of construction and resumption of services are expected to take place in March, 19X3.

Sample Community Services Center

Schedule of Federal Awards

Year Ended June 30, 19X2

Federal Grantor/Pass-Through Grantor/Program Title	Federal CFDA Number	Expenditures
U.S. Department of Housing and Urban Development		
Direct Program:		
Supplemental Assistance for Facilities to Assist the Homeless	14.231	$ 99,617
U.S. Department of Agriculture		
Passed through the New Jersey Department of Social Services:		
Food Distribution	10.550	4,781
Federal Emergency Management Agency		
Passed through the Hanlin Local (FEMA) Board:		
Emergency Food and Shelter National Board Program	83.523	20,909
U.S. Department of Health and Human Services		
Passed through the New Jersey Department of Health — Division of Maternal Child and Family Health:		
Preventive Health and Health Services Block Grant — Sexual Assault Prevention and Services to Victims	93.991	6,894
Passed through the New Jersey Department of Social Services — Division of Family Services:		
Family Violence Prevention and services	93.671	15,847
Total U.S. Department of Health and Human Services		22,741
U.S. Department of Housing and Urban Development		
Passed through the New Jersey Department of Social Services — Division of Family Services and through Treeland County, Missouri:		
Emergency Shelter Grant Program of the Stewart B. McKinney Homeless Assistance Act	14.231	14,615
U.S. Department of Justice		
Passed through the New Jersey Department of Public Safety:		
Victims of Crime Act of 1994	16.582	38,820
Total Federal Awards		$201,483

9.306 *SFAS 116 and 117 have not been adopted.*

> The illustrative financial statements do not include all disclosures and presentation items promulgated.

Sample Foundation

Balance Sheet

June 30, 19X2

Assets

	Expandable funds			Nonexpandable Fund	Total
	Unrestricted	Restricted	Total	Endowment	All Funds
Cash	$ 1,540	$ 16,380	$ 17,920	$ —	$ 17,920
Interest receivable	14,711	39,110	53,821	—	53,821
Investments, at cost (Note 2)	1,162,433	524,591	1,687,024	1,451,243	3,138,267
Property held for investment (Note 3)	16,875	—	16,875	102,600	119,475
Due from trusts	43,927	—	43,927	—	43,927
Due from other funds	2,600	—	2,600	—	2,600
Total Assets	$1,242,086	$580,081	$1,822,167	$1,553,843	$3,376,010

Liabilities and Fund Balance

	Unrestricted	Restricted	Total	Endowment	All Funds
Due to XYZ College	$ 10,000	$ 89,097	$ 99,097	$ —	$ 99,097
Due to other funds	—	—	—	2,600	2,600
Deferred amounts (Note 4)	—	490,984	490,984	—	490,984
Total Liabilities	10,000	580,081	590,081	2,600	592,681
Fund Balances:					
Restricted	—	—	—	1,551,243	1,551,243
Unrestricted:					
Designated (Note 5)	278,690	—	278,690	—	278,690
Undesignated	953,396	—	953,396	—	953,396
Total Fund Balances	1,232,086	—	1,232,086	1,551,243	2,783,329
Total Liabilities and Fund Balances	$1,242,086	$580,081	$1,822,167	$1,553,843	$3,376,010

The accompanying notes are an integral part of these financial statements.

Sample Foundation

Statement of Support, Revenues, Expenses and Capital Additions

Year Ended June 30, 19X2

	Expandable funds			Nonexpandable Fund	Total
	Unrestricted	Restricted	Total	Endowment	All Funds
Support and revenues:					
Contributions	$ 300,712	$ 48,696	$349,408	$ —	$349,408
Earnings on investments	171,113	108,389	279,502	—	279,502
Total support and revenues	471,825	157,085	628,910	—	628,910
Expenses:					
Scholarships awarded	235,775	60,174	295,949	—	295,949
Executive salaries	61,074	—	61,074	—	61,074
Executive travel and membership	2,473	—	2,473	—	2,473
Faculty support	29,103	—	29,103	—	29,103
Fund drives	22,400	—	22,400	—	22,400
College departments support	18,058	—	18,058	—	18,058
Designated gifts to XYZ College	42,990	96,911	139,901	—	139,901
Cultural activities support	9,376	—	9,376	—	9,376
Miscellaneous	21,897	—	21,897	—	21,897
Total expenses	443,146	157,085	600,231	—	600,231
Excess of support and revenues over expenses before capital additions	28,679	0	28,679	—	28,679
Capital additions:					
Contributions	—	—	—	52,741	52,741
Excess of support and revenues over expenses after capital additions	$ 28,679	$ 0	$ 28,679	$ 52,741	$ 81,420

The accompanying notes are an integral part of these financial statements.

Sample Foundation

Statement of Changes in Fund Balance

Year Ended June 30, 19X2

	Expandable funds			Nonexpandable Fund	Total
	Unrestricted	Restricted	Total	Endowment	All Funds
Fund balance, beginning of year	$ 1,203,407	$ 0	$ 1,203,407	$ 1,498,502	$2,701,909
Excess of support and revenues over expenses after capital additions	28,679	0	28,679	52,741	81,420
Fund balance, end of year	$ 1,232,086	$ 0	$ 1,232,086	$ 1,551,243	$2,783,329

The accompanying notes are an integral part of these financial statements.

Sample Foundation

Statement of Cash Flows

Year Ended June 30, 19X2

	Expandable funds			Nonexpandable Fund	Total
	Unrestricted	Restricted	Total	Endowment	All Funds
Cash flows from operating activities					
Excess of support and revenues over expenses after capital additions	$ 28,679	$ —	$ 28,679	$ 52,741	$ 81,420
Changes in:					
Interest receivable	(29)	(18,469)	(18,498)	—	(18,498)
Due from trusts	(43,927)	—	(43,927)	—	(43,927)
Due to XYZ College	10,000	17,097	27,097	—	27,097
Deferred amounts	—	146,107	146,107	—	146,107
Net cash provided by (used in) operating activities	(5,277)	144,735	139,458	52,741	192,199
Cash flows from investing activities					
Purchases of investments	(894,574)	(403,767)	(1,298,341)	(1,119,426)	(2,417,767)
Sales of investments	900,156	274,748	1,174,904	1,066,685	2,241,589
Net cash provided by (used in) investing activities	5,582	(129,019)	(123,437)	(52,741)	(176,178)
Increase in cash	305	15,716	16,021	0	16,021
Cash, beginning of year	1,235	664	1,899	0	1,899
Cash, end of year	$ 1,540	$ 16,380	$ 17,920	$ 0	$ 17,920

The accompanying notes are an integral part of these financial statements.

Sample Foundation

Notes to Financial Statements

June 30, 19X2

Note 1—Organization and Summary of Significant Accounting Policies

Nature of Entity

The Sample Foundation ("Foundation") is a not-for-profit corporation organized to foster, cooperate, and assist in the growth, development, and advancement of XYZ College.

Fund Accounting

To ensure observance of limitations and restrictions placed on the use of resources available to the Foundation, the accounts of the Foundation are maintained in accordance with the principles of fund accounting. This is the procedure by which resources are classified for accounting and reporting purposes into funds established according to their nature and purposes. Separate accounts are maintained for each fund and all financial transactions have been recorded and reported by fund group.

The assets, liabilities, fund balances, support, revenues, expenses and capital additions of the Foundation are reported in three self-balancing fund groups as follows:

Unrestricted Expendable Fund
Restricted Expendable Fund
Endowment Fund

Unrestricted and restricted expendable funds are available for support of the Foundation's activities and operations. The Endowment Fund represents resources restricted by gift instruments requiring that the principal be invested and only the income be used.

Restricted Resources

Operating funds, restricted by the donor for particular operating purposes, are deemed to be earned and reported as revenues of the Restricted Expendable Fund when the Foundation has incurred expenses in compliance with the specific restrictions. Such amounts received but not yet earned are reported as restricted deferred amounts.

Income Taxes

The Foundation is exempt from income taxes under the Internal Revenue Code and similar provisions of the State Code. Therefore, no provision for income taxes has been made.

Gifts of Nonmonetary Items

Donations of securities, land, equipment and other nonmonetary items are recorded at estimated fair value when received.

Note 2—Investments

Investments of the individual funds are combined to form a pool of investments which is managed by ABC State Bank. Income earned on investments is allocated, based on cost, to the unrestricted and restricted expendable funds with earnings of the endowment investments being included with the restricted funds. Investments of the pooled accounts at June 30, 19X2 are as follows:

	Carrying Value	Market Value
Common stocks	$1,083,751	$1,311,587
Convertible preferred stocks	5,247	2,987
Convertible debentures	28,875	29,450
U. S. Treasury and federal agency bonds	1,334,007	1,417,830
Corporate bonds	257,271	260,737
Certificates of deposit	429,116	435,376
	$3,138,267	$3,457,967

Note 3—Property Held for Investment

Property valued at $100,000 was donated to the Foundation in December, 19W2 and property valued at $16,875 was donated in December, 19W6. During 19X0, $2,600 was expended for site improvement on the first property. The proceeds from the sale of the first property are to be set aside in a nonexpendable endowment fund, the income of which is to be expended for such purposes as are consistent with the principles and objectives of the Foundation. The proceeds from the sale of the latter property will be unrestricted.

Note 4—Deferred Amounts

Activity for the year is summarized as follows:

Balance, July 1, 19X1	$ 344,877
Additions:	
Contributions	95,479
Earnings on investments	207,713
Deductions:	
Restricted expenses	(157,085)
Balance, June 30, 19X2	$ 490,984

Note 5—Designated Fund Balance

Designated fund balances at June 30, 19X2, are:

Science Lab Fund	$ 24,332
John Crust Memorial Fund	48,235
Phon-A-Thon Designations	12,891
Business School Fund	872
Smith Estate Fund	192,360
	$278,690

Note 6—Funds Held in Trust by Others

The Foundation is a beneficiary of a trust established by the David and Martha Smith estate. The Foundation is to receive one-half of the income to be distributed on a quarterly basis. Earnings for the year totaled $58,638 and will be used to fund general scholarships.

The Foundation is the beneficiary of the earnings on the Adam Glick Trust Fund. The money received is used to provide scholarships for students pursuing a degree in Business. Earnings totaling $63,873 were received during the year ended June 30, 19X2.

Note 7—Pension Plan

The Foundation has a defined benefit pension plan covering substantially all of its employees. The benefits are based on years of service and the employee's compensation during the last five years of employment. The Foundation's funding policy is to contribute annually at a rate that is intended to remain a level percentage of compensation for the covered employees (presently 12%). Contributions are intended to provide not only for benefits attributed to service to date but also for those expected to be earned in the future.

The following table sets forth the plan's funded status and amounts recognized in the Foundation's financial statements at June 30, 19X2:

	June 30, 19X2
Service cost-benefits earned during the year	$ XX,XXX
Interest cost on projected benefit obligation	XX,XXX
Actual return on plan assets	(XX,XXX)
Net asset gain(loss) deferred for later recognition	(XX,XXX)
Amortization of unrecognized net asset	(XX,XXX)
Net periodic pension income	$(XX,XXX)
Funded status of plan:	
Actuarial present value of benefit obligation	
Accumulated benefit obligation, including vested benefits of $XX,XXX in 19X2	(XX,XXX)
Projected benefit obligation for service rendered to date	(XX,XXX)
Assets available for benefits	
Plan assets at fair value, primarily listed stock and U.S. government securities	XX,XXX
Unrecorded net (gain)loss from past experience different from that assumed and effects of changes in assumptions	XXX
Unrecognized net assets at July 1, 19X0, being recognized over XX years	(XX,XXX)
Prepaid pension cost included in other assets	$ XX,XXX

The weighted-average discount rate and rate of increase in future compensation levels in determining the actuarial present value of the projected benefit obligation was X%. The expected long-term rate of return on assets was X%.

In 19X2, $X,XXX of the vested benefit portion of the projected benefit obligation, was settled through the purchase of nonparticipating annuity contracts for certain retired participants and lump sum payments for certain terminated participants. As a result, the Foundation recognized gains of $X,XXX in 19X2.

Note 8—Postretirement Health Care and Life Insurance Benefits

The Foundation sponsors employee postretirment health care and life insurance plans and contributes toward the annual cost of retirees remaining in these plans. Expense for these plans, recognized on the cash basis, was $15,000 for the year ended June 30, 19X2.

In December 1990, the FASB issued Statement of Financial Accounting Standards No. 106, *Employers' Accounting for Postretirment Benefits Other Than Pensions* (SFAS No. 106). SFAS No. 106 requires that, beginning no later than the Foundation's fiscal year ending June 30, 19X6, the cost of providing retiree health care and life insurance benefits is to be recognized during the years that service is rendered by employees expected to receive benefits under the plans. The Foundation can elect to record the cumulative effect of the accounting change as a charge against income when SFAS No. 106 is adopted or alternatively, on a deferred basis as part of future annual benefit costs.

The Foundation is continuing to evaluate various alternative arrangements for providing these benefits. Based on the analyses to date, the Foundation believes the adoption of SFAS No. 106 could result in charges to expense of between 5 and 12 times current expense, assuming SFAS No. 106 is adopted on a deferred basis.

Note 9—Subsequent Event

The Foundation is the defendant in a lawsuit filed in August, 19X2 that asserts damage to property and seeks damages of $86,000. The lawsuit is in the discovery stage and no estimate of the eventual outcome is presently determinable. Management believes that the Foundation has strong defenses against the claims and intends to vigorously defend the suit. No provision has been made in the financial statements for any adverse results from this litigation.

9.400 FINANCIAL STATEMENT AND AUDITOR'S REPORT DISCLOSURE CHECKLIST

TABLE OF CONTENTS

Financial Statement and Auditor's Report Disclosure Checklist

This checklist has been developed by the staff of the Technical Information Division of the AICPA as a nonauthoritative practice aid. Disclosures relating to SFAS No. 116, *Accounting for Contributions Received and Contributions Made*, and SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*, have been incorporated into this edition of the checklists. Icons preceding related disclosures identify whether the practitioner should be following the disclosure. If you are preparing or reporting on financial statements of an organization that has adopted SFAS 116 and 117, complete all disclosure items denoted with a ★. For organizations that have not adopted SFAS 116 and 117, complete all disclosure items marked with a ♦. (See Explanation of References section of this checklist.)

The checklists and illustrative financial statements do not include all disclosures and presentation items promulgated. Pronouncements for which the likelihood of applicability to not-for-profit organizations is deemed remote are not included in this document.

Explanation of References:

★	=	Disclosure applicable if applying SFAS No. 116, *Accounting for Contributions Received and Contributions Made,* and/or SFAS No. 117, *Financial Statements of Not-for-Profit Organizations*. Note that not all such disclosure items cite a SFAS 116 or SFAS 117 paragraph because provisions in AICPA Audit and Accounting Guides and Statements of Position that are consistent with or are not addressed by SFAS 116 or SFAS 117 remain applicable for organizations that have adopted SFAS 116 and/or SFAS 117. [SFAS 116, par. 2; SFAS 117, par. 3]
♦	=	Disclosure applicable if SFAS No. 116 and/or SFAS No. 117 have not been adopted.
AAG-NPR	=	AICPA Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations* (May, 1994)[1]
AAG-VHW	=	AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (May, 1994)[1]
SFAS	=	Statement of Financial Accounting Standards
FASBI	=	Financial Accounting Standards Board Interpretation
APB	=	Accounting Principles Board Opinion
ARB	=	Accounting Research Bulletin
FTB	=	Technical Bulletin issued by the staff of the FASB[2]
SOP	=	AICPA Statement of Position

[1] The AICPA has released an exposure draft of a proposed Audit and Accounting Guide, *Not-for-Profit Organizations*. The final guide, which is expected to be issued in the second quarter of 1996, will supersede the AICPA Industry Guide, *Audits of Voluntary Health and Welfare Organizations*, the AICPA Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations*, and Statement of Position 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, as well as an Industry Audit Guide and Statement of Position related to colleges and universities.

[2] The FASB staff issues FASB Technical Bulletins to provide guidance concerning the application of FASB Statements or Interpretations, APB Opinions, or Accounting Research Bulletins. FASB Technical Bulletins do not establish new financial accounting and reporting standards or amend existing standards.

PB	= AICPA Accounting Standards Division Practice Bulletin
EITF	= Emerging Issues Task Force Abstracts
AC	= Reference to section number in *FASB Accounting Standards Current Text*
AU	= Reference to section number in *AICPA Professional Standards, Volume I*
ACC & AUD	= Reference to section number in AICPA *Technical Practice Aids, Volume II*
SAS	= Statement on Auditing Standards

Some questions in this checklist do not cite a specific authoritative reference but indicate that the disclosure is generally accepted. Most organizations disclose that information even though a requirement to do so in the authoritative literature cannot be identified.

This checklist is organized into the sections listed below. Carefully review the topics listed and consider whether they represent potential disclosure items for the not-for-profit organization. Place a check mark by the topics or sections considered not applicable; these sections need not be completed. For example, if the organization does not have any extraordinary items, place a check by "Extraordinary Items" and skip this section when completing the checklist.

	Place ✓ by Sections Not Applicable
• General	
A. Titles and References	___
B. Accounting Policies and Other Disclosures	___
C. Accounting Changes	___
D. Comparative Financial Statements	___
E. Related Entities	___
F. Business Combinations	___
G. Consolidated Financial Statements	___
H. Financial Instruments	___
I. Derivatives	___
J. Nonmonetary Transactions	___
K. Contingencies and Commitments	___
L. Risks and Uncertainties	___
M. Related Parties	___
N. Subsequent Events	___
O. Pension Plans	___
P. Postretirement Benefits Other than Pensions	___
Q. Extraordinary Items	___
R. Advertising Costs	___
S. Costs to Exit an Activity	___
• Statement of Financial Position/Balance Sheet	
A. General	___
B. Cash	___

	Place ✓ by Sections Not Applicable
C. Investments/Marketable Securities	___
D. Receivables	___
E. Inventories	___
F. Property and Equipment	___
G. Collections of Works of Art and Similar Items	___
H. Other Assets and Deferred Charges	___
I. Interfund Borrowings	___
J. Current Liabilities	___
K. Notes Payable and Other Debt	___
L. Lessee Leases	___
M. Other Liabilities and Deferred Credits	___
N. Trust Funds and Gifts of Future Interests	___
O. Net Assets/Fund Balances	___
P. Restricted Resources	___

- Statement of Activities/Activity (or Statement of Revenues and Expenses, or Statement of Support and Revenue, Expenses, Capital Additions, and Changes in Fund Balances)

A. General	___
B. Fund Accounting	___
C. Taxes	___
D. Transfers	___
E. Third-Party Reimbursements	___
F. Donated or Contributed Services	___
G. Donated Materials and Facilities	___
H. Subscription and Membership Income	___
I. Fund Raising	___
J. Contributions	___
K. Gifts of Future Interest	___
L. Expenses	___
M. Wills or Trusts	___
N. Investments and Endowments	___

- Additional Financial Statements

A. Statement of Changes in Financial Position	___
B. Statement of Cash Flows	___
C. Statement of Functional Expenses	___

- Exhibit A — Postretirement Health Care Benefits (for organizations that have not adopted SFAS 106) ___

Place ✓ by Sections Not Applicable

- Exibit B — Impairment of Long-Lived Assets ___
- Auditors' Report ___
- Auditors' Reports on Audits Performed Under Government Auditing Standards and OMB Circular A-133 ___

CHECKLIST QUESTIONNAIRE

Note: If you are preparing or reporting on financial statements of an organization that has adopted SFAS 116 and 117, complete all disclosure items denoted with a ★. For organizations that have not adopted SFAS 116 and 117, complete all disclosure items marked with a ♦.

	Yes	No	N/A
I. General			
A. Titles and References			
★♦ 1. Are the financial statements suitably titled? [SAS 62, par. 7 (AU 623.07)]	___	___	___
★♦ 2. Does each statement include a general reference that the notes are an integral part of the financial statement presentation? [Generally Accepted]	___	___	___
3. For each period, are the following financial statements presented:			
★♦ a. Statement of financial position?[3]	___	___	___
★♦ b. Statement of activities?	___	___	___
♦ c. Statement of changes in fund balance (if not shown as part of the statement of activity)?	___	___	___
★ d. Statement of cash flows?	___	___	___

[3] For simplicity, we have used throughout this checklist, the financial statement titles that would be used by organizations that have adopted SFAS 117, even though a disclosure item may also relate to organizations that have not adopted SFAS 117. In other words, if you are completing the checklist for an organization that has not adopted SFAS 117 and a disclosure item refers to the "statement of financial position date," you should interpret that statement as the "balance sheet date."

	Yes	No	N/A
VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS (VHWO) OMIT STEP e.			
◆ e. Statement of changes in financial position?	___	___	___
ORGANIZATIONS OTHER THAN VHWO OMIT STEPS f. AND g.			
★◆ f. Statement of functional expenses?	___	___	___
★◆ g. Supplemental schedule of changes in designated portions of unrestricted net assets or fund (optional)? [SFAS 117, pars. 1 and 6 (AC No. 5.104); SOP 78-10, pars. 16–18; AAG-NPR, par. 1.10; AAG-VHW, pars.1.14 and 7.05]	___	___	___
B. Accounting Policies and Other Disclosures			
★◆ 1. Is a description of all significant accounting policies adopted and followed presented as an integral part of the financial statements? [APB 22, par. 9 (AC A10.103)]	___	___	___
a. Are the organization's accounting policies disclosed for:			
(1) Grant commitments?	___	___	___
(2) Carrying value of investments?	___	___	___
(3) Carrying value of property, plant, equipment, and collections?	___	___	___
(4) Pledges receivable? [Generally accepted]	___	___	___
★◆ 2. If the organization prepared its financial statements on a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), was disclosure made of the basis of presentation and how that basis differs from GAAP? [SAS 62, par. 10 (AU 623.10)]	___	___	___
★◆ 3. Does disclosure of significant accounting policies encompass important judgments as to appropriateness of principles concerning recognition of revenue, and allocation of asset costs to current and future periods? [APB 22, par. 12 (AC A10.105)]	___	___	___

	Yes	No	N/A
★◆ 4. Does the disclosure of significant accounting policies include appropriate reference to details presented elsewhere (in the statements and notes thereto) so duplication of details is avoided? [APB 22, par. 14 (AC A10.107)]	___	___	___
★◆ 5. Do the financial statements identify the organization's:			
a. Principal programs?	___	___	___
b. Principal program costs? [SOP 78-10, par. 9]	___	___	___
★◆ 6. Do the financial statements or notes disclose the degree of control exercised by donors over the use of resources? [SOP 78-10, par. 9]	___	___	___

C. Accounting Changes

	Yes	No	N/A
★ 1. In the initial year of application of SFAS 116 and SFAS 117, is the nature of any restatement and its effect on the change in net assets for each period presented disclosed? [SFAS 116, par. 30; SFAS 117, par. 31]	___	___	___
★ 2. If SFAS 116 is not applied retroactively, is the cumulative effect of the change in accounting on each class of net assets reported in the statement of activities between the captions, "extraordinary items," if any, and "change in unrestricted net assets," and "change in permanently restricted net assets"? [SFAS 116, par. 29]	___	___	___
★◆ 3. For an accounting change, does disclosure in the period of the change include:			
a. Nature of the change?	___	___	___
b. Justification for the change and a clear explanation of why the newly adopted principle is preferable?	___	___	___
c. Effect on excess of revenues over expenses? [APB 20, par. 17 (AC A06.113)]	___	___	___
★◆ 4. Is a correction of an error shown as a prior period adjustment with disclosure of the following in the period of its discovery and correction:			

	Yes	No	N/A
a. Nature and effect of the error in previously issued financial statements?	___	___	___
b. Effect of its correction on excess of revenues over expenses before and after extraordinary items? [APB 20, par. 37 (AC A35.105); SFAS 109, par. 288n (AC A35.103); APB 9, par. 26 (AC A35.107)]	___	___	___
c. For single period statements, the effects of the prior period adjustment on net assets or fund balance, as applicable, at the beginning of the period? [APB 9, par. 26 (AC A35.107)]	___	___	___

D. Comparative Financial Statements

	Yes	No	N/A
★◆ 1. Has presentation of comparative statements been considered? [SFAS 117, par. 69; ARB 43, Ch. 2A, pars. 1–2 (AC F43.101–.102); SOP 78-10, par. 41]	___	___	___
★◆ 2. Are the disclosures included in the prior year's financial statements repeated, or at least referred to, to the extent that they continue to be of significance? [ARB 43, Ch. 2A, par. 2 (AC F43.102)]	___	___	___
★◆ 3. If changes have occurred in the manner of or basis for presenting corresponding items for two or more periods, are appropriate explanations of the changes disclosed? [ARB 43, Ch. 2A, par. 3 (AC F43.103)]	___	___	___
★ 4. If comparative annual financial statements are presented for earlier periods, are those financial statements reclassified (or restated) to reflect retroactive application of the provisions of SFAS 116 and SFAS 117? [SFAS 116, par. 30; SFAS 117, par. 31]	___	___	___

E. Related Entities

SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations,* is effective for financial statements issued for fiscal years beginning after December 15, 1994, except for not-for-profit organizations that have less than $5 million in total assets and less than $1 million in annual expenses. For those organizations, the effective date is for fiscal years beginning after December 15, 1995. Earlier application is permitted and for organizations that adopt SFAS 117 before its effective date, earlier application is encouraged.

	Yes	No	N/A
★◆ 1. If consolidated financial statements are presented in accordance with SOP 94-3, refer to section I.G., "Consolidated Financial Statements"; if an investment is accounted for under the equity method, refer to section II.C., "Investments/Marketable Securities." [SOP 94-3, pars. 5-13(ACC 10,610.05-.13)]	___	___	___
★◆ 2. Is the nature of a controlled relationship disclosed, even though there are no transactions between the enterprises, if the reporting entity and one or more other enterprises are under common ownership or management control, and the existence of the control could result in operating results or financial position of the reporting entity being significantly different from those that would have been obtained if the entity were autonomous? [SFAS 57, pars. 2 and 4 (AC R36.102 and .104)]	___	___	___
★◆ 3. If the organization controls a separate not-for-profit organization through a form other than majority ownership or voting interest and has an economic interest in that other organization and consolidated financial statements are not presented, do disclosures include:			
a. Identification of the other organization and the nature of its relationship with the reporting organization that results in control?	___	___	___
b. Summarized financial data of the other organization including: total assets, liabilities, net assets, revenue, and expenses, and resources that are held for the benefit of the reporting organization or that are under its control?	___	___	___
c. Disclosures required by SFAS 57 as described in items 2. and 3.? [SOP 94-3, par. 12 (ACC 10,610.12)]	___	___	___

F. Business Combinations

	Yes	No	N/A
★◆ 1. If a business combination occurred during the period and met the specified conditions for a pooling-of-interests, do the statements and notes include the required disclosures? Note: Not-for-profit organizations are, under certain circumstances, permitted to use the pooling-of-interests method, even though they generally do not issue common stock. [SOP 94-2, pars. 18-19] [APB 16, pars. 45-48 and 63-65 (AC B50.104-.107 and .122-.124)]	___	___	___

	Yes	No	N/A
★◆ 2. If a business combination does not meet the specified conditions for a pooling-of-interests:			
a. Is the combination accounted for by the purchase method? [APB 16, pars. 66–88, 90–94 (AC B50.125-.146 and .159-.163); SFAS 38 (AC B50.148-.150 and .166); FASBI 4 (AC B50.151-.152) concerns research and development activities of an acquired subsidiary]	___	___	___
b. Do the statements and notes include the required disclosures? [APB 16, pars. 95–96 (AC B50.164-.165); SFAS 79, par. 6 (AC B50.165)]	___	___	___

G. Consolidated Financial Statements

	Yes	No	N/A
★◆ 1. If consolidated financial statements are presented:			
a. Is the consolidation policy disclosed? [ARB 51, par. 5 (AC C51.108); APB 22, pars. 12–14 as amended by SFAS 95, par. 152 (AC A10.105-.107)]	___	___	___
b. In instances in which the financial reporting periods of subsidiaries differ from that of the parent, is recognition given to the effect of intervening events that materially affect financial position or the results of operations? [ARB 51, par. 4 (AC C51.107)]	___	___	___
c. Are restrictions made by entities outside of the reporting entity on distributions from the controlled not-for-profit organization to the reporting organization and any resulting unavailability of the net assets of the controlled not-for-profit organization for use by the reporting organization disclosed? [SOP 94-3, par. 14 (ACC 10, 610.14)]	___	___	___

H. Financial Instruments

In October 1994, the FASB issued SFAS 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*,[4] which expands the disclosure requirements for entities that hold or issue derivative financial instruments. It also amends

[4] SFAS 119 is effective for fiscal years ending after December 15, 1994. For organizations with less than, $150 million in total assets in the current statement of financial position, the effective date is for fiscal years ending after December 15, 1995. However, earlier application is encouraged.

Yes No N/A

certain disclosure requirements of SFAS 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and SFAS 107, *Disclosures about Fair Value of Financial Instruments*. This section has been updated to reflect SFAS 119's amendments to SFAS 105 and 107. For entities that have *not* adopted SFAS 119, guidance is provided in certain footnotes in this section of the checklist for applying the disclosure requirements of SFAS 105 and 107 prior to adoption of SFAS 119.

Only organizations that have adopted SFAS 119 should complete the following section, Section I., "Derivatives."

★◆ 1. For financial instruments with off-balance-sheet risk (except for those excluded in SFAS 105), are the following disclosed either in the body of the financial statements or in the notes by category of financial instrument:[5]

a. The face or contract amount (or notional principal amount if there is no face or contract amount)? ___ ___ ___

b. The nature and terms, including, at a minimum, a discussion of:

(1) The credit and market risk of those instruments? ___ ___ ___

(2) The cash requirements of those instruments? ___ ___ ___

(3) The related accounting policy pursuant to the requirements of APB 22 [AC A10]? ___ ___ ___
[SFAS 105, par. 17, as amended by SFAS 119, par. 14 (AC F25.112)]

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5 *Category of financial instrument* refers to class of financial instrument, business activity, risk, or other category that is consistent with the management of those instruments. If disaggregation of financial instruments is other than by class, the entity also should describe for each category the classes of financial instruments included in that category. Practices for grouping and separately identifying similar financial instruments into *classes* in statements of financial position, in notes to financial statements, and in various regulatory reports have developed and become generally accepted, largely without being codified in authoritative literature. In SFAS 105 [AC F25], "class of financial instrument" refers to those classifications. If the organization has not adopted SFAS 119, the disclosures in steps 1.a.-b. should be made by *class* of financial instrument, rather than by *category*.

Yes No N/A

★◆ 2. Do the disclosures in steps 1a. and b. distinguish between financial instruments with off-balance-sheet risk held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments with off-balance-sheet risk held or issued for purposes other than trading?[6] ___ ___ ___
[SFAS 105, par. 17, as amended by SFAS 119, par. 14 (AC F25.112A)]

★◆ 3. For financial instruments with off-balance-sheet credit risk (except for those excluded in SFAS 105), are the following disclosed either in the body of the financial statements or in the notes by category of financial instrument:[7]

a. The amount of accounting loss the organization would incur if any party to the financial instrument failed completely to perform according to the terms of the contract and the collateral or other security, if any, for the amount due proved to be of no value to the organization? ___ ___ ___

b. The organization's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the organization's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments? ___ ___ ___
[SFAS 105, par. 18 as amended by SFAS 119, par. 14 (AC F25.113)]

★◆ 4. Do disclosures of all significant concentrations of credit risk arising from all financial instruments, whether from an individual counterparty or groups of counterparties (except for certain insurance and investment contracts, purchase and pension obligations), include:

a. Information about the (shared) activity, region, or economic characteristic that identifies the concentration? ___ ___ ___

[6] Not applicable to organizations that have not adopted SFAS 119.

[7] See footnote 5. If the organization has not adopted SFAS 119, the disclosures in step 3 should be made by *class* of financial instrument, rather than by *category*.

	Yes	No	N/A
b. The amount of the accounting loss due to credit risk the organization would incur if parties to the financial instruments that make up the concentration failed completely to perform according to the terms of the contracts and the collateral or other security, if any, for the amount due proved to be of no value to the organization?	___	___	___
c. The organization's policy of requiring collateral or other security to support financial instruments subject to credit risk, information about the organization's access to that collateral or other security, and the nature and a brief description of the collateral or other security supporting those financial instruments? [SFAS 105, par. 20 (AC F25.115)]	___	___	___
NOTE: For organizations with less than $150 million in total assets in the current statement of financial position, the effective date for SFAS 107 disclosures is for financial statements issued for fiscal years ending after December 15, 1995. However, earlier application is encouraged.			
★♦ 5. Is the fair value of financial instruments for which it is practicable to estimate that value (except for those excluded in paragraphs 8 and 13 of SFAS 107) disclosed, together with the related carrying amount in a form that makes it clear whether the fair value and carrying amount represent assets or liabilities and how the carrying amounts relate to what is reported in the statement of financial position?[8, 9] [SFAS 107, par. 10 as amended by SFAS 119, par. 15 (AC F25.115C)]	___	___	___
★♦ 6. Do the disclosures in step 5. distinguish between financial instruments held or issued for trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings, and financial instruments held or issued for purposes other than trading?[9] [SFAS 107, par. 10 as amended by SFAS 119, par. 15 (AC F25.115C)]	___	___	___

[8] If disclosed in more than a single note, one of the notes should include a summary table containing the fair value and related carrying amounts and cross-references to the location(s) of the remaining disclosures required by SFAS 107, as amended.

[9] Not applicable to organizations that have not adopted SFAS 119.

	Yes	No	N/A
★◆ 7. Are the methods and significant assumptions used to estimate the fair value of financial instruments disclosed? [SFAS 107, par. 10 (AC F25.115C)]	___	___	___
★◆ 8. If it is not practicable to estimate the fair market value of a financial instrument, do disclosures include:			
a. Information pertinent to estimating the fair value of the financial instrument or class of financial instruments, such as the carrying amount, effective interest rate, and maturity?	___	___	___
b. The reasons why it is not practicable to estimate fair value? [SFAS 107, par. 14 (AC F25.115J)]	___	___	___
★◆ 9. If the offsetting of derivative financial instruments against nonderivative financial instruments is not permitted under FASB Interpretation No. 39, *Offsetting of Amounts Related to Certain Contracts,* does the organization, in disclosing the fair value of a derivative financial instrument, not:[10]			
a. Combine, aggregate, or net the fair value with the fair value of a nonderivative financial instrument?	___	___	___
b. Net the fair value with the fair value of other derivative financial instruments? [SFAS 107, par. 13 as amended by SFAS 119, par. 15 (AC F25.115I)]	___	___	___
★◆ 10. For all fiscal years subsequent to the year of transition, are SFAS 107 disclosures included for each year for which a statement of financial position is presented for comparative purposes? [SFAS 107, par. 17]	___	___	___

I. Derivatives (SFAS 119 is effective for financial statements issued for fiscal years ending after December 15, 1994, except for entities with less than $150 million in total assets. For those entities, the Statement is effective for financial statements issued for fiscal years ending after December 15, 1995.)

★◆ 1. For options held and other derivative financial instruments not within the scope of SFAS 105 that do not have off-balance-sheet

[10] See footnote 9.

	Yes	No	N/A
risk, are the following disclosures made by category of financial instrument:			
a. The face or contract amount (or notional principal amount if there is no face or contract amount)?	___	___	___
b. The nature and terms, including a discussion of:			
(1) Credit and market risk?	___	___	___
(2) Cash requirements?	___	___	___
(3) Related accounting policy as required by APB 22?	___	___	___
c. Do disclosures in Steps 1.a. and b. above distinguish between financial instruments held or issued for:			
(1) Trading purposes, including dealing and other trading activities measured at fair value with gains and losses recognized in earnings?	___	___	___
(2) Purposes other than trading? [SFAS 119, pars. 8 and 9]	___	___	___
★◆ 2. Does the organization that holds derivative financial instruments for trading purposes disclose:			
a. The average fair value during the reporting period and the related end-of-period fair value, distinguishing between assets and liabilities?	___	___	___
b. The net gains or losses (net trading revenue) arising from trading activities during the reporting period disaggregated by class, business activity, risk or other category consistent with management of those activities and where those net trading gains or losses are reported in the income statement?	___	___	___
(1) If the disaggregation is other than by class, did the organization also disclose for each category the classes of derivative financial instruments, other financial instruments, and nonfinancial assets and liabilities from which the net trading gains and losses arose?	___	___	___

	Yes	No	N/A
c. The average fair value for assets and liabilities from the trading of other types of financial instruments or nonfinancial assets? (This disclosure is encouraged but not required.) [SFAS 119, par. 10]	___	___	___
★◆ 3. Does an organization that holds derivative financial instruments for purposes other than trading disclose:			
a. A description of:			
(1) The objectives for holding?	___	___	___
(2) The context needed to understand those objectives?	___	___	___
(3) The strategies for achieving those objectives?	___	___	___
(4) The classes of derivative financial instruments used?	___	___	___
b. A description of how each class of derivative financial instrument is reported in the financial statements, including:			
(1) The policies for recognition and measurement or nonrecognition of the derivative financial instruments?	___	___	___
(2) When recognized, where the instruments and related gains and losses are reported?	___	___	___
c. For derivative financial instruments that are held or issued and accounted for as hedges of anticipated transactions, both firm and forecasted transactions for which there is no firm commitment, including:			
(1) A description of the anticipated transactions whose risks are hedged, including the expected time period of occurrence?	___	___	___
(2) A description of the classes of derivative financial instruments used to hedge?	___	___	___
(3) The amount of explicitly deferred hedging gains and losses?	___	___	___
(4) A description of the transaction or events that result in the recognition in earnings of the deferred gains or losses? [SFAS 119, par. 11]	___	___	___

	Yes	No	N/A
★◆ 4. Are the following encouraged, but not required, quantitive disclosures made:			
a. Interest rate?	___	___	___
b. Foreign exchange?	___	___	___
c. Commodity price?	___	___	___
d. Other market risks consistent with management's strategies?	___	___	___
e. Information of the risk of other financial instruments or nonfinancial assets and liabilities related by risk management strategy pertaining to the objectives for holding or issuing derivative financial instruments?[11] [SFAS 119, pars. 12 and 13]	___	___	___

J. Nonmonetary Transactions

	Yes	No	N/A
★◆ 1. Do disclosures for nonmonetary transactions during the period include:			
a. Nature of the transactions?	___	___	___
b. Basis of accounting for the assets transferred?	___	___	___
c. Gains or losses recognized on the transfers? [APB 29, par. 28 (AC C11.102 and N35.120); FASBI 30 (AC N35.114-.119)]	___	___	___

[11] Suggested methods of disclosure of the above include:

a. Additional details about current positions and period activity.

b. Hypothetical effects on equity or on annual income due to several possible changes in market prices.

c. Gap analysis of interest rate repricing or maturity dates.

d. Duration of financial instruments.

e. The entity's value at risk from derivative financial instruments and other positions at period end and the average value at risk during the year.

f. Any other helpful informative disclosures.

	Yes	No	N/A

K. Contingencies and Commitments

★◆ 1. Are the nature and amount of accrued loss contingencies disclosed as necessary to keep the financial statements from being misleading? [SFAS 5, par. 9 (AC C59.108)] ___ ___ ___

★◆ 2. For loss contingencies not accrued, do disclosures indicate:

a. Nature of the contingency? ___ ___ ___

b. Estimate of possible loss or range of loss, or a statement that such estimate cannot be made? [SFAS 5, par. 10 (AC C59.109)] ___ ___ ___

★◆ 3. If exposure to loss exists in excess of the amount accrued for a loss contingency, do disclosures include the excess amount or state that no estimate is possible? [SFAS 5, par. 10 (AC C59.109)] ___ ___ ___

★◆ 4. Are the nature and amount of guarantees disclosed (for example, of indebtedness of others)? [SFAS 5, par. 12 (AC C59.113); FASBI 34, pars. 2-3 (AC C59.114)] ___ ___ ___

★◆ 5. Are gain contingencies adequately disclosed to avoid any misleading implications about likelihood of realization? [SFAS 5, par. 17 (AC C59.118)] ___ ___ ___

★◆ 6. Is there adequate disclosure of commitments such as those for capital expenditures, grants to be awarded to others, restrictive covenants in financing agreements, inventory purchase agreements, and employment contracts? [SFAS 5, pars. 18–19 (AC C59.120)] ___ ___ ___

★◆ 7. Are encumbrances, appropriations of fund balance, unspecified reserves, and other commitments not meeting the criteria of SFAS 5, par. 8 not reported as expenses or liabilities? Note: These may be reported as segregations of net assets of individual funds if such funds are reported separately on the statement of financial position (if SFAS 117 has been adopted) or as segregations of fund balance on the balance sheet (if SFAS 117 has not been adopted). [SFAS 5, pars. 14–15 (AC C59.116–.117); SOP 78-10, par. 12] ___ ___ ___

	Yes	No	N/A
★◆ 8. Are commitments to fund future grants that are not unconditional grants at the statement of financial position date disclosed? [SOP 78-10, par. 102]	___	___	___

L. Risks and Uncertainties (SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties,* is effective for financial statements issued for fiscal years ending after December 15, 1995, and for financial statements for interim periods in fiscal years subsequent to the year for which this SOP is to be first applied. Early application is encouraged but not required.)

	Yes	No	N/A
★◆ 1. Is a description of the principal services performed by the organization and the revenue sources for the organization's services included in the financial statements? [SOP 94-6, par. 10]	___	___	___
★◆ 2. Is an explanation that the preparation of financial statements in conformity with GAAP requires the use of management's estimates included in the financial statements? [SOP 94-6, par.11]	___	___	___
★◆ 3. Is disclosure regarding an estimate made when known information available prior to the issuance of the financial statements indicates that both of the criteria in SOP 94-6, par. 13 are met? [SOP 94-6, par. 13]	___	___	___
★◆ 4. Does the disclosure in Step 3. above, indicate the nature of the uncertainty including an indication that it is at least reasonably possible that a change in estimate will occur in the near term? [SOP 94-6, par. 14]	___	___	___
★◆ 5. Have the optional disclosures in paragraphs 14-15 of SOP 94-6 been considered? [SOP 94-6, par. 14–15]	___	___	___
★◆ 6. Is disclosure of the concentrations described in paragraph 22 of SOP 94-6 made, if, based on information known to management prior to issuance of the financial statements, the criteria in paragraph 21 are met? [SOP 94-6, pars. 21–22]	___	___	___

M. Related Parties

★◆ 1. For related-party transactions, do disclosures include:

	Yes	No	N/A
a. The nature of the relationships involved (e.g., affiliate companies, officers, etc.)?	___	___	___
b. A description of the transactions to which no amounts or nominal amounts were ascribed, for each of the periods for which a statement of activity is presented, and such other information deemed necessary to an understanding of the effects of the transactions on the financial statements?	___	___	___
c. The dollar amount of transactions for each of the periods for which a statement of activities is presented and the effects of any change in the method of establishing the terms from that used in the preceding period?	___	___	___
d. Amounts due from or to related parties as of the date of each statement of financial position presented and, if not otherwise apparent, the terms and manner of settlement? [SFAS 57, pars. 2–4 (AC R36.102–.104)]	___	___	___
★◆ 2. With respect to disclosure of related-party transactions, is consideration given to disclosing transactions with chapters, foundations, auxiliaries, guilds, trusts, etc., as well as to members of management and the governing board and other organizations with which such parties are affiliated? [SOP 78-10, par. 7.01]			

N. Subsequent Events

	Yes	No	N/A
★◆ 1. Are the financial statements adjusted for any changes in estimates resulting from subsequent events that provided additional evidence about conditions that existed at the statement of financial position date? [SFAS 5, par. 8 (AC C59.105); SAS 1, secs. 560.03–.04, 560.07 and 561.01–.10 (AU 560.03–.04, .07 and 561.01–.10)]	___	___	___
★◆ 2. Are subsequent events that provide evidence about conditions that did not exist at the statement of financial position date, but arose subsequent to that date adequately disclosed to keep the financial statements from being misleading? [SFAS 5, par. 11 (AC C59.112); APB 16, par. 61 (AC B50.120) and SAS 1, secs. 560.05–.07, 561.01–.10 (AU 560.05–.07, and 561.01–.10)]	___	___	___

	Yes	No	N/A
[Consider the appropriateness of dual dating the auditor's report if a subsequent event is disclosed in the financial statements. SAS 1, sec. 530.05 (AU 530.05)]			
O. Pension Plans [For defined benefit pension plans, accounting and reporting by the plans themselves should be in conformity with SFAS 35 (AC Pe5)]			
★◆ 1. **If there is a defined benefit plan**, do disclosures include:			
a. A description of the plan including employee groups covered, type of benefit formula, funding policy, types of assets held and significant nonbenefit liabilities, if any, and the nature and effect of significant matters affecting comparability of information for all periods presented? [SFAS 87, par. 54a (AC P16.150a)]	___	___	___
b. The amount of net periodic pension cost for the period showing separately the service cost component, the interest cost component, the actual return on assets for the period, and the net total of other components?[12] [SFAS 87, par. 54b (AC P16.150b)]	___	___	___
c. A schedule reconciling the funded status of the plan with amounts reported in the employer's statement of financial position, showing separately:			
(1) The fair value of plan assets?	___	___	___
(2) The projected benefit obligation identifying the accumulated benefit obligation and the vested benefit obligation?	___	___	___
(3) The amount of unrecognized prior service cost?	___	___	___

[12] The net total of other components is the net effect during the period of certain delayed recognition provisions of SFAS 87 (AC P16). That net total includes:

(1) The net asset gain or loss during the period deferred for later recognition (in effect, an offset or a supplement to the actual return on assets)
(2) Amortization of the net gain or loss from earlier periods
(3) Amortization of unrecognized prior service cost
(4) Amortization of the unrecognized net obligation or net asset existing at the date of initial application of SFAS 87 (AC P16).

	Yes	No	N/A
(4) The amount of unrecognized net gain or loss (including asset gains and losses not yet reflected in market-related value)?	___	___	___
(5) The amount of any remaining unrecognized net obligation or net asset existing at the date of initial application of SFAS 87 (AC P16)?	___	___	___
(6) The amount of any additional liability recognized pursuant to SFAS 87, paragraph 36 (AC P16.130)?	___	___	___
(7) The amount of net pension asset or liability recognized in the statement of financial position pursuant to SFAS 87, paragraphs 35-36 (AC P16.129-.130) (which is the net result of combining the preceding six items)? [SFAS 87, par. 54c (AC P16.150c)]	___	___	___
d. The weighted-average assumed discount rate and rate of compensation increase (if applicable) used to measure the projected benefit obligation and the weighted-average expected long-term rate of return on plan assets? [SFAS 87, par. 54d (AC P16.150d)]	___	___	___
e. If applicable, the amounts and types of securities of the employer and related parties included in plan assets, and the approximate amount of annual benefits of employees and retirees covered by annuity contracts issued by the employer and related parties? [SFAS 87, par. 54e (AC P16.150e)]	___	___	___
f. If applicable, the alternative amortization method used pursuant to SFAS 87, paragraphs 26 and 33 (AC P16.120 and .127), and the existence and nature of the commitment discussed in SFAS 87 paragraph 41 (AC P16.135)? [SFAS 87, par. 54e (AC P16.150e)]	___	___	___
g. If more than one defined benefit plan exists:			
(1) Are the required disclosures above aggregated for all of the employer's single-employer-defined benefit plans or disaggregated in groups so as to provide the most useful information?	___	___	___

	Yes	No	N/A
(2) Are plans with assets in excess of accumulated benefit obligations not aggregated with plans that have accumulated benefit obligations that exceed plan assets? [SFAS 87, par. 56 (AC P16.153)]	___	___	___
★◆ 2. **If there is a defined contribution plan**, are the following items disclosed:			
a. A description of the plan including employee groups covered, the basis for determining contributions, and the nature and effect of significant matters affecting comparability of information for all periods presented?	___	___	___
b. The amount of cost recognized during the period? [SFAS 87, par. 65 (AC P16.162)]	___	___	___
c. If the pension plan has characteristics of both a defined benefit plan and a defined contribution plan and the substance of the plan is to provide a defined benefit, is Step 1 (a-g) followed? [SFAS 87, par. 66 (AC P16.163)]	___	___	___
★◆ 3. **If there is a multiemployer plan**, do disclosures include:			
a. A description of the multiemployer plan, including the employee groups covered, the type of benefits provided (defined benefit or defined contribution), and the nature and effect of significant matters affecting comparability of information for all periods presented? [SFAS 87, par. 69a (AC P16.166a)]	___	___	___
b. The amount of cost recognized during the period? [SFAS 87, par. 69b (AC P16.166b)]	___	___	___
c. If the situation arises where the withdrawal from a multiemployer plan may result in the employer having an obligation to the plan for a portion of its unfunded benefit obligations that is either probable or reasonably possible, are the provisions of SFAS 5 [AC C59] applied? [SFAS 87, par. 70 (AC P16.167)]	___	___	___
★◆ 4. If there is a settlement or curtailment of a defined benefit pension plan or of termination benefits under such plan, do disclosures include:			
a. A description of the nature of the event(s)?	___	___	___

	Yes	No	N/A
b. The amount of gain or loss recognized? [SFAS 88, par. 17 (AC P16.187)]	___	___	___
★◆ 5. If the organization terminates a defined benefit plan and (1) contributes the assets withdrawn to a defined contribution plan, (2) the amount contributed is in excess of the employer's required annual contribution to the plan, and (3) the risk and rewards of the ownership of the assets are retained by the employer, were the following considered for the defined contribution plan:			
a. Is the excess contribution that is not allocated to individual participants accounted for as an asset regardless of the source of funds?	___	___	___
b. Is the unallocated amount treated as if it were part of the employer's investments portfolio and recorded as an asset?	___	___	___
(1) Is the income attributed to such securities including dividends, interest, and realized gains and losses reported in a manner consistent with the employer's reporting of similar items?	___	___	___

P. Postretirement Benefits Other Than Pensions (See Exhibit A if SFAS 106 has not been adopted)

	Yes	No	N/A
★◆ 1. If there are one or more defined benefit postretirement plans, do disclosures include:			
a. A description of the substantive plan(s) that is the basis for the accounting, including the nature of the plan, any modifications of the existing cost-sharing provisions that are encompassed by the substantive plan(s), and the existence and nature of any commitment to increase monetary benefits provided by the postretirement benefit plan, employee groups covered, types of benefits provided, funding policy, types of assets held and significant nonbenefit liabilities, and the nature and effect of significant matters affecting the comparability of information for all periods presented, such as the effect of a business combination or divestiture?	___	___	___
b. The amount of net periodic postretirement benefit cost, showing separately the service cost component, the interest cost component, the actual return on plan assets for the period, amortization			

	Yes	No	N/A
of the unrecognized transition obligation or transition asset, and the net total of other components?[13]	___	___	___
c. A schedule reconciling the funded status of the plan(s) with amounts reported in the employer's statement of financial position, showing separately:			
(1) The fair value of plan assets?	___	___	___
(2) The accumulated postretirement benefit obligation, identifying separately the portion attributable to retirees, other fully eligible plan participants, and other active plan participants?	___	___	___
(3) The amount of unrecognized prior service cost?	___	___	___
(4) The amount of unrecognized net gain or loss (including plan asset gains and losses not yet reflected in market-related value)?	___	___	___
(5) The amount of any remaining unrecognized transition obligation or transition asset?	___	___	___
(6) The amount of net postretirement benefit asset or liability recognized in the statement of financial position, which is the net result of combining the preceding five items?	___	___	___
d. The assumed health care cost trend rate(s) used to measure the expected cost of benefits covered by the plan (gross eligible charges) for the next year and a general description of the direction and pattern of change in the assumed trend rates thereafter, together with the ultimate trend rate(s) and when that rate is expected to be achieved?	___	___	___
e. The weighted-average of the assumed discount rate(s) and rate(s) of compensation increase (for pay-related plans) used to measure the accumulated postretirement benefit obligation and the weighted-average of the expected long-term rate(s) of return on plan assets?	___	___	___

[13] The net total of other components is generally the net effect during the period of certain delayed recognition provisions of SFAS 106 (AC P40). That net total includes:

a. The net asset gain or loss during the period deferred for later recognition (in effect, an offset or a supplement to the actual return on plan assets).
b. Amortization of unrecognized prior service cost.
c. Amortization of the net gain or loss from earlier periods.
d. Any gain or loss recognized due to a temporary deviation from the substantive plan (of SFAS 106, par. 61 (AC P40.156)).

	Yes	No	N/A
f. The effect of a one-percentage- point increase in the assumed health care cost trend rates for each future year on the aggregate of the service and interest cost components of net periodic postretirement health care benefit cost; and the accumulated postretirement benefit obligation for health care benefits (for purposes of this disclosure, all other assumptions should be held constant and the effects should be measured based on the substantive plan that is the basis for the accounting)?	___	___	___
g. The amounts and types of securities of the employer and related parties included in plan assets, and the approximate amount of future annual benefits of plan participants covered by insurance contracts issued by the employer and related parties?	___	___	___
h. Any alternative amortization method used pursuant to paragraph 53 or 60 of SFAS 106 (e.g., a straight-line amortization of the cost over the average remaining years of service to full eligibility for benefits of the active plan participants)?	___	___	___
i. The amount of gain or loss recognized during the period for a settlement or curtailment and a description of the nature of the event(s)?	___	___	___
j. The cost of providing special or contractual termination benefits recognized during the period and a description of the nature of the event(s)? [SFAS 106, par. 74a-j (AC P40.169a-j)]	___	___	___
★◆ 2. **If more than one defined benefit postretirement plan exists:**			
a. Are the disclosures required by Step 1. above aggregated for all of an employer's single-employer defined benefit postretirement plans or disaggregated in groups so as to provide the most useful information (except, for purposes of the disclosures required by Step 1.c. above, the aggregate plan assets and the aggregate accumulated postretirement benefit obligation of the underfunded plans should be separately disclosed)? [SFAS 106, par. 77 (AC P40.172)]	___	___	___
b. Are plans that provide primarily postretirement healthcare benefits and plans that provide primarily other postretirement welfare benefits separately disclosed if the accumulated postretirement benefit obligation of the latter plans is significant relative to the aggregate accumulated postretirement benefit obligation for all the plans? [SFAS 106, par. 78 (AC P40.173)]	___	___	___

	Yes	No	N/A
★◆ 3. **If there is a multiemployer plan**, do disclosures include:			
a. A description of the multiemployer plan(s) including the employee groups covered, the type of benefits provided (defined benefit or defined contribution), and the nature and effect of significant matters affecting comparability of information for all periods presented?	___	___	___
b. The amount of postretirement benefit cost recognized during the period, if available. Otherwise, the amount of the aggregate required contribution for the period to the general health and welfare benefit plan that provides health and welfare benefits to both active employees and retirees? [SFAS 106, par. 82 (AC P40.178)]	___	___	___
c. Are the provisions of SFAS 5 [AC C59] applied if the situation arises where withdrawal from a multiemployer plan may result in an employer's having an obligation to the plan for a portion of the plan's unfunded accumulated postretirement benefit obligation and it is probable or reasonably possible that:			
(1) An employer would withdraw from the plan under circumstances that would give rise to an obligation?	___	___	___
or			
(2) An employer's contribution to the fund would be increased during the remainder of the shortfall in the funds necessary to maintain the negotiated level of benefit coverage? [SFAS 106, par. 83 (AC P40.179)]	___	___	___
★◆ 4. If there is one or more defined contribution postretirement plans, are the following items disclosed separately from defined benefit postretirement plan disclosures:	___	___	___
a. A description of the plan(s) including employee groups covered, the basis for determining contributions, and the nature and effect of significant matters affecting comparability of information for all periods presented?	___	___	___
b. The amount of cost recognized during the period? [SFAS 106, par. 106 (AC P40.198)]	___	___	___

	Yes	No	N/A
Q. Extraordinary Items			
★◆ 1. Are extraordinary items segregated and shown on the face of the Statement of Activities using the caption "extraordinary items"?	___	___	___
★◆ 2. Are descriptive captions and amounts presented for individual extraordinary events or transactions, preferably on the face of the Statement of Activities?	___	___	___
★◆ 3. Do disclosures include descriptions of extraordinary events or transactions and the principal items entering into determination of extraordinary gains or losses? [APB 30, par. 11 (AC I17.102)]	___	___	___
★◆ 4. For an adjustment of an extraordinary item reported in a prior period:			
a. Is the adjustment classified separately as an extraordinary item in the current period?	___	___	___
b. Are the nature, origin, and amount of the item disclosed? [SFAS 16, par. 16(c) (AC I17.119)]	___	___	___
R. Advertising Costs [Note: Fund-raising by nonprofit organizations is not considered advertising. (SOP 93-7, par. 22 fn. 4)]			
★◆ 1. Do the disclosures for advertising costs include:			
a. The accounting policy selected from the two alternatives in paragraph 26 of SOP 93-7 (as interpreted by PB 13, *Direct-Response Advertising and Probable Future Benefits*), including whether such costs are expensed as incurred or the first time the advertising takes place?	___	___	___
b. A description of the direct-response-advertising reported as assets (if any), the related accounting policy, and the amortization method and period?	___	___	___
c. The amount charged to advertising expense for each statement of activities presented, with separate disclosure of amounts, if any, representing a write-down of the capitalized advertising costs to net realizable value and the reasons for the write-down?	___	___	___

	Yes	No	N/A
d. The amount of advertising reported as assets in each statement of financial position presented? [SOP 93-7, par. 49; APB 17, pars. 30 and 31 (AC I60.111-.112)]	___	___	___

S. Costs to Exit an Activity

	Yes	No	N/A
★◆ 1. If an organization commits to an exit plan meeting the criteria of EITF 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, has the organization made the disclosures prescribed by EITF 94-3? [EITF 94-3]	___	___	___

II. Statement of Financial Position/Balance Sheet

A. General

	Yes	No	N/A
★◆ 1. For classified statements of financial position, are assets and liabilities segregated into current and noncurrent classifications, with totals presented for current assets and current liabilities? [ARB 43, Ch. 3A, par.3; SFAS 78, pars. 5 and 13 (AC B05.102-.109B); SFAS 6, par. 15 (AC BO5.118); FASBI 8, par. 3, (AC BO5.117); TB 79-3, par. 2; (AC BO5.501-.503); SOP 78-10, pars. 23, 24; SFAS 117, par. 12 (AC No. 5.110)]	___	___	___
★◆ 2. Are assets not expected to be realized during the current operating cycle classified as noncurrent? [ARB 43, Ch. 3A, pars. 5-6 (AC BO5 .106-.107)]	___	___	___
★ 3. Does the statement of financial position report total assets, liabilities, and net assets as well as separate amounts for each of three classes of net assets with captions used to describe their meaning as explained in SFAS 117? [SFAS 117, pars. 10, 13, and 100 (AC No5.131, fn. a)]	___	___	___
★ 4. Does the organization provide information about liquidity by one or more of the following presentations:			
a. Sequencing assets according to their nearness of conversion to cash and sequencing liabilities according to the nearness of their maturity and resulting use of cash?	___	___	___
b. Classifying assets and liabilities as current and noncurrent?	___	___	___

	Yes	No	N/A
c. Disclosing in notes to financial statements relevant information about the liquidity or maturity of assets and liabilities, including restrictions on the use of particular assets? [SFAS 117, par. 12 (AC No5.110)]	___	___	___
★◆ 5. Are valuation allowances for assets shown as deductions from their related assets with appropriate disclosure? [APB 12, par. 3 (AC V18.102); AAG-VHW, par. 4.12]	___	___	___
★◆ 6. Is the need for disclosure of the impact of a new FASB Statement issued but not yet effective where restatement of prior periods is required considered? [SAS 1, sec. 9410.13-.18 (AU 9410.13-.18)]	___	___	___
B. Cash			
★◆ 1. Are restricted amounts appropriately segregated from other cash balances? [ARB 43, Ch. 3A, par. 6 (AC BO5.107)]	___	___	___
★◆ 2. If a concentration of credit risk arises from deposits in excess of federally insured limits, is it disclosed? [SFAS 105, par. 20 (AC F25.115)]	___	___	___
★◆ 3. If the organization has material bank overdrafts or a material balance of undelivered checks as of the statement of financial position date, are:			
a. Bank overdrafts presented as a separate caption within current liabilities?	___	___	___
b. Undelivered checks classified as accounts payable? [Generally Accepted]	___	___	___
★◆ 4. Is the organization's policy for treating items as cash equivalents disclosed? [SFAS 95, par. 10 (AC C25.108)]	___	___	___
C. Investments/Marketable Securities			
★◆ 1. Are the appropriate disclosures made for investments in common stock accounted for under the equity method? [APB 18, par. 20 as amended and superseded by SFAS 94 (AC I82.110)]	___	___	___

	Yes	No	N/A
★◆ 2. ***FOR ORGANIZATIONS OTHER THAN VHWO:***			
a. If investments in marketable securities are not carried at market value, is the market value for that group as of the statement of financial position date disclosed? [SOP 78-10, par. 79]	___	___	___
b. Do the notes to financial statements summarize total realized and unrealized gains and losses and income earned from investments held by all funds except life income and custodial funds? [SOP 78-10, par. 83]	___	___	___
★◆ 3. ***FOR VHWO:***			
a. Is the basis of carrying investments the same in all funds and clearly disclosed in the financial statements?	___	___	___
(1) If carried at cost, is the total market value of investments at the balance sheet date shown parenthetically for each fund, or disclosed in the notes?	___	___	___
(2) If carried at market value, is the cost disclosed parenthetically for each fund or disclosed in the notes?	___	___	___
(3) Is the unrealized appreciation (or depreciation) in such investments at the beginning and end of the year disclosed in the notes? [AAG-VHW 2.05]	___	___	___
D. Receivables[14]			
★◆ 1. Are accounts and notes receivable due from officers, employees, and affiliated organizations shown separately with appropriate disclosures? [ARB 43, Ch. 1A, par. 5 (AC R36.105)]	___	___	___
★◆ 2. If a note is noninterest bearing or has an inappropriate stated interest rate:			
a. Is the discount or premium presented as a deduction from or addition to the face amount of the note?	___	___	___

[14] If the organization has extended a loan that is impaired, refer to SFAS 118 and SFAS 114, as amended by SFAS 118, for presentation and disclosure requirements.

	Yes	No	N/A
b. Does the disclosure include the effective interest rate and face amount of the note?	___	___	___
c. Is amortization of discount or premium reported as interest in the statement of activity? [APB 21, par. 16 (AC I69.109)]	___	___	___
★♦ 3. Are unearned discounts, finance charges and interest included in the face amount of receivables shown as a deduction from the related receivables? [APB 6, par. 14 (AC B05.107A, note 3)]	___	___	___
★♦ 4. Are legally enforceable pledges, grants, and reimbursements receivable, net of allowance for uncollectible amounts, recorded? [SOP 78-10, pars. 64-66; AAG-NPR 5.07; AAG-VHW 4.12 and 4.13]	___	___	___
★ 5. Do organizations that receive unconditional promises to give disclose the following:			
a. The amounts of promises receivable in less than one year, in one to five years, and in more than five years?	___	___	___
b. The amount of any allowance for uncollectible promises receivable? [SFAS 116, par. 24 (AC C67.121)]	___	___	___
★ 6. Do organizations that receive conditional promises to give disclose the following:			
a. The total of the amounts promised?	___	___	___
b. A description and amount for each group of promises having similar characteristics (such as amount of promises conditioned on establishing new programs, completing a new building, and raising matching gifts by a specified date)? [SFAS 116, par. 25 (AC C67.122)]	___	___	___
E. Inventories			
★♦ 1. Are the major classes of inventory disclosed (e.g., finished goods, work in process, raw materials)? [ARB 43, Ch. 3A, par. 4 (AC B05.105); ARB 43, Ch. 4, par. 3 (AC I78.102-.103)]	___	___	___

	Yes	No	N/A
★♦ 2. Is the method of determining inventory cost (e.g., LIFO, FIFO) disclosed? [ARB 43, Ch. 3A, par. 9 (AC I78.120)]	___	___	___
★♦ 3. Is the basis for stating inventory disclosed (e.g., lower of cost or market) and, if necessary, the nature of a change in basis for stating inventory and the effect on income of such a change? [ARB 43, Ch. 4, pars. 4–16 (AC I78.104–.117 and .119–.120); APB 22, par 13 (AC A10.106)]	___	___	___
★♦ 4. Are valuation allowances for inventory losses shown as a deduction from the related inventory? [APB 12, par. 3 (AC V18.102)]	___	___	___
F. Property and Equipment			
VHWO OMIT STEP #1.			
★♦ 1. Are the amounts of depreciation provided on (1) assets carried at historical cost and (2) assets carried on a basis other than historical cost separately disclosed? [SOP 78-10, par. 110]	___	___	___
★♦ 2. Are the following disclosed:			
(1) Depreciation expense for each period?	___	___	___
(2) Balances of major classes of depreciable assets by nature or function, at the balance sheet date?	___	___	___
(3) Accumulated depreciation, either by major classes of assets or in total?	___	___	___
(4) The method(s) used in computing depreciation with respect to major classes of depreciable assets? [APB 12, par. 5 (AC D40.105); SOP 78-10, par. 108]	___	___	___
★♦ 3. Is the amount of capitalized interest disclosed? [SFAS 34, par. 21 (AC I67.118)]	___	___	___
G. Collections of Works of Art and Similar Items			
★ 1. For organizations that maintain a collection of works of art, historical treasures, or similar assets, that are not capitalized, are the			

	Yes	No	N/A
following items reported separately on the statement of activities, separately from revenues, expenses, gains, and losses:			
a. Costs of collection items purchased as a decrease in the appropriate class of net assets?	___	___	___
b. Proceeds from the sale of collection items as an increase in the appropriate class of net assets?	___	___	___
c. Proceeds from insurance recoveries of lost or destroyed collection items as an increase in the appropriate class of net assets? [SFAS 116, pars. 13 and 26 (AC C67.113 and .123)]	___	___	___
★ 2. For organizations that capitalize collections prospectively, are proceeds from sales and insurance recoveries of items not previously capitalized reported separately from revenues, expenses, gains, and losses? [SFAS 116, par. 26 (AC C67.123)]	___	___	___
★ 3. For organizations that do not capitalize collections or that capitalize prospectively, are the following items disclosed:			
a. Description of collections including their relative significance?	___	___	___
b. Accounting and stewardship policies for collections? [SFAS 116, par. 27 (AC C67.124)]	___	___	___
★ 4. If collection items not capitalized are disposed of during the period, does the organization also:			
a. Describe the items given away, damaged, destroyed, lost, or otherwise deaccessed during the period, or	___	___	___
b. Disclose their fair value? [SFAS 116, par. 27 (AC C67.124)]	___	___	___
★ 5. Is the line item on the financial statement that refers to the disclosures required by steps 3. and 4. dated if collections are capitalized prospectively? [SFAS 116, par. 27 (AC C67.124)]	___	___	___

	Yes	No	N/A
VHWO OMIT STEPS 6. AND 7.			
◆ 6. If the organization has inexhaustible collections (usually associated with museums, art galleries, botanical gardens, libraries or similar entities), and if such collections are not capitalized, does the caption "Collections" appear on the balance sheet with no amount shown, but with a reference to a note that describes the collections? [SOP 78-10, par. 113]	___	___	___
◆ 7. Is the cost or contributed value of current period accessions and the nature of and proceeds from deaccessions disclosed? [SOP 78-10, par. 114]	___	___	___
H. Other Assets and Deferred Charges			
★◆ 1. Do disclosures include the method and period of amortization of intangible assets? [APB 17, par. 30 (AC I60.111); APB 22 par. 13 (AC A10.106)]	___	___	___
★◆ 2. Is an asset (prepaid pension cost) recognized if net periodic pension cost is less than amounts the employer has contributed to the plan? [SFAS 87, pars. 35 (AC P16.129]	___	___	___
★◆ 3. If an additional minimum liability is recognized pursuant to SFAS 87, paragraph 36 (AC P16.130), is an equal amount recognized as an intangible asset, provided that the asset recognized does not exceed the amount of unrecognized prior service cost? [SFAS 87, pars. 37–38 (AC P16.131 and .132)]	___	___	___
I. Interfund Borrowings			
◆ 1. Are restricted funds used in interfund borrowings and any liquidity problems in either fund disclosed? [SOP 78-10, par. 119]	___	___	___
◆ 2. When funds for repayment are not available, are such borrowings considered permanent and recorded as transfers? [SOP 78-10, par. 118]	___	___	___
★ 3. Are interfund receivables and payables clearly identified and arranged in the statement of financial position to eliminate their amounts when displaying total assets or liabilities? [SFAS 117, par. 85, fn. 8 (AC No5.109, fn.4)]	___	___	___

	Yes	No	N/A
J. Current Liabilities			
★◆ 1. For classified statements of financial position, do current liabilities include:			
a. Obligations for items that have entered the operating cycle?	___	___	___
b. Collections received in advance of the delivery of goods or performance of services?	___	___	___
c. Debts that arise from operations directly related to the operating cycle?	___	___	___
d. Other liabilities whose regular and ordinary liquidation is expected to occur within a relatively short time period?	___	___	___
e. Obligations that, by their terms, are due on demand or will be due within one year (or operating cycle, if longer) from the balance-sheet date, even though liquidation may not be expected within that period? [ARB 43, Ch. 3A, pars. 7-8 (AC B05 .108-.109B); SFAS 78, par. 5 (AC B05.109A and B05.118)]	___	___	___
★◆ 2. In classified statements of financial position, are the current portions of debt obligations presented as current liabilities? [ARB 43, Ch.3A, pars. 7-8 (AC B05.108-.109)]	___	___	___
★◆ 3. In classified statements of financial position, do current liabilities exclude short-term obligations that the organization intends to refinance on a long-term basis, provided the organization has demonstrated the ability to consummate the long-term financing? [SFAS 6, pars. 9-14 (AC B05.113-.116); FASBI 8 (AC B05.117 and B05.138-.139)]	___	___	___
K. Notes Payable and Other Debt			
★◆ 1. Is there adequate disclosure of interest rates, maturities, and other terms and conditions provided in loan agreements and bond indentures, such as assets pledged as collateral, etc.? [SFAS 5, pars. 18-19 (AC C59.120); and Generally Accepted]	___	___	___
★◆ 2. Are the combined aggregate amount of maturities and sinking fund requirements for all long-term borrowings disclosed for each of the five years following the date of the latest statement of financial position presented? [SFAS 47, par. 10b (AC C32.105b)]	___	___	___

	Yes	No	N/A
★◆ 3. For unconditional purchase obligations that have been recorded in accordance with SFAS No. 47, par. 6, are the amount of payments due in the aggregate and for each of the five years following the date of the latest statement of financial position presented disclosed? [SFAS 47, par. 10a (AC C32.105a)]	___	___	___
★◆ 4. If a note is noninterest bearing or has an inappropriate stated interest rate:			
a. Is the discount or premium presented as a deduction from or addition to the face amount of the note?	___	___	___
b. Does the disclosure include the effective interest rate and face amount of the note?	___	___	___
c. Is amortization of the discount or premium reported as interest in the statement of activity?	___	___	___
d. Are issue costs reported in the statement of financial position as deferred charges? [APB 21, par. 16 (AC I69.109)]	___	___	___
★◆ 5. If a short-term obligation is to be classified as a long-term borrowing, do disclosures include:			
a. General description of the financing agreement?	___	___	___
b. Terms of any new obligation incurred or expected to be incurred, as a result of the refinancing? [SFAS 6, par. 15 (AC B05.118)]	___	___	___

L. Lessee Leases

	Yes	No	N/A
★◆ 1. For capital leases, do disclosures include:			
a. Gross amounts of assets recorded by major classes as of the date of each statement of financial position presented? [SFAS 13, par. 16a (AC L10.112a (1))]	___	___	___
b. Future minimum lease payments as of the date of the latest statement of financial position presented, in the aggregate and for			

	Yes	No	N/A
each of the five succeeding fiscal years, with separate deductions therefrom for executory costs and imputed interest to reduce net minimum lease payments to present value? [SFAS 13, par. 16a (AC L10.112a (2))]	___	___	___
c. Total of future minimum sublease rentals under noncancelable subleases as of the date of the latest statement of financial position presented? [SFAS 13, par. 16a (AC L10.112a (3))]	___	___	___
d. Total contingent rentals actually incurred for each period for which a statement of activities is presented? [SFAS 13, par. 16a (AC L10.112a (4))]	___	___	___
e. Separate identification of:			
(1) Assets recorded under capital leases?	___	___	___
(2) Accumulated amortization of capital leases?	___	___	___
(3) Obligations under capital leases?	___	___	___
(4) Amount of amortization of capital lease assets or the fact that the amortization of capital lease assets is included in depreciation expense? [SFAS 13, par. 13 (AC L10.112a (5))]	___	___	___
★♦ 2. For operating leases that have initial or remaining noncancelable lease terms in excess of one year, do disclosures include:			
a. Future minimum rental payments required as of the date of the latest statement of financial position presented in the aggregate and for each of the five succeeding fiscal years?	___	___	___
b. Total of future minimum rentals to be received under noncancelable subleases as of the date of the latest statement of financial position presented? [SFAS 13, par. 16b (AC L10.112b)]	___	___	___
★♦ 3. For all operating leases, do disclosures include rental expense for each period for which a statement of activities (or revenue and			

	Yes	No	N/A
expenses, etc.) is presented, with separate amounts for minimum rentals, contingent rentals, and sublease rentals? [SFAS 13, par. 16c (AC L10.112c)]	___	___	___
★◆ 4. Do disclosures include a general description of the lessee's leasing arrangements including but not limited to:			
a. Basis for determining contingent rentals?	___	___	___
b. Existence and terms of any renewal or purchase options or escalation clauses?	___	___	___
c. Restrictions imposed by lease agreements (e.g., those concerning dividends, additional debt, and further leasing)? [SFAS 13, par. 16d (AC L10.112d)]	___	___	___
★◆ 5. Is the nature and extent of leasing transactions with related parties disclosed? [SFAS 13, par. 29 (AC L10.125)]	___	___	___

M. Other Liabilities and Deferred Credits

	Yes	No	N/A
★◆ 1. Are grants subject to periodic renewal recorded as expenses and liabilities at renewal date with disclosure of the remaining commitment? [SOP 78-10, par. 102]	___	___	___
VHWO OMIT STEP #2.			
◆ 2. Are balances of unexpended restricted gifts, grants and bequests reported as deferred revenue and support on the statement of financial position? [SOP 78-10, par. 62]	___	___	___
★◆ 3. Are liabilities properly accrued and reported for employees' compensation for future absences? [SFAS 43, par. 6 (AC C44.104)]	___	___	___
★◆ 4. If an obligation for postemployment benefits is not accrued in accordance with SFAS 5 or SFAS 43 only because the amount cannot			

	Yes	No	N/A
be reasonably estimated, is the fact that the benefits have not been accrued disclosed in the financial statements? [SFAS 112, par. 7 (AC P32.105)]	___	___	___

N. Trust Funds and Gifts of Future Interests

	Yes	No	N/A
◆ 1. Are funds held in trust by others, and that are not under the control of the organization, disclosed either parenthetically (in the endowment funds group in the balance sheet) or in the notes to the financial statements? [SOP 78-10, par. 122]	___	___	___
★◆ 2. Is significant income from such trusts reported separately? [SOP 78-10, par. 122]	___	___	___
★◆ 3. Is the basis of valuing gifts of future interests, e.g., life income and annuity gifts, and interest-free loans disclosed? [AAG-NPR 4.27]	___	___	___
★◆ 4. Is the restrictive nature of other fund groups not mentioned in SOP 78-10 (e.g., those fund groups used to account for resources relating to activities such as agency or custodial relationships, self-administered pensions, and permanent maintenance funds) disclosed? [SOP 78-10, par. 123]	___	___	___

O. Net Assets/Fund Balances

	Yes	No	N/A
★ 1. Are limits on the use of unrestricted net assets (such as loan covenants and board-designated endowments) disclosed? [SFAS 117, par. 16 (AC No5.114)]	___	___	___
◆ 2. Are unrestricted fund balances, designated for a specific purpose by the governing board of the organization, segregated on the balance sheet? [SOP 78-10, par. 120]	___	___	___
◆ 3. Are internally designated fund balances, such as quasi-endowment funds or designated funds, excluded from donor-restricted fund			

	Yes	No	N/A
balances and is a term such as "other than restricted" used to describe the fund? [AAG-VHW, par. 1.06; SOP 78-10, app. A — definition of quasi-endowment)]	___	___	___
◆ 4. Are restricted resources, such as endowment funds, shown separately in the fund section of the balance sheet? [SOP 78-10, par. 21]	___	___	___
◆ 5. Is the nature of the restrictions on fund balances and deferred revenues disclosed? [SOP 78-10, par. 21]	___	___	___

P. Restricted Resources

	Yes	No	N/A
★ 1. Are cash or other assets received with a donor-imposed restriction that limits their use to long-term purposes reported separately from assets that are unrestricted and available for current use? [SFAS 117, par. 11(AC No5.109)]	___	___	___
★ 2. Does the organization provide information about the nature and amounts of different types of permanent restrictions and temporary restrictions by reporting their amounts on the face of the statement of financial position or by including relevant details in notes to financial statements? [SFAS 117, par. 14(AC No5.112)]	___	___	___
◆ 3. Are significant restrictions disclosed in the financial statements? [SOP 78-10, par. 59c]	___	___	___

VHWO OMIT STEP #4.

	Yes	No	N/A
◆ 4. Do the notes disclose the changes in deferred restricted amounts of gifts, grants, bequests, and other income? [SOP 78-10, Exhibit 1D, Note 7]	___	___	___

	Yes	No	N/A

III. Statement of Activities/Activity (or Statement of Revenue and Expenses, or Statement of Support and Revenue, Expenses, Capital Additions and Changes in Fund Balances)

A. General

★ 1. Does the statement of activities report the amount of change in net assets for the period for the organization as a whole (using a descriptive term such as "change in net assets" or "change in equity"), and does that amount articulate to the net assets reported in the statement of financial position? ___ ___ ___
[SFAS 117, par. 18 (AC No5.116)]

★ 2. Does the statement of activities report the amount of change in permanently restricted net assets, temporarily restricted net assets, and unrestricted net assets for the period? ___ ___ ___
[SFAS 117, par. 19 (AC No5.117)]

★ 3. Does the statement of activities report the following:

a. Revenues as increases in unrestricted net assets unless the use of the assets received is limited by donor-imposed restrictions? ___ ___ ___

b. Expenses as decreases in unrestricted net assets? ___ ___ ___

c. Events that simultaneously increase one class of net assets and decrease another (reclassifications), including expiration of donor-imposed restrictions, separately from revenues, expenses, gains, and losses? ___ ___ ___
[SFAS 117, pars. 19–20 (AC No5.117–118); SFAS 116, par. 17 (AC No 5.146)]

★ 4. If the organization reports an intermediate measure of operations (for example, excess or deficit of operating revenues over expenses), is this intermediate measure reported only in a financial statement that, at a minimum, reports the change in unrestricted net assets for the period? ___ ___ ___
[SFAS 117, par. 23 (AC No5.120)]

★ 5. If the organization's use of the term operations is not apparent from the details provided on the face of the statement of activities, does a

	Yes	No	N/A
note to financial statements describe the nature of the reported measure of operations or the items excluded from operations? [SFAS 117, par. 23 (AC No5.120)]	___	___	___
★ 6. Does the statement of activities report gross amounts of revenues and expenses? [SFAS 117, par. 24 (AC No5.121)]	___	___	___
★ 7. If the organization reports net gains and losses or revenue and expense on its statement of activities, do these net amounts result from peripheral or incidental transactions or from events largely beyond the control of the organization and its management? [SFAS 117, pars. 25 and 138 (AC No5.122)]	___	___	___
B. Fund Accounting			
◆ 1. Does the statement of activity include the activity in the unrestricted, restricted, plant and endowment funds, as well as other capital funds that represent resources of the organization? [SOP 78-10, par. 26]	___	___	___
◆ 2. If a columnar format is used, do the statements show a Total All Funds column? (Alternative formats are acceptable.) [SOP 78-10, pars. 37–30]	___	___	___
◆ 3. If there are capital additions, are captions for the excess (deficiency) of revenue and support over expenses, both before and after capital additions, shown? [SOP 78-10, pars. 30–31]	___	___	___
C. Taxes			
★◆ 1. Does the organization disclose the following information about its tax status:			
a. Reference to the Internal Revenue Code section under which the organization is exempt?	___	___	___
b. Whether the organization is classified as a private foundation? [Generally Accepted]	___	___	___

	Yes	No	N/A
★◆ 2. If the organization is subject to federal excise tax on investment income or to federal and state income taxes on unrelated business income, are classifications and disclosures made in accordance with SFAS 109? [SOP 78-10, par. 103]	___	___	___
★◆ 3. If the organization's tax exempt status is in question by the IRS, is the potential impact disclosed? [SFAS 5, pars. 1 and 39 (AC C59.101 and .145)]	___	___	___

D. Transfers

	Yes	No	N/A
★◆ 1. Are transfers of resources among fund groups reported as changes in net assets of fund balances under the caption "net assets or fund balance at beginning of period"? (Note: This step is applicable for an organization that has adopted SFAS 117 only if the organization chooses to disaggregate classes of net assets into fund groups.)	___	___	___
★◆ 2. Are transfers required under contractual arrangements with third parties and transfers as a result of the expiration of a term endowment fund disclosed separately? [SOP 78-10, par. 104]	___	___	___

ORGANIZATIONS OTHER THAN VHWO OMIT STEP #3.

	Yes	No	N/A
◆ 3. Is the amount of realized (and, when applicable, unrealized) investment gains included in endowment funds that are available for transfer to the unrestricted fund at the discretion of the governing board, and the authority on which such funds may be transferred, disclosed? [AAG-VHW 2.12]	___	___	___

E. Third-Party Reimbursements

	Yes	No	N/A
★◆ 1. If the organization depends significantly on third-party reimbursement arrangements to carry out its program activities, do the financial statements adequately disclose these arrangements? [AAG-NPR 3.18]	___	___	___

Yes No N/A

F. Donated or Contributed Services

★ 1. If the organization receives contributed services, does it disclose the following:

a. A description of the programs or activities for which those services were used, including the nature and extent of contributed services received for the period and the amount recognized as revenues for the period? ___ ___ ___

b. The fair value of contributed services received but not recognized, if practicable (optional)? ___ ___ ___

c. Nonmonetary information such as the number and trends of donated hours received or service outputs provided by volunteer efforts (optional)? ___ ___ ___

d. Dollar amount of contributions raised by volunteers (optional)? ___ ___ ___
[SFAS 116, pars. 10 and 123 (AC C67.110)]

◆ 2. Do the notes to the financial statements disclose the methods used in valuing, recording, and reporting donated or contributed services? ___ ___ ___
[SOP 78-10, par. 70; AAG-VHW 5.07]

◆ 3. Do the notes indicate which donated or contributed services are recorded and which are not recorded? ___ ___ ___
[SOP 78-10, par. 70; AAG-VHW 5.07]

G. Donated Materials and Facilities

★◆ 1. If donated materials merely pass through the organization to its charitable beneficiaries, and the organization is only an agent for the donors, has that donation not been recorded as a contribution? ___ ___ ___
[SFAS 116, pars. 52–53; SOP 78-10, par. 71; AAG-VHW 5.03]

	Yes	No	N/A

H. Subscription and Membership Income

★◆ 1. If dues, assessments and nonrefundable initiation fees are in substance contributions and services are not to be provided to the member, are they recognized as revenue and support in the period the organization is entitled to them? ___ ___ ___
[SOP 78-10, par. 84]

I. Fund Raising[15]

★◆ 1. If the organization receives significant support from the general public, are the expenses reported on a functional basis presenting separately expenses for program services, fund-raising, membership development, and management and general activities? ___ ___ ___
[SOP 78-10, pars. 85–88, and 96; AAG-VHW pars. 6.02–6.07]

★◆ 2. If revenue from fund-raising affairs is reported net of expenses, are such expenses disclosed? ___ ___ ___
[SOP 78-10, par. 93; AAG-VHW 8.01]

★◆ 3. Is the total cost of all fund-raising activities disclosed whether the organization reports expenses on a functional basis or some other basis? ___ ___ ___
[SOP 78-10, par. 94; AAG-VHW 6.13]

★◆ 4. Do fund-raising expenses include any applicable portion of management salaries, depreciation, and other occupancy expenses? ___ ___ ___
[SOP 78-10, par. 98; AAG-VHW 6.10]

★◆ 5. Is the total support received and the related fund-raising costs for the period disclosed? ___ ___ ___
[SOP 78-10, par. 94; AAG-VHW 6.13]

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[15] In September, 1993, the AICPA issued an exposure draft of a proposed Statement of Position, *Accounting for Costs of Materials and Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include a Fund-Raising Appeal.* The proposed SOP would apply to all not-for-profit organizations that report expenses by function and would require reporting the costs of all materials and activities that include a fund-raising appeal as fund-raising expenses, unless a program or management and general function has been conducted in conjunction with the appeal for funds. The disclosure requirements of the exposure draft of the SOP are not reflected in this checklist. The final SOP is expected to be issued in the fourth quarter of 1995.

	Yes	No	N/A
★◆ 6. If joint costs of informational materials and activities that include fund-raising appeals are incurred and allocated between fund-raising and the appropriate program or management and general function, are the following disclosed:			
a. The fact that such costs have been allocated?	___	___	___
b. The total amount allocated during the period?	___	___	___
c. The portion allocated to each functional expense category? [SOP 87-2, par. 22; AAG-VHW 6.11]	___	___	___

J. Contributions

	Yes	No	N/A
★ 1. Does the organization distinguish between contributions received with permanent restrictions, those received with temporary restrictions, and those received without donor-imposed restrictions, so that they are reported as support increasing permanently restricted net assets, temporarily restricted net assets, or unrestricted net assets, respectively? [SFAS 116, par. 14 (AC No5.143)]	___	___	___
★ 2. If donor-restricted contributions whose restrictions are met in the same reporting period are reported as unrestricted support, is such treatment consistent from period to period and is the policy disclosed? [SFAS 117, par. 21; SFAS 116, par. 14 (AC No5.143)]	___	___	___
★ 3. Does the organization report receipt of unconditional promises to give with payments due in future periods as restricted support, unless explicit donor stipulations or circumstances surrounding the receipt of the promise make clear that the donor intended the contribution to be used to support activities of the current period? [SFAS 116, par. 15 (AC No5.144)]	___	___	___
★ 4. Does an organization that receives gifts of long-lived assets without donor stipulation about how long the donated asset must be used:			
a. Disclose its accounting policy of implying or not implying a time restriction that expires over the useful life of the asset?	___	___	___

	Yes	No	N/A
b. Report such support as restricted if it is the organization's policy to imply a time restriction that expires over the useful life of the donated asset?	___	___	___
c. Report such support as unrestricted in the absence of such a policy? [SFAS 116, par. 16 (AC No5.145)]	___	___	___
★ 5. Does an organization that receives unconditional promises to give in which cash promised will be received in future periods measure the fair value of the contribution as the present value of estimated future cash flows using a discount rate commensurate with the risks involved and report subsequent accruals of the interest element as contribution income increasing either the temporarily or permanently restricted class of net assets if the underlying promise to give is donor restricted? [SFAS 116, par. 20 (AC C67.116)]	___	___	___
★ 6. In discounting unconditional promises to give (as described in step 5.), are the provisions of APB 21 applied? [SOP 94-2, par. 20]	___	___	___
◆ 7. Are restricted contributions that possess many of the characteristics of capital, and that cannot be spent for program or supporting services because of donor or legal restrictions, recorded as "capital additions" or "nonexpendable additions" and disclosed? [SOP 78-10, par. 28]	___	___	___

K. Gifts of Future Interest

1. Annuity Gifts

	Yes	No	N/A
★◆ a. Is the present value of the actuarially determined liability resulting from such gifts recorded at the date of the gift?	___	___	___
★◆ b. Is any excess or deficiency in the amount of an annuity gift over the liability recorded as support in the year of the gift?	___	___	___
◆ c. If the excess is restricted for specific purposes, has the excess been reported as deferred revenue?	___	___	___

	Yes	No	N/A
◆ d. Is the amount previously recorded as deferred revenue reflected as support or a capital addition at the future date when the terms of the annuity gift are met? [SOP 78-10, par. 121]	___	___	___

2. Life Income Gifts

	Yes	No	N/A
◆ a. For the principal amount of life income gifts where the donor reserves the right to the income from the gift for life or some other stipulated period, is this principal amount recorded as deferred support in the period the gift is received?	___	___	___
◆ b. Is the amount previously recorded as deferred support reflected as support or a capital addition when the terms of the life income gift are met? [SOP 78-10, par. 121]	___	___	___

L. Expenses

VHWO OMIT STEP 1.

	Yes	No	N/A
★ 1. Does the organization provide information about expenses reported by their functional classification (such as major classes of program services and supporting services) either in the statement of activities or in notes to financial statements? [SFAS 117, par. 26 (AC No5.123)]	___	___	___

ORGANIZATIONS OTHER THAN VHWO OMIT STEP 2.

	Yes	No	N/A
★ 2. Does the organization report information about expenses both by function and by natural classification (such as salaries, rent, electricity, etc.) in a matrix format in a separate financial statement? [SFAS 117, par. 26 (AC No5.123)]	___	___	___

	Yes	No	N/A
◆ 3. Is a reasonable allocation of the organization's functional expenses made to various programs and supporting services, and is the method of these allocations disclosed?[16] [SOP 78-10, par. 100; AAG-VHW, Ch. 6]	___	___	___
◆ 4. For deferred compensation agreements, are estimated amounts to be paid properly accrued? [APB 12, par. 6-7 (AC C38.101-.102)]	___	___	___

M. Wills

	Yes	No	N/A
★ 1. If the organization receives a promise to give conditioned on a future uncertain event that is contained in a will and the will has been declared valid by the probate court, has the organization disclosed the conditional promise to give? [SFAS 116, par. 208]	___	___	___

N. Investments and Endowments

	Yes	No	N/A
★ 1. Does the organization report gains and losses on investments or other assets (or liabilities) as increases or decreases in unrestricted net assets, unless their use is temporarily or permanently restricted by explicit donor stipulations or by law? [SFAS 117, par. 22 (AC No5.119)]	___	___	___
★ 2. Does the organization report gains and losses on endowments in the following manner:			
a. As an increase or decrease in permanently restricted net assets if the governing board has determined that the relevant law requires the organization to retain permanently some portion of gains on investments? [SFAS 117, pars. 22 and 129 (AC No5.119)]	___	___	___
b. As an increase or decrease in unrestricted or temporarily restricted net assets, whichever is consistent with the reporting of the endowment's income, in the absence of such a law noted in step 2a.? [SFAS 117, par. 129 (AC No5.119, fn. 8)]	___	___	___

[16] See footnote 15.

	Yes	No	N/A
★ 3. If the organization elects to report investment revenues net of related expenses, does the organization disclose the amount of expenses, either on the face of the statement of activities or in the notes to financial statements? [SFAS 117, par. 24 (AC No5.121)]	___	___	___

IV. Additional Financial Statements

FOR ORGANIZATIONS OTHER THAN VHWO:

A. Statement of Changes in Financial Position[17]

	Yes	No	N/A
◆ 1. Is a statement of changes in financial position presented as a basic financial statement for each period for which a statement of activity (or statement of support, revenue and expenses) is presented? [SOP 78-10, pars. 16 and 17; Exhibit 1C]	___	___	___
◆ 2. Does the statement of changes in financial position disclose all financing and investing activities including capital additions, and changes in deferred support and revenue? [SOP 78-10, par. 34]	___	___	___

B. Statement of Cash Flows[18]

	Yes	No	N/A
★◆ 1. Is a statement of cash flows presented as a basic financial statement for each period for which both a statement of financial position and a statement of activities is presented? [SFAS 95, par. 3 as amended by SFAS 117, par. 30a (AC C25.101)]	___	___	___

[17] Not-for-profit organizations that have not adopted SFAS 117 are not subject to SFAS 95, *Statement of Cash Flows*. Therefore, they may present either a statement of changes in financial position or a statement of cash flows. The AICPA Industry Guide, *Audits of Voluntary Health and Welfare Organizations*, states that because the information that would be presented in a statement of changes in financial position as discussed in APB 19 will, in most cases, be readily apparent from other financial statements, such a statement is generally not required.

[18] See note 17.

	Yes	No	N/A
★◆ 2. Does the statement of cash flows report net cash provided or used by operating, investing, and financing activities and the net effect of those flows on cash and cash equivalents during the period in a manner that reconciles beginning and ending cash and cash equivalents? [SFAS 95, par. 26 (AC C25.124)]	___	___	___
★◆ 3. Are cash receipts and disbursements classified as cash flows from operating, investing, and financing activities in accordance with the classifications prescribed by SFAS 95, paragraphs 14 through 24 (as amended by SFAS 102 and SFAS 117)? [SFAS 95, pars. 14 - 24 as amended by SFAS 102 and SFAS 117 (AC C25.112–122)]	___	___	___
★◆ 4. Do the notes disclose the organization's accounting policy for determining which items are treated as cash equivalents? (Note: any change in policy for determining which items are treated as cash equivalents is a change in accounting principle.) [SFAS 95, par. 10 (AC C25.108)]	___	___	___
★◆ 5. Does the statement of cash flows separately report:			
a. Cash received from contributors?	___	___	___
b. Cash received from service recipients?	___	___	___
c. Interest and dividends received?	___	___	___
d. Cash collected on pledges?	___	___	___
e. Other operating cash receipts (if any)?	___	___	___
f. Cash paid to employees and suppliers?	___	___	___
g. Grants paid?	___	___	___
h. Interest paid?	___	___	___
i. Other operating cash payments (if any)? [SFAS 95, par. 27 as amended by SFAS 117, par. 30e. (AC C25.125)]	___	___	___

	Yes	No	N/A
★◆ 6. If the direct method is used, is a separate reconciling schedule provided to reconcile the change in net assets or excess of revenue and support over expenses, as applicable, to net cash used (provided) by operating activities? [SFAS 95, par. 29 (AC C25.127)]	___	___	___
★◆ 7. If the indirect method is used, is the change in net assets or excess of revenue and support over expenses, as applicable, reconciled to net cash flow from operating activities within the statement of cash flows or in a separate schedule? [SFAS 95, pars. 28 and 30 as amended by SFAS 117, par. 30f. (AC C25. 126 and .128)]	___	___	___
★◆ 8. Are investing and financing activities that affect recognized assets or liabilities but that do not result in cash receipts or cash payments disclosed? [SFAS 95, par. 32 as amended by SFAS 117, par. 30g. (AC C25.134)]	___	___	___
★ 9. In its statement of cash flows, does the organization include in cash flows from financing activities any amounts received with donor-imposed stipulations that they must be used for long-term purposes? [SFAS 117, par. 30(c) (AC C25.116)]	___	___	___

FOR VHWOs:

C. Statement of Functional Expenses

	Yes	No	N/A
★◆ 1. Is a statement of functional expenses presented as a basic financial statement for each period for which a statement of support, revenue, and expenses is presented? [AAG-VHW 6.17; SFAS 117, par. 26 (AC No5.123)]	___	___	___
★◆ 2. Does the statement of functional expenses contain sufficient information to enable a reader to obtain a general understanding of the nature of the costs of carrying out the organization's activities? [AAG-VHW 6.17; SFAS 117, par. 26 (AC No5.123]	___	___	___

EXHIBIT A

Postretirement Health Care and Life Insurance Benefits

The effective date of SFAS 106 is for fiscal years beginning after December 15, 1992, except for plans outside the United States, and for defined benefit plans of employers that (a) are nonpublic entities and (b) sponsor-defined benefit postretirement plan(s) with no more than 500 plan participants in the aggregate, in which case the effective date is for fiscal years beginning after December 15, 1994. Earlier application is encouraged. If the not-for-profit organization has 500 or fewer plan participants and does not elect early application, the following disclosures remain in effect:

	Yes	No	N/A
★◆ 1. Do disclosures include:			
a. Description of benefits and employee groups covered?	___	___	___
b. Description of accounting and funding policies?	___	___	___
c. Cost of benefits recognized during the period unless the provisions of Step 2 apply?	___	___	___
d. Effect of significant matters affecting the comparability of the costs recognized for all periods presented? [SFAS 81, par. 6 (AC P50.102)]	___	___	___
★◆ 2. If the cost of any postretirement health care or life insurance benefit cannot readily be separated from the cost of providing such benefits for active employees or otherwise be reasonably approximated, is the total cost of providing those benefits to both active employees and retirees as well as the number of active employees and the number of retirees covered by the plan disclosed? [SFAS 81, par. 7 (AC P50.103)]	___	___	___

EXHIBIT B

Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of

SFAS 121 establishes accounting standards for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to assets to be held and used or disposed of. This standard is effective for financial statements for fiscal years beginning after December 15, 1995, however earlier application is encouraged. Restatement of previously issued financial statements is not permitted.

	Yes	No	N/A
★◆ 1. If an impairment loss is recognized for assets to be held and used, are the following disclosures made in financial statements that include the period of the impairment write-down:			
a. A description of the impaired assets and the facts and circumstances leading to the impairment?	___	___	___
b. The amount of the impairment loss and how fair value was determined?	___	___	___
c. The caption in the statement of activities in which the impairment loss is aggregated if that loss has not been presented as a separate caption or reported parenthetically on the face of the statement? [SFAS 121, par. 14]	___	___	___
★◆ 2. If assets to be disposed of are accounted for in accordance with paragraphs 15-17 of SFAS 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, are all of the following disclosed in financial statements that include a period during which those assets are held:			
a. A description of assets to be disposed of, the facts and circumstances leading to the expected disposal, the expected disposal date, and the carrying amount of those assets?	___	___	___
b. The loss resulting from the application of paragraph 15 of SFAS 121?	___	___	___
c. The gain or loss resulting from changes in the carrying amounts of assets to be disposed of that arises from application of paragraph 17 of SFAS 121?	___	___	___
d. The caption in the statement of activities in which the gains or losses in (b) and (c) are aggregated if those gains or losses have not been presented as a separate caption or reported parenthetically on the face of the statement?	___	___	___
e. The results of operations for assets to be disposed of to the extent that those results are included in the entity's results of operations for the period and can be identified? [SFAS 121, par. 19]	___	___	___
★◆ 3. If an impairment loss is recognized, is it reported as a component of income from continuing operations before income taxes, or similar caption, in the statement of activities? [SFAS 121, pars. 13 and 18]	___	___	___

Checklist for Auditor's Reports on Audits of Financial Statements of Not-for-Profit Organizations Performed Under Generally Accepted Auditing Standards

This checklist has been developed by the staff of the Technical Information Division of the AICPA as a nonauthoritative practice aid.

Explanation of References:

SAS	=	Statement on Auditing Standards
AU	=	Reference to section number in *AICPA Professional Standards, Volume 1*
AAG-NPR	=	AICPA Audit and Accounting Guide, *Audits of Certain Nonprofit Organizations* (with conforming changes as of May 1, 1994)
SOP	=	AICPA Statement of Position
AAG-VHW	=	AICPA Industry Audit Guide, *Audits of Voluntary Health and Welfare Organizations* (with conforming changes as of May 1, 1994)

CHECKLIST QUESTIONNAIRE

	Yes	No	N/A
1. Does the auditor's report include the appropriate:			
a. Addressee? [SAS 58, par. 9 (AU 508.09)]	___	___	___
b. Date (or dual dates) of the report? [SAS 1, sec. 530.05 (AU 530.05); SAS 58, pars. .08 and .46 (AU 508.08 and .46)]	___	___	___
c. Title that includes the word "independent"? [SAS 58, par. 8 (AU 508.08)]	___	___	___
2. If the auditor is not independent, is a compilation report the highest level of service performed? [SAS 26, par. 10 (AU 504.10); SSARS 1, pars. 22 and 38 (AR 100.22 and .38)]	___	___	___
3. Does the reporting language conform with the auditor's standard report on:			
a. Financial statements of a single year or period?	___	___	___
b. Comparative financial statements? [SAS 58, par. 8 (AU 508.08)]	___	___	___

Yes No N/A

4. Does the report include appropriate language for the following situations:

   a. Only one basic financial statement is presented and there are no scope limitations? ___ ___ ___
   [SAS 58, pars. 47–48 (AU 508.47–.48)]

   b. Audited and unaudited financial statements are presented in comparative form? ___ ___ ___
   [SAS 26, pars. 14–17 (AU 504.14–.17)]

5. Is an explanatory paragraph (or other explanatory language) added to the standard auditor's report if:

   a. The financial statements are affected by uncertainties concerning future events, the outcome of which is not susceptible of reasonable estimation at the date of the report? ___ ___ ___
   [SAS 58, pars. 16–33 (AU 508.16–.33)]

   Note: Consult the Topical Index to the *AICPA Professional Standards* under "Uncertainties" for additional references to specific types of uncertainties.

   b. There is substantial doubt about the organization's ability to continue as a going concern for a reasonable period of time, and is that conclusion expressed through the use of the phrase "substantial doubt about the organization's ability to continue as a going concern"? ___ ___ ___
   [SAS 64, par. 1 (AU 341.12)]

   c. There is a material change between periods in accounting principles or in the method of their application? ___ ___ ___
   [SAS 58, pars. 34–36 (AU 508.34–.36)]

   d. In an updated report on comparative financial statements, the current opinion on the prior period is different from the one previously expressed? ___ ___ ___
   [SAS 58, pars. 77, 78 and 81–83 (AU 508.77–.78 and .81–.83)]

   e. The prior period financial statements are audited by a predecessor auditor whose report is not presented? ___ ___ ___
   [SAS 58, par. 83 as amended by SAS 64, par. 2 (AU 508.83)]

	Yes	No	N/A
f. The auditor's opinion is based in part on the report of another auditor? [SAS 1, se. 543 (AU 543); SAS 58, pars. 12–13 (AU 508.12–.13)]	___	___	___
g. The financial statements contain a departure from a promulgated accounting principle when conformity with GAAP would result in a misleading presentation? [SAS 58, pars. 14–15 (AU 508.14–.15)]	___	___	___
h. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements? [SAS 8, par. 4 (AU 550.04)]	___	___	___
i. The auditor decides to emphasize a matter in the report? [SAS 58, par. 37 (AU 508.37); Interpretation 38 of SAS 1, sec. 410 (AU 9410.17); Interpretation 1 of SAS 57 (AU 9342.03)]	___	___	___
j. The auditor uses the work of a specialist in performing an audit and the auditor decides to add an explanatory paragraph?	___	___	___

Note: Reference to and identification of the specialist may be made if the auditor believes such a reference will facilitate an understanding of the reason for the explanatory paragraph.
[SAS 73, par. 16 (AU 336.16)]

6. Is a qualified opinion or disclaimer of opinion expressed if:

	Yes	No	N/A
a. Scope limitations preclude application of one or more auditing procedures considered necessary in the circumstances? [SAS 58, pars. 40–45 (AU 508.40–.45); SAS 31, par. 22 (AU 326.23)]	___	___	___
b. The organization has inadequate internal control structure policies and procedures over contributions and there is a significant risk that such revenue may be materially underrecorded? [AAG-VHW 4.15; AAG-NPR 8.06–.07]	___	___	___

Note: Consult the Topical Index to the *AICPA Professional Standards* under "Scope of Audit-Limitations" for additional references to specific types of scope limitations that could result in either a qualified or disclaimer of opinion.

	Yes	No	N/A
7. Is a qualified opinion or adverse opinion expressed if a lack of conformity with GAAP (including inadequate disclosure) is present? [SAS 58, pars. 49–69 (AU 508.49–.69); SAS 32, par. 3 (AU 431.03)]	___	___	___

	Yes	No	N/A
Note: Consult the Topical Index to the *AICPA Professional Standards* under "Departures from Established Principles," "Adverse Opinions," and "Qualified Opinions" for additional references to specific types of GAAP departures that could result in either a qualified or adverse opinion.			
8. If a qualified opinion, adverse opinion, or disclaimer of opinion is expressed, are all the substantive reasons for the opinion or disclaimer disclosed and is the reporting language appropriately modified? [SAS 58, pars. 39, 68–69, and 71 (AU 508.39, .68–.69, and .71)]	___	___	___
9. If information accompanies the basic financial statements in an auditor-submitted document, does the report on the accompanying information:			
a. State that the audit is performed for the purpose of forming an opinion on the basic financial statements taken as a whole?	___	___	___
b. Specifically identify the accompanying information?	___	___	___
c. State that the accompanying information is presented for purposes of additional analysis and is not a required part of the basic financial statements?	___	___	___
d. State whether the accompanying information is subject to the auditing procedures applied in audit of the basic financial statements and the appropriate expression of opinion or disclaimer? [SAS 29, pars. 6-11 (AU 551.06–.11)]	___	___	___
10. Is the reporting form and content of SAS 60, paragraphs 9-19, followed when communicating internal control structure related matters noted in an audit?[1] [SAS 60, pars. 9-19 (AU 325.09–.19)]	___	___	___
11. If the auditor is requested to audit Internal Revenue Form 990, "Return of Organizations Exempt from Income Tax," is the appropriate report prepared? [Interpretation 2 of SAS 62, Sec. 623 (AU 9623.47–54)]	___	___	___

[1] Reportable conditions in internal control structure that have not been corrected must be communicated, preferably in writing, to senior management and the board of trustees or its audit committee. [SAS 60]

	Yes	No	N/A
12. If during a GAAS audit of the financial statements the auditor becomes aware that the organization is subject to an audit requirement not encompassed in the terms of the engagement (e.g., the entity is required to have an audit performed in accordance with OMB Circular A-133), the auditor must communicate to mangement and the audit committee, or to others with equivalent authority and responsibility that a GAAS audit may not satisfy relevant legal, regulatory, or contractual requirements. Did the auditor consider the client's actions in response to such communication (e.g., not arranging for an audit that meets the applicable requirements) including the potential effect on the financial statements and auditor's report? [SAS 74, pars. 22–23]	___	___	___

Checklist for Auditors' Reports on Audits Performed Under Government Auditing Standards and Under OMB Circular A-133[1]

This checklist has been developed by the staff of the Technical Information Division of the AICPA as a nonauthoritative practice aid. Accordingly, the notice on page i is incorporated herein by reference.

This checklist has two parts: Part I is for reports on audits performed under Government Auditing Standards ("Yellow Book"). Part II contains the additional requirements for reports on audits performed in accordance with OMB Circular A-133. For audits performed under Circular A-133, both Parts I and II of this checklist must be completed.

Explanation of References:

A-133 = Office of Management and Budget (OMB) Circular A-133
GAS = *Government Auditing Standards* ("Yellow Book", issued by GAO, 1994 Revision)
SAS = Statement on Auditing Standards
AU = Reference to section number in AICPA *Professional Standards, Volume I* of SAS cited
SOP 92-9 = AICPA Statement of Position, *Audits of Not-for-Profit Organizations Receiving Federal Awards*

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[1] On March 8, 1990, The Office of Management and Budget issued Circular A-133, *Audits of Institutions of Higher Education and Other Nonprofit Institutions*, to implement a "single audit" requirement for nonprofit institutions. Circular A-133 requires that the auditor perform the audit in accordance with *Government Auditing Standards* (the "Yellow Book") issued by the Comptroller General of the United States.

SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, (which supersedes SAS 68) provides guidance on planning, performing, and reporting on the compliance aspects of audits in accordance with GAAS, GAO Standards, Circular A-133 and Circular A-128, which applies to state and local governmental entities.

On December 28, 1992, the AICPA issued SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, to provide guidance on the auditor's responsibilities when conducting an audit in accordance with Circular A-133. It incorporates the guidance in SAS 68 (which has been superseded by SAS 74), SOP 92-7, OMB's October 1991 *Compliance Supplement for Audits of Institutions of Higher Learning and Other Non-Profit Institutions*, and the President's Council on Integrity and Efficiency Standards Subcommittee's Position Statement No. 6 (A-133 Questions and Answers).

CHECKLIST QUESTIONNAIRE

	Yes	No	N/A
Part I — Reports on Audits Performed in Accordance with *Government Auditing Standards* (the "Yellow Book")			
1. In an audit performed in accordance with the Yellow Book, are the following reports issued:			
a. A report on the organization's basic financial statements?[2]	___	___	___
b. A report on internal control structure?	___	___	___
c. A report on compliance with laws and regulations that may have a direct and material effect on the basic financial statements? [SOP 92-9, par. 7.2]	___	___	___
2. Does each auditor's report listed in Step No. 1 above contain a statement that the audit was conducted in accordance with GAAS and the Yellow Book?[3] [GAS, Ch. 5, par. 11; SOP 92-9, par. 7.4]	___	___	___
Report on Internal Control Structure[4]			
3. Does the report on internal control structure conform to the standard report illustrated in Exhibit D-3 of Appendix D of SOP 92-9? [GAS, Ch. 5, pars. 17 and 18; SOP 92-9, Appendix D, Exhibit D-3]	___	___	___
4. If material weaknesses were noted, is the condition, cause, criteria, and effect of those material weaknesses included in the report? [GAS, Chap. 6, pars. 49–52]	___	___	___
5. If deficiencies in the internal control structure were not considered reportable conditions (referred to as "nonreportable conditions"), are those matters			

[2] See checklist for auditor's reports on the basic financial statements.

[3] SOP 92-9, paragraph 7.4, states that federal reviewers accept reports on the basic financial statements only that do not refer to *Government Auditing Standards*. However, state reviewers and others may insist on full compliance with the "Yellow Book" requirement. Practitioners are advised to determine the requirements of any non-federal reviewers before deleting the reference to *Government Auditing Standards* in reports on the basic financial statements.

[4] Under the Yellow Book, a report on the internal control structure is required in <u>all</u> audits, even if no reportable conditions were noted. Also, the matters contained in this report are beyond those required to be communicated under SAS 60 (AU 325) in a GAAS audit.

	Yes	No	N/A
communicated to the organization in writing (or orally, with working paper documentation)? [GAS Chap. 5, par. 28 and Chap. 7, par. 29]	___	___	___
6. If a separate written communication describing nonreportable conditions is issued, does the auditor's report on the internal control structure refer to that separate communication? [SOP 92-9, par. 7.12]	___	___	___
7. If no reportable conditions are noted during the audit, has the report on internal control structure been modified in accordance with Note 3 to Exhibit D-3 of appendix D to SOP 92-9? [SOP 92-9, par. 7.11]	___	___	___
Report on Compliance With Laws and Regulations			
8. Does the report on compliance with laws and regulations (included in either the report on the financial statements or a separate report) conform to the standard report illustrated in Exhibits D-4 to D-7 in Appendix D of SOP 92-9?	___	___	___
9. Does the report on compliance with laws and regulations contain:			
a. A statement of positive assurance on those items that were tested for compliance and negative assurance on those items not tested? [SOP 92-9, par. 7.13]	___	___	___
b. All material instances of noncompliance? [SOP 92-9, par. 7.16]	___	___	___
c. All instances of illegal acts have or are likely to have occurred, described in perspective? [GAS, Chap. 5, pars. 18–19]	___	___	___
10. In rare circumstances in which the auditor has decided not to test compliance with laws and regulations, does the report contain a statement that compliance with laws and regulations is not tested? [SOP 92-9, Appendix D, Exhibit D-7]	___	___	___
11. Did the auditor consider the best estimate of total costs questioned for each major federal financial assistance program (likely questioned costs) in evaluating the effect of questioned costs on the opinion on compliance? [SAS 74, par. 18]	___	___	___

	Yes	No	N/A
12. If the auditing procedures disclosed material instances of noncompliance, is the report on compliance appropriately modified? [SAS 74, par. 19; GAS, Chap. 7, par. 26–27]	___	___	___
13. If the report contains material instances of noncompliance, is the effect of such instances on the auditor's report on the basic financial statements considered? [SAS 74, par. 20]	___	___	___
14. Are immaterial instances of noncompliance reported in a separate communication to the organization?[5] [GAS, Chap. 7, par. 29; SAS 74, par. 19]	___	___	___
15. If the auditor issued a separate letter describing immaterial instances of noncompliance, did the compliance report include a reference to that letter? [SOP 92-9, par. 7.16]	___	___	___
16. If the auditor became aware of illegal acts or of possible illegal acts, are they communicated to management or to the appropriate oversight body? [GAS, Chap. 5, par. 18]	___	___	___
17. If the auditor became aware of illegal acts and remains uncertain about whether they will materially affect the financial statements, is the report qualified or a disclaimer of opinion issued? [SOP 92-9, par. 7.18]	___	___	___

Other Matters

	Yes	No	N/A
18. If performance audits are required by contractual obligations, are findings presented in accordance with the Yellow Book? [GAS, Ch. 7]	___	___	___
19. Does the auditor's report on the financial statements disclose the status of known but uncorrected significant or material findings and recommendations from prior audits that could have an effect on the current audit objective? [GAS, Ch. 4, par. 10; SOP 92-9, par. 7.41]	___	___	___

[5] If there are no immaterial instances of noncompliance, the auditor may so note in the report. [SOP 92-9, par. 7.24]

Yes No N/A

20. Did the auditor consider the impact on his or her report of the effects of noncompliance findings from other simultaneous audits that may result in claims for refunds? ___ ___ ___
[SOP 92-9, par. 7.43; See also SFAS 5 (AC C59)]

21. Do the reports on the schedule of federal awards, compliance, and internal control structure carry the same date as the report on the basic financial statements? ___ ___ ___
[SOP 92-9, par. 7.27]

Part II — Reports on Audits Performed Under OMB Circular A-133

1. If the organization is subject to the requirements of Circular A-133, are the following additional reports issued:

   a. A report on a supplementary schedule of the entity's federal awards?[6] ___ ___ ___

   b. A report on the internal control policies and procedures used to administer federal awards? ___ ___ ___

   c. A report on compliance with specific laws and regulations that may have a direct and material effect on each major program? ___ ___ ___

   d. A report on compliance with certain laws and regulations applicable to nonmajor programs?[7] ___ ___ ___

   e. A report on compliance with general requirements?[8] ___ ___ ___
   [SOP 92-9, par. 7.19]

2. Does each auditor's report listed in Step no. 1 above contain a statement that the audit was conducted in accordance with generally accepted auditing standards; *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Circular A-133? ___ ___ ___
[SOP 92-9, Appendix D, Exhibits D-8 through D-18]

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[6] Under Circular A-133, a recipient or subrecipient of an award is required to prepare a schedule of federal awards. A sample schedule is presented in Appendix E of SOP 92-9. [Attachment to Circular A-133, par. 15(c)(1), SOP 92-9, pars. 4.7 and 7.20]

[7] If the entity has no nonmajor programs, or if the auditor has not selected any nonmajor program transactions, this report is not required. [SOP 92-9, par. 7.26]

[8] A report on compliance with general requirements is required regardless of whether there are any major programs. [SOP 92-9, par. 7.25]

	Yes	No	N/A

Report on Internal Control Structure Used in Administering Federal Awards

3. Does the report on the internal control structure used in administering federal awards conform to the standard report illustrated in Exhibit D-8 in Appendix D of SOP 92-9? ___ ___ ___

4. Does the report on internal control structure include:

   a. If applicable, a statement that the auditor has audited the financial statements and a reference to the auditor's report on the financial statements? ___ ___ ___

   b. A description of the scope of the auditor's work to obtain an understanding of the internal control structure, to assess control risk, and to test the internal control structure policies and procedures? ___ ___ ___

   c. A description of the organization's significant control policies and procedures established to provide reasonable assurance that it is managing its federal awards in compliance with applicable laws and regulations? ___ ___ ___

   d. Any reportable conditions noted, including the identification of material weaknesses? ___ ___ ___
   [SOP 92-9, par. 7.22]

5. If the auditor determines that tests of controls are likely to be ineffective in preventing or detecting noncompliance, is that matter disclosed as a "reportable condition"? ___ ___ ___
   [SOP 92-9, par. 7.23]

6. If the auditor has limited his or her consideration of the internal control structure for any reason, are the circumstances disclosed in the report on the internal control structure? ___ ___ ___
   [SOP 92-9, par. 7.23]

Report on Compliance With Specific Requirements Related to Major Programs

7. For audits of major programs, does the report on compliance with specific requirements conform to the standard report illustrated in Exhibits D-9 through D-14 in Appendix D of SOP 92-9? ___ ___ ___

8. If the auditor is disclaiming an opinion due to a scope limitation:

	Yes	No	N/A
a. Are the reasons indicated, in a separate paragraph, as to why the audit did not comply with GAAS, the Yellow Book, or Circular A-133?	___	___	___
b. Is a statement included that the scope of the audit was not sufficient to warrant the expression of an opinion?	___	___	___
c. Does the report exclude identification of the procedures performed and exclude a paragraph describing the characteristics of an audit?	___	___	___
d. Does the auditor disclose any reservations he or she has regarding compliance with applicable laws and regulations? [SOP 92-9, Appendix D, Exhibit D-13]	___	___	___
9. If the auditing procedures disclosed instances of noncompliance on major programs:			
a. Did the resulting modification to the auditor's report on compliance consider factors that include:			
(1) The number and types of instances of noncompliance?	___	___	___
(2) Determinability of questioned costs?	___	___	___
(3) Materiality of questioned costs?	___	___	___
b. If, after considering those factors, the auditor concludes that the instances of noncompliance have a material effect on a federal program, was a qualified or adverse opinion issued?	___	___	___
<u>or</u>			
c. If, after considering those factors, the auditor is unable to determine if the instance of noncompliance could have a material effect on the program, does the report state that noncompliance occurred but the effect on the programs presently cannot be determined?	___	___	___
(1) Is the effect of such uncertainties considered, and if necessary, is the report on the basic financial statements modified? [SOP 92-9; par. 7.24]	___	___	___
10. If the auditor was unable to examine appropriate evidence to support the comply/noncomply decision, is the report appropriately modified? [SOP 92-9, par. 7.24]	___	___	___

	Yes	No	N/A

Report on Compliance With General Requirements

	Yes	No	N/A
11. Does the report on compliance with general requirements conform to the standard report illustrated in Exhibits D-15 through D-17 in Appendix D of SOP 92-9?	___	___	___

Report on Compliance Related to Nonmajor Programs

	Yes	No	N/A
12. For nonmajor programs, does the report on compliance conform to the standard report illustrated in Exhibit D-18 in Appendix D of SOP 92-9?	___	___	___

General

	Yes	No	N/A
13. Does each auditor's report on compliance with laws and regulations include, for each federal award:			
a. An identification of total amounts questioned as a result of noncompliance?	___	___	___
b. Any corrective action recommended by the auditor? [SOP 92-9, pars. 7.30 and 7.32]	___	___	___
14. Are any immaterial findings included either (1) in a schedule of findings and costs, or (2) in a separate communication to management? [SOP 92-9, par. 7.30]	___	___	___
15. If the audit is biennial, are both years within the period covered? [SOP 92-9, par. 2.47]	___	___	___

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Financial Statement Control Form

Client: ______________________________

Financial Statement Date: ______________________________

INSTRUCTIONS: This form should be prepared by the In-charge to accompany the draft of the financial statements and report. Each step should be initialed and dated as it is completed, or checked "N/A." Step 8 must be initialed and dated by the engagement partner in order to release the financial statements and report.

	Performed by		
	Initials	**Date**	**N/A**
1. Submit financial statements and report to typing.	______	______	☐
2. Proofread the financial statements and report.	______	______	☐
3. Resubmit the financial statements and report for correction.	______	______	☐
4. Submit to technical reviewer, if applicable.	______	______	☐
5. Resubmit the financial statements and report for corrections.	______	______	☐
6. Foot and crossfoot all pages.	______	______	☐
7. Submit to engagement partner for final review.	______	______	☐
8. Release the financial statements and report.	______	______	☐

Number of Copies:

Bound: ____________ Unbound: ____________

Other: ______________________________

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References are to section numbers.

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