

The Single Audit Act: How Compliant Are Nonprofit Organizations?
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March 2003
Working Paper No. 16

We acknowledge the helpful comments of the participants of the 2001 ARNOVA conference. We thank Jodi Piippo and Jennifer Hsu for their research support and Charles Cullinan, Paul Copley, and Daniel Tinkelman for their helpful comments.

The data used for this paper is available from the National Center for Charitable Statistics and US Census Bureau.

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Abstract

Audits are an important legal accountability tool used by resource providers (donors, grantors, and others) to assure that resources are spent by nonprofit organizations in accordance with the resource provider's intentions. This paper reports on audits that are required by the government of the United States for organizations receiving large amounts of federal financial assistance. Since 1990, nonprofits receiving substantial federal funds are required to undergo this rigorous and expensive form of federal oversight. We report on 11,841 nonprofit entities that underwent such audits, and the 3,592 audit firms that conducted them, from 1997 to 1999. Overall, compliance with federal regulations appears to be high. Our study indicates that smaller nonprofits, those that are new to government grants, and those with prior audit findings have a significantly higher rate of adverse audit findings. Perhaps for cost or other reasons, these nonprofits are being audited by less experienced auditors. Current federal funding does not provide any additional funds for Single Audit Act compliance. One policy implication of our work might be to provide federal funding specifically for Single Audit Act compliance to these nonprofits.

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INTRODUCTION

Nonprofit accountability has been thrust on to the public agenda by a series of financial scandals, revelations of excessive compensation, and concerns over unethical behavior. Lapses in accountability have affected nonprofit organizations as varied as the United Way of America (Murawski 1995), Adelphi University (Thornburg 1997), and the NAACP (Greene 1995). In response to increasing public concern, Congress has instituted measures designed to increase accountability and oversight in this sector.¹ However, little attention has focused on the impact of these measures. The particular measure examined in this paper is the effectiveness of a long-standing form of oversight, the Single Audit Act (SAA). Single audits were mandated by Congress to improve financial management of the over \$100 billion in annual federal assistance through a uniform set of auditing requirements for federal grants.

Effective January 1, 1990, most nonprofit organizations receiving government funding became subject to the SAA and its associated regulations as promulgated in OMB Circular A-133: Audits of States, Local Governments, and Nonprofit Organizations. Since 1996, any nonprofit entity expending at least \$300,000 in federal funds in any one year must undergo an annual A-133 audit. Each A-133 audit consists of a traditional audit conducted by a licensed certified public accountant (CPA), an assessment of the internal control structure, and procedures that assess the use of federal funds and compliance with certain laws and regulations. Since an A-133 audit demands skills beyond those necessary for a standard CPA audit, auditors are required to obtain specialized training and expertise. Overall, A-133 audits are a highly rigorous

form of nonprofit oversight, which is expensive and challenging for both the auditor and the auditee.

Kearns (1996, 9) describes nonprofit accountability, in part, as that “wide spectrum of public expectations dealing with organizational performance, responsiveness . . . of nonprofit organizations.” Under the Kearns framework, single audits would be categorized as a compliance-type of accountability designed to fulfill legal and regulatory requirements. They are externally imposed by a higher authority and implemented through explicit standards. Several researchers have questioned the effectiveness of the monitoring and enforcement of other forms of legal accountability imposed upon nonprofit organizations (Chisholm 1995, Brody 2002) but did not address the implementation of the Single Audit Act. According to Kearns, nonprofit organizations make strategic and tactical decisions to respond to the accountability system.

Our study is designed to empirically examine nonprofit organizations’ response to legal accountability requirements imposed by the Single Audit Act. Anecdotally, we observe that some nonprofit organizations, such as Tuskegee University, have lost government funding due to adverse audit findings arising from its A-133 audit (Tuskegee 1998). This loss of funding for Tuskegee resulted in significant declines in service provision and weakened the financial health of the university. McKenzie College, established in 1885, went out of business in 1992 when it lost both government financial aid funding and accreditation (HED 1993). These potentially unfavorable outcomes from noncompliance with the Single Audit Act suggest that nonprofits may make strategic and tactical decisions to comply, in fact and/or appearance, with the A-133 requirements. We examine two research questions that are indicative of these decisions:

1. Nonprofits can select from a large pool of potential auditors who may vary in their level of experience. Are nonprofits choosing audit firms with extensive general and/or specialized A-133 audit experience?
2. Nonprofits can undertake measures to reduce the likelihood of adverse audit findings. What is the likelihood that a nonprofit is found to be out of compliance with the A-133 requirements? Are particular characteristics (such as, industry subsector, organizational size, experience with federal grants or auditor's experience) factors that effect the likelihood of an adverse finding?

The remainder of the paper is organized as follows. Information about the requirements of the Single Audit Act is provided in Section II, followed by a review of empirical research on A-133 audits in Section III. The sample and methodology are presented in Section IV. Results and discussion of findings conclude the paper in Sections V and VI, respectively.

BACKGROUND ON THE SINGLE AUDIT ACT

History Of The Single Audit Act²

The General Accounting Office (GAO) became concerned over the laxity of internal controls of organizations receiving federal funds that surfaced in the 1970s (GAO 1986a, 1986b, 1989). These concerns led to the issuance of uniform audit requirements embodied in the Office of Management and Budget (OMB) Circulars A-110 for certain nonprofit organizations and A-102 for state and local governments. Unfortunately, the guidance was not effectively implemented (Gross et al. 2000) and resulted in federal agencies requiring recipient organizations to have audits conducted on each separate grant or contract. The Single Audit Act (SAA) of 1984 was adopted to improve audit efficiency and reduce audit costs through uniform audit requirements that eliminated these duplicate audit processes. The issuance of OMB

Circular A-133 in 1990 expanded the coverage to federally-funded nonprofit organizations as well. Currently, recipients of federal financial assistance that expend \$300,000 or more in federal awards during a fiscal year are required to undergo a single audit for that fiscal year.

Organizations receiving less than the \$300,000 threshold amount must still keep adequate accounting records and make them available for inspection and audit upon request.

Prior Empirical Studies of the Single Audit Act

The academic research on single audits can be grouped into four areas: impact on auditee compliance, quality of the audit work, auditor selection, and frequency of adverse findings.

Although all of the studies have focused on single audits of governmental entities, the findings may be generalizable to nonprofit organizations.

The findings of studies examining the impact of the SAA on auditee compliance have been somewhat mixed. Engstrom (1992) reported that CPAs (but not their municipal clients) believe that audits were more effective and efficient under the SAA and that single audits had improved over time. However, neither group believed that the SAA had resulted in more effective or efficient use of federal funds. In contrast, Brannan (1993) found that auditors believe that the SAA had improved recipient compliance with applicable federal rules and regulations. Overall, however, both papers suggest some improvement in the level of compliance by organizations receiving government funding.

The literature examining the quality of work done by auditors examining governmental entities is extensive (see, for example, Marks and Raman 1986; Hardiman, Squires and Smith 1987; Palmrose 1988; Roberts, Glezen and Jones 1990; Raman and Wallace 1994; Deis and Giroux 1992; Lawrence 1999). Studies of single audits began when GAO reports criticized the quality of audits of governmental entities conducted by certified public accounting firms (GAO

1986a, 1986b, 1989). The 1986 GAO report indicated that as many as one-third of all audits of recipients of federal financial assistance failed to conform to professional standards. Using the GAO data, Copley and Doucet (1993) found a positive relationship between fixed fee arrangements and single audits deemed substandard, suggesting that audit quality suffers when the auditor has an incentive to limit the amount of audit testing to assure the engagement remains profitable. Brown and Raghunandan (1995 and 1997) found little improvement in the quality of governmental audits since the original 1986 GAO report despite government standards (known as the “Yellow Book”) that require government-specific continuing education for auditors conducting single audits and increased use of quality reviews. The President’s Council on Integrity and Efficiency found that 34 percent of A-133 audits of governmental entities report some significant shortcoming in the audit work performed (Broadus and Comtois 1987).

Auditor selection in the nonprofit sector was studied by Krishman and Schauer (2000) through an examination of the quality of United Way operating agency audits (A-133 audits were not separately analyzed). They found that the extent of noncompliance decreased as audit firm size increased (2000, p. 17). Other researchers have examined the role of audit fees in auditor selection. The audit fee research hypothesizes that the Single Audit Act has increased auditing fees due to additional audit procedures, more potential liability, and requirements that auditors receive supplemental audit training. However, this increase in costs might be offset by reducing the number of audits conducted and/or enhancing auditor efficiency. One notable study (Raman and Wilson 1992) provides evidence indicating no significant gains in auditor efficiency. They also found that independent accounting firms absorbed the incremental costs associated with the SAA rather than passing them along to their municipal clients.

Finally, some researchers have focused on the frequency of adverse findings. In particular, Jakubowski (1995) looked at which auditors conducted A-133 audits and the frequency of audit findings for governmental entities. He found that state auditors conducting A-133 audits report more internal control weaknesses than do private audit firms. In addition when the frequency of reported internal control weaknesses during the first four years of single audits was examined, he found significant differences between cities and counties. In the first year of the SAA, an average of 2.8 material internal control weaknesses were found in counties and 1.8 in cities. By the third and fourth years of the SAA, the number of reported material internal control weaknesses had fallen by 42 percent for cities, but only by 13 percent for counties. As a result, Jakubowski concluded that county governments made few changes in their control structures while municipal governments made significant improvements. This confirms earlier findings by Coe and Ellis (1991) that improper acts were more common in county government than in municipalities.

SAMPLE AND METHODOLOGY

Sample Selection

While Jakubowski studied governmental entities, our investigation focuses on nonprofit organizations. Our data set is derived from A-133 audit information available from the Federal Audit Clearinghouse and Form 990 IRS tax data available from the National Center for Charitable Statistics (NCCS). The A-133 database provides data collected from auditors conducting the single audits and includes the auditee, auditor, cognizant or oversight federal agency, total awards amount, and audit findings. After our efforts to eliminate incomplete and duplicate data and standardize spelling of audit firm names, the resulting data set includes 83,708 single audits of both nonprofit and governmental organizations conducted from 1997 through

2000. We combined the single audit act data with the IRS Business Master File using the employer identification number (EIN). From this we identified 37,540 audit reports representing 17,363 nonprofit organizations. We then matched the dataset to the NCCS 1999 “core file” using name and audit year.³ The core file covers one year of tax filings and contains 228,011 nonprofit organizations for 125 variables, including descriptive information and financial variables from the IRS Return Transaction Files after they have been cleaned⁴ by NCCS. Some nonprofits in the resulting sample reported multiple 990 filings under different EINs. Due to the uncertainty associated with determining which EIN represented the main entity, these organizations were excluded. The final sample includes audit findings and financial information on 11,841 nonprofit organizations and 12,654 audit reports covering periods ending between June 30, 1997 and August 31, 1999.

Descriptive Statistics

The nonprofit sector is quite diverse. For descriptive purposes, we partitioned the database into the five largest industry sectors based on the National Taxonomy of Exempt Entities (NTEE): arts, education, health, human services, and public or societal benefit. All other nonprofit organizations (environmental, international and foreign affairs, mutual/membership benefit, etc.) are included in the “Other NPOs” column in Table 1. The majority (54.1 percent) of nonprofit organizations (NPOs) undergoing single audits during this period were human service entities. Health and educational organizations accounted for 19.3 percent and 13.7 percent of the audits, respectively. In contrast, only 210 arts, culture and humanities organizations (less than two percent of the audits) expended enough federal funds to be covered by the SAA.

Although human service agencies represented the majority of single audits, their average total assets (\$4.1 million) and total revenues (\$3.7 million) were substantially smaller than the other sectors. In contrast, the health and education sectors had the most assets (\$33.3 and \$139.0 million, respectively) and revenues (\$31.9 and \$54.0 million, respectively). Educational organizations, on average, expended the most federal awards annually (\$16.9 million), probably due to the inclusion of financial aid and educational loans to students. Arts organizations, at the other extreme, expended the least federal award amounts (\$1.6 million). Note that medians for the dollar figures in Table 1 were often dramatically different than the averages indicating wide variability in organizational size and award amounts – particularly for the education sector.

To assess the relative financial health of these organizations, we computed two ratios, financial leverage (debt/assets) and the surplus margin (net income/total revenue). While the sectors differ based on average assets, liabilities, revenues, and expenses, these differences were accentuated when examining the ratios. The average financial leverage for the entire sample was 56.5 percent, yet only 34.9 and 35.2 percent of art and educational organizations' assets, respectively, were financed through debt. In contrast, human services agencies relied on debt to finance 66.7 percent of their assets. Arts organizations reported the highest mean surplus margin (16.2 percent). Human service agencies have the lowest mean and median surplus margin (0.4 percent for both measures).

RESULTS OF ANALYSIS

Nonprofit Organizations' Audit Firm Selection

In Table 2, we examine which audit firms were selected by nonprofit organizations to conduct single audits of nonprofit organizations. During the three-year period under examination, 3,592 audit firms conducted 12,654 A-133 nonprofit audits for 11,841 separate

NPO clients, an overall average of 3.5 NPO audits per firm during the period. The mean per audit firm was 23 for A-133 audits during the period. We divided the firms into four classifications that correspond to general and/or specialized A-133 audit experience:

1. Big-5: the five largest international public accounting and auditing firms⁵. These firms audit most of the large publicly traded corporations in the United States and have offices in all of the largest cities and many smaller cities.
2. Regional: the next 25 largest public accounting firms in the United States based on revenue reported to Accounting Today.⁶ Of these 25, only 15 firms reported conducting A-133 audits in the Census Bureau dataset.
3. Specialist: those firms that are neither “Big-5” nor “Regional” but conducted 30 or more A-133 audits of both governmental and nonprofit entities over the sample period.
4. Other: those smaller audit firms not included in the previous groups and a few government auditors.⁷

As Table 2 indicates, larger nonprofit organizations tend to hire the Big-5 firms, which is not surprising since these auditors are the firms that typically audit the largest business enterprises in the for-profit sector. Nonprofit organizations with higher mean and median total assets, total revenues, total expenses, and federal awards expended were significantly more likely to select these firms. Although each Big-5 firm performed an average of 303 nonprofit A-133 audits, this represented only 12 percent of the total number of A-133 audits conducted. In contrast, the 15 regional firms completed an average of 50 nonprofit A-133 audits (6 percent of audits), while 411 specialist firms conducted an average of 10 nonprofit A-133 audits (30 percent of audits) during the study period. The remaining firms performed the majority of the NPO

single audits, but averaged only 2.0 NPO audits during the entire study period. The smallest nonprofit organizations (in terms of mean and median total assets, total revenues, total expenses and federal awards expended) tended to use these small, non-specialist audit firms. This auditor group was selected by a disproportionately high number of human services organizations and a disproportionately low number of educational organizations. In contrast, the Big-5 firms performed 34 percent of the A-133 audits of educational institutions and a disproportionately high percentage of the arts organizations (22 percent).

Frequency of Adverse Audit Findings

1. Overview

When completing a single audit, the auditor must produce numerous reports. First, the auditor reports whether the financial statements were in conformity with generally accepted accounting principles (GAAP) and the schedule of Federal award expenditures were fairly presented in all material respects (financial statement opinion). The opinion⁸ can be unqualified or “clean,” qualified, adverse or a disclaimer of opinion. The audit opinion may also contain language that questions whether the nonprofit can continue to operate as a going concern. Second, the auditor must provide an opinion on whether the major programs are in material compliance with laws, regulations, and the provisions of contract or grant agreements (material compliance opinion). Since the auditee may have multiple programs, the opinion can be mixed, where some programs receive an unqualified opinion, and others receive qualified or adverse opinions or disclaimers of opinion. Third, a schedule of any reportable conditions in internal controls must be filed.⁹ If a finding is reported, the auditor must indicate whether or not it is a material weakness. Finally, the auditor must indicate if there is any material noncompliance with laws, regulations or cost allocations. For each major program, the auditor must also provide an

opinion on whether the particular program is in compliance with laws, regulations, and cost allocations. If the auditor observes a failure by the auditee to comply, then the audit firm issues an adverse finding.

Overall, 95.8 percent of the financial statement opinions were unqualified (Table 3). Of the 529 financial statement opinions that were not unqualified, the majority (95.7 percent) was qualified, indicating some limitation of the audit, such as the inability to gather certain information or the use of a nonstandard accounting practice that affected some aspect of the financial statements. Public/societal benefit organizations were more likely to receive a qualified opinion (6.0 percent as compared to 4.0 percent overall), while arts organizations were the least likely to receive a qualified opinion (1.9 percent). Just over one percent (136) of the financial statement opinions questioned the organization's ability to continue in existence (going concern). Arts organizations had the lowest (0.5 percent), while health care had the highest rate of going concern disclosures (1.6 percent). Interestingly, more than 75 percent of these "going concern" nonprofits received an unqualified financial statement audit opinion.

A reportable condition was disclosed in 15.7 percent of the single audits and 29.1 percent of these conditions were considered to be a material weakness in internal control. Health care organizations had the highest rate of reportable conditions and human service organizations had the lowest. Reportable conditions that were considered to be a material weakness were reported at the highest rate for public or societal benefit organizations, with 6.9 percent of all audit reports. This was over 40 percent of the reportable conditions in the public and societal benefit organizations. Arts organizations reported the fewest, with only 2.4 percent of all audit reports. Arts had the lowest rate of material weaknesses at 16.7 percent (5 material weaknesses out of 30 audits with reportable conditions).

When looking at contract and legal compliance, auditors disclosed that only 3.0 percent of nonprofits were not in material compliance, and this finding was not affected by nonprofit industry sector. Most nonprofit organizations (95.0 percent) received unqualified opinions on all their major programs. Disclaimers of opinion comprised the bulk of the remaining reports. Other and educational organizations received the highest rates of disclaimers of opinion (6.8 and 6.5 percent respectively, compared to 4.9 percent overall); arts institutions had the lowest disclaimer rate (3.3 percent).

2. Low vs. Not Low-Risk Auditees

The extent of a nonprofit's audit under SAA is determined by a risk-based approach that considers current and prior audit experience, the amount of funding, and nature of the federal program. Each federal award is categorized as either Type A (major) or Type B (minor) based on the size of the grant. Some programs are then identified as either low risk or not low risk using various criteria.¹⁰ Finally, certain nonprofits can gain low-risk auditee status by having single audits in the past two years in which the financial statements were unqualified with no reported material weaknesses in internal controls or legal compliance problems. Hence, a nonprofit that is inexperienced with government grants will not receive low-risk status and will be subject to a more stringent set of audit procedures.

Once the auditor has determined the status of the programs and the auditee, the auditor must audit as a "major program" all high risk Type A programs, at least half of low-risk Type A programs, and at least half of high risk Type B programs. For many nonprofits, the auditor must expand the audit scope to ensure that the audited programs encompass at least 50 percent of all federal award money expended by the recipient. In addition, each Type A program must be audited at least once every three years as a major program, regardless of risk classification.

Nonprofits that do not obtain low-risk status are ex ante deemed more likely to be noncompliant. By virtue of being subject to more extensive audit procedures, these organizations have a higher probability of being found noncompliant ex post.

In our sample, 58 percent of the audits were classified as low-risk. Table 4 shows the rate at which nonprofit organizations met the A-133 criteria for classification as low risk auditees and the effect of this classification on the rate at which adverse audit findings were reported. The classification varied significantly by industry sub-sector. Educational and arts institutions had the highest percentage of low-risk auditees (63.4 and 61.1 percent, respectively, as compared to 58 percent overall). Other and public/societal benefit organizations were less likely to be classified as low-risk auditees (51.8 and 54.1 percent, respectively). Low-risk auditees were much less likely to have qualified audit opinions (2.4 percent versus 6.2 percent for other than low-risk auditees). The auditees with low risk status were three times less likely to receive going concern language (0.6 percent to 1.7 percent for their higher risk counterparts). The low-risk auditees were also less likely to have reportable conditions (9.1 percent to 24.8 percent for those without low-risk status). Note that the reportable conditions were less often material for the low-risk entities (11.2 percent) than for the other auditees (38.3 percent). Material noncompliance was also significantly less likely for low risk auditees.

3. The Role of Auditor Selection

Table 5 shows the effect of auditor type on the disclosure of adverse audit findings. Big-5 firms were the most likely to have clients classified as low-risk auditees (63.5 percent), and they were also the most likely to render a clean opinion on the financial statements (98.2 percent versus 95.8 percent overall). Their clients were also among the least likely to have going concern language (0.7 percent to 1.1 percent overall), reportable conditions (4.4 percent to 15.7 percent

overall), and reportable conditions considered material weaknesses (22.4 percent to 29.3 percent overall). In contrast, the large regional firms disclosed reportable conditions in internal controls at a disproportionately higher rate (21.6 percent) and were the most likely type of firm to include going concern language in their financial statement opinions (1.33 percent). Specialist auditors audited a disproportionately higher percentage of higher risk clients and were substantially more likely to conduct a program-specific audit (5.3 percent of all specialist audits as compared to 3.2 percent overall). While nonprofits that did not receive low-risk status were on a percentage basis, more likely to select a specialist auditor, numerically most of these organizations selected the small, non-specialist audit firms. Despite the relative lack of experience in conducting A-133 audits, these small non-specialist audit firms were more likely to issue financial statements that were qualified (4.8 percent to 4.0 percent overall) and reportable conditions that were material weaknesses (30.0 percent to 29.3 percent overall).

4. The Role of Organizational and Grant Size

Finally, we examined the relation between audit findings and federal grant size and nonprofit organization size as measured by total revenues. Table 6 splits the sample at the median for each of the size-related measures. Large organizations or those expending large grants were more likely to be classified as low risk. Interestingly, organizations with smaller federal grants received significantly more clean opinions than those with large grants (96.2 percent versus 95.4 percent). Similarly, organizations with lower revenues received significantly more clean opinions (96.7 versus 94.9 percent). Smaller engagements (under both measurement criteria) more frequently received opinions containing going concern language, had proportionally more reportable conditions, and the reportable conditions were more likely to be

considered material. In addition, the auditors more often reported material noncompliance with legal and program requirements.

DISCUSSION AND CONCLUSIONS

Audits are an important legal accountability tool used by resource providers (donors, grantors, and others) to assure that resources are spent by nonprofit organizations in accordance with the resource provider's intentions. This paper reports on audits that are required by the government of the United States for organizations receiving large amounts of federal financial assistance. In accordance with the Single Audit Act, these nonprofit organizations must undergo an A-133 audit, a rigorous and expensive form of federal oversight. During the period we examined (1997 to 1999), 3,592 audit firms conducted A-133 audits for 11,841 nonprofit entities. Overall, compliance with federal regulations appears to be high. Although the audit reports indicated relatively few reportable conditions and even fewer instances of material noncompliance, we did observe some variations in audit findings depending on both the type of audit firm, the specific industry sub-sector of their clients, size of the organization, federal award amount, and risk classification.

Our study indicates that smaller nonprofits and those who are not classified as low-risk have a significantly higher rate of adverse audit findings. This suggests that small organizations, those with less experience with federal funding or with audit findings in prior years have the greatest difficulty complying with the Single Audit Act. Perhaps, due to cost or other factors, these organizations more frequently select specialist or small, non-specialist auditors rather than the Big 5 or regional audit firms. Hence, the nonprofits that may need more assistance to comply are obtaining advice and being audited by the less experienced auditors. Overall, these findings indicate that these organizations, in particular, need assistance to comply with the Single Audit

Act. Current federal funding does not provide any additional funds for Single Audit Act compliance. One policy implication of our work might be to provide federal funding specifically for Single Audit Act compliance to these nonprofits.

We found the arts and education sectors to be similar in several respects, having the most assets, the highest profit margins, and the least reliance on debt. Possibly because of these attributes, more low-risk audits were identified in these two sectors. Interestingly, in spite of appearing to be in excellent financial health, the education sector tended to have far more adverse audit findings than the arts sector.

The human service and public and societal benefit sectors are similar in terms of asset size: both are small. However, they differ in almost all other respects. The human service sector, which constitutes the largest number of organizations in our study, appears to be in relatively poor financial condition with the smallest surplus margin and the most reliance on debt. Organizations in the public and societal benefit sector, on the other hand, appear to be in much better financial condition. They have an above average surplus margin and lower than average reliance on debt. The average size of federal awards in public and societal benefit sector is, well above average, yet it has a lower than average proportion of organizations falling into the low-risk category. In addition, the public and societal benefit organizations reported the fewest unqualified audit opinions on financial statements and the most material weakness in internal controls and noncompliance items. In contrast, the human services organizations received on average small federal awards (only the arts sector had smaller grants). They also had close to an average percentage of low risk audits. Finally, their audits resulted in relatively few reportable conditions, and their A-133 audits were more likely to result in unqualified opinions.

Health care organizations appear from this study to be in poor financial condition as well. Although this sector had, on average, the third most assets, only human service organizations reported a lower surplus margin. In addition, they rank third highest in their reliance on debt. In addition, audits of health care organizations resulted in the most reportable conditions and going concern issues.

Unlike for-profit firms, nonprofit organizations do not predominantly select Big-5 audit firms. Instead, we found that numerous specialist and small audit firms are selected to conduct most of these audits. Auditees that are smaller and less likely to be classified as low risk tend to choose small audit firms. Not surprising given the risks inherent in accepting higher risk clients, the small audit firms issued the majority of the qualified audit opinions. The smaller audit firms that conducted less than three single audits of the nonprofit organizations during the period were the dominant force in this market. These non-specialist firms accounted for half of the audit reports.

Since little research has been conducted in the nonprofit area, many avenues for further research are available. Different cognizant agencies may require additional or more complex reporting requirements. Thus, an analysis of the type and source of federal awards might shed further light on the different audit outcomes. A majority of the accounting firms conducting these complex audits complete, on average, fewer than two per year. An analysis of the quality of these audits would be useful. Since each organization can choose which auditor will perform its A-133 audit, an exploration of why an organization chooses a particular audit firm could be an important extension of this study. Public or societal benefit agencies and educational institutions were generally more likely to receive adverse audit findings, while the arts institutions were relatively less likely. Again, further research is needed to ascertain why the

recipients of federal financial assistance in some sub-sectors appear to have more internal control and other adverse audit findings than in other sub-sectors. It may be that the program compliance requirements associated with some grants or cognizant agencies may be more stringent than those in others.

This study only examined nonprofit organizations that underwent a financial audit as part of an A-133 audit. The results of these audits are publicly available. Because the audit findings of nonprofits (unlike those of both for-profit and governmental entities) are generally *not* publicly available, we were unable to compare the two groups. Thus, an analysis of the differences in attributes (if any) between nonprofits required to undergo A-133 audits and those who are not so required, both cross-sectionally and longitudinally, would be a very important extension of our study.

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Table 1 - Descriptive Statistics - Nonprofit Organizations with A-133 Audits for Periods Ending between July 31, 1997 and August 31, 1999

| NTEE Classification | Arts | Education | Health | Human Services | Public or Societal Benefit | Other NPOs | Total Sample |
|--|---------|-----------|---------|----------------|----------------------------|------------|--------------|
| Number of audit reports filed | 211 | 1,664 | 2,344 | 6,968 | 895 | 572 | 12,654 |
| Number of organizations | 210 | 1,617 | 2,280 | 6,403 | 869 | 509 | 11,841 |
| Percentage of total organizations | 1.77% | 13.66% | 19.26% | 54.07% | 7.34% | 4.30% | 100.00% |
| <u>Total assets (000s)</u> | | | | | | | |
| Mean | 45,700 | 139,000* | 33,300 | 4,113* | 11,200 | 13,900 | 28,900 |
| Median | 3,442* | 17,100* | 2,147* | 1,549* | 1,787 | 1,658 | 1,909 |
| <u>Total revenues (000s)</u> | | | | | | | |
| Mean | 18,700 | 54,000* | 31,900* | 3,667* | 8,502 | 9,038 | 16,300 |
| Median | 2,861* | 12,800* | 3,681* | 1,136* | 2,140 | 1,765 | 1,964 |
| <u>Total expenses (000s)</u> | | | | | | | |
| Mean | 14,700 | 43,500* | 30,800* | 3,498* | 7,784 | 7,877 | 14,500 |
| Median | 2,037* | 11,600* | 3,507* | 1,084* | 1,962 | 1,694 | 1,256 |
| <u>Leverage (liabilities/assets)</u> | | | | | | | |
| Mean | 34.89%* | 35.23%* | 47.23%* | 66.70%* | 46.78%* | 54.19% | 56.45% |
| Median | 23.09%* | 28.44%* | 40.78%* | 59.49%* | 39.26%* | 45.02% | 45.48% |
| <u>Surplus Margin ((Total Revenues – Total Expenses)/Total Revenues)</u> | | | | | | | |
| Mean | 16.21%* | 10.79%* | 0.82% | 0.44%* | 5.24% | 2.34% | 2.56% |
| Median | 7.54%* | 7.11%* | 1.80% | 0.41%* | 1.95%* | 1.42% | 1.44% |
| <u>Federal awards expended (000s)</u> | | | | | | | |
| Mean | 1,571 | 16,912* | 2,664* | 2,359* | 5,576 | 4,207 | 4,627 |
| Median | 693* | 3,303* | 902* | 1,244* | 1,237 | 1,242 | 1,256 |

Note: Assets, liabilities, revenues and expenses are from the NCCS "Core" files. Federal awards figures are derived from the Federal Audit Clearinghouse.

* Significantly different from rest of sample at the 1% level (two-tailed test), using t-test for comparison of means and Wilcoxon sign rank test for medians

Table 2 – A-133 Audits Conducted and Nonprofit Client Characteristics by Type of Auditor

| Type of Auditor | Big-5 Audit Firms | Large Regional Firms | Specialist Audit Firms | All Other Auditors | Total Sample |
|--|-------------------|----------------------|------------------------|--------------------|--------------|
| Number of audit firms | 5 | 15 | 411 | 3,161 | 3,592 |
| Number of NPO A-133 audits conducted | 1,513 | 754 | 3,940 | 6,447 | 12,654 |
| Number of unique NPO audit clients | 1,427 | 722 | 3,629 | 6,137 | 11,841 |
| Mean number of NPO A-133 audits conducted per audit firm (1997-1999) | 302.6 | 50.3 | 9.6 | 2.0 | 3.5 |
| <u>Total Assets (000s)</u> | | | | | |
| Mean | 189,000* | 18,000 | 6,682* | 6,100* | 28,900 |
| Median | 33,000* | 3,301* | 1,739 | 1,423* | 1,909 |
| <u>Total Revenues (000s)</u> | | | | | |
| Mean | 97,800* | 10,400 | 5,312* | 4,651* | 16,300 |
| Median | 22,700* | 3,538* | 1,538* | 1,592* | 1,964 |
| <u>Total Expenses (000s)</u> | | | | | |
| Mean | 85,100* | 9,330 | 5,013 | 4,325* | 14,500 |
| Median | 19,800* | 3,299* | 1,488* | 1,509* | 1,256 |
| <u>Leverage (Total Liabilities/Total Assets)</u> | | | | | |
| Mean | 46.07%* | 54.30% | 61.70%* | 55.92%* | 56.45% |
| Median | 35.33%* | 41.87% | 54.94%* | 44.59%* | 45.48% |
| <u>Surplus Margin ((Total Revenues – Total Expenses)/Total Revenues)</u> | | | | | |
| Mean | 6.05%* | 3.52% | 0.12%* | 3.13% | 1.44% |
| Median | 5.45%* | 1.71% | 0.38%* | 1.53%* | 2.56% |
| <u>Total Federal Awards Expended by Clients (000s)</u> | | | | | |
| Mean | 18,410* | 4,774 | 32,746 | 2,528* | 4,629 |
| Median | 3,321* | 1,551* | 1,391* | 981* | 1,256 |
| <u>Client NTEE Category</u> | | | | | |
| Arts | 46 | 12 | 52 | 101 | 211 |
| Education | 564 | 141 | 310 | 850 | 1,664 |
| Health | 331 | 144 | 616 | 1,253 | 2,344 |
| Human Services | 358 | 381 | 2,491 | 3,738 | 6,968 |
| Public, Societal Benefit | 111 | 51 | 283 | 450 | 895 |
| Other Nonprofit Organizations | 103 | 26 | 188 | 255 | 572 |
| Total ($\chi^2_{(15)} = 1,172.1, p= 0.00$) | 1,513 | 754 | 3,940 | 6,447 | 12,654 |

* Significantly different from rest of sample at the 1% level (two-tailed test), using t-test for comparison of means and Wilcoxon sign rank test for medians.

Table 3 - Compliance with Single Audit Act - by Type of Nonprofit Organization

| NTEE Classification | Arts | Education | Health | Human Services | Public or Societal Benefit | Other NPOs | Total Sample |
|--|--------|-----------|--------|----------------|----------------------------|------------|--------------|
| Financial Statement Opinion (Organization as a whole) | | | | | | | |
| Adverse | 0 | 0 | 1 | 2 | 1 | 0 | 4 |
| Disclaimer | 0 | 1 | 6 | 10 | 1 | 1 | 19 |
| Qualified | 4 | 77 | 76 | 274 | 54 | 21 | 506 |
| Unqualified | 207 | 1,586 | 2,261 | 6,682 | 839 | 550 | 12,125 |
| Total ^a ($\chi^2_{(5)} = 16.1, p=0.01$) | 211 | 1,664 | 2,344 | 6,968 | 895 | 572 | 12,654 |
| Going Concern Language in Opinion Letter | | | | | | | |
| Number of audit reports | 1 | 19 | 38 | 63 | 11 | 4 | 136 |
| Percentage of sub-sectors' audits | 0.47% | 1.14% | 1.62% | 0.90% | 1.23% | 0.70% | 1.07% |
| ($\chi^2_{(5)} = 10.2, p=0.07$) | | | | | | | |
| Reportable Condition Disclosed by Auditor | | | | | | | |
| Number of audit reports | 30 | 287 | 441 | 974 | 152 | 103 | 1,987 |
| Percentage of audits | 14.22% | 17.25% | 18.81% | 13.98% | 16.98% | 18.01% | 15.70% |
| ($\chi^2_{(5)} = 39.6, p=0.00$) | | | | | | | |
| Reportable Conditions Considered a Material Weakness | | | | | | | |
| Number of audit reports | 5 | 84 | 134 | 267 | 62 | 27 | 579 |
| Percentage of audits | 2.37% | 5.05% | 5.72% | 3.83% | 6.93% | 4.72% | 4.58% |
| Percentage of reportable conditions | 16.67% | 29.27% | 30.39% | 27.41% | 40.79% | 26.21% | 29.14% |
| ($\chi^2_{(5)} = 30.4, p=0.00$) | | | | | | | |
| Material Noncompliance Disclosed by Auditor | | | | | | | |
| Number of audit reports | 5 | 52 | 72 | 197 | 35 | 14 | 375 |
| Percentage of audits | 2.37% | 3.12% | 3.07% | 2.83% | 3.91% | 2.45% | 2.96% |
| ($\chi^2_{(5)} = 4.3, p=0.51$) | | | | | | | |
| Type of Audit Report on Major Program Compliance | | | | | | | |
| Adverse | 0 | 5 | 2 | 3 | 0 | 0 | 10 |
| Disclaimer | 7 | 108 | 108 | 296 | 56 | 39 | 614 |
| Qualified | 0 | 1 | 3 | 2 | 2 | 1 | 9 |
| Adverse and Qualified | 0 | 0 | 1 | 3 | 0 | 0 | 4 |
| Disclaimer and Qualified | 0 | 0 | 0 | 0 | 1 | 0 | 1 |
| Unqualified | 204 | 1,550 | 2,230 | 6,664 | 836 | 532 | 12,016 |
| Total ^a ($\chi^2_{(5)} = 28.6, p=0.00$) | 211 | 1,664 | 2,346 | 6,962 | 895 | 572 | 12,654 |

^a Chi-square test compares unqualified opinions to the total of all other types of opinions.

Table 4 - Compliance with the Single Audit Act - Effect of NPO Risk Category

| Audit Risk Category | Not Low Risk | Low Risk | Total (% Low risk) |
|--|--------------|----------|-----------------------|
| <u>NTEE classification</u> | | | |
| Arts, culture and humanities | 82 | 129 | 211 (61.1%) |
| Education | 604 | 1,055 | 1,664 (63.4%) |
| Health care | 959 | 1,385 | 2,344 (59.1%) |
| Human services | 2,977 | 3,991 | 6,968 (57.3%) |
| Public and societal benefit | 411 | 484 | 895 (54.1%) |
| Other | 276 | 296 | 572 (51.8%) |
| Total ($\chi^2_{(5)} = 38.3, p=0.00$) | 5,314 | 7,340 | 12,654 (58.0%) |
| <u>Financial Statement Opinion (Organization as a whole)</u> | | | |
| Adverse | 3 | 1 | 4 (25.0%) |
| Disclaimer | 17 | 2 | 19 (10.5%) |
| Qualified | 330 | 176 | 506 (34.8%) |
| Unqualified | 4,964 | 7,161 | 12,125 (59.1%) |
| Total ^a ($\chi^2_{(1)} = 132.4, p=0.00$) | 5,314 | 7,340 | 12,654 (58.0%) |
| <u>Going Concern Language in Opinion Letter</u> | | | |
| Number of audit reports | 91 | 45 | 136 |
| Percentage of audits | 1.71% | 0.61% | 1.07% |
| $(\chi^2_{(1)} = 35.0, p=0.00)$ | | | |
| <u>Reportable Condition Disclosed by Auditor</u> | | | |
| Number of audit reports | 1,316 | 671 | 1,987 |
| Percentage of audits | 24.76% | 9.14% | 15.70% |
| $(\chi^2_{(1)} = 568.4, p=0.00)$ | | | |
| <u>Reportable Conditions Considered a Material Weakness</u> | | | |
| Number of audit reports | 504 | 75 | 579 |
| Percentage of reportable conditions | 38.30% | 11.18% | 29.14% |
| $(\chi^2_{(1)} = 505.6, p=0.00)$ | | | |
| <u>Material Noncompliance Disclosed by Auditor</u> | | | |
| Number of audit reports | 283 | 92 | 375 |
| Percentage of audits | 5.33% | 1.25% | 2.96% |
| $(\chi^2_{(1)} = 177.7, p=0.00)$ | | | |
| <u>Type of Audit Report on Major Program Compliance</u> | | | |
| Adverse | 7 | 3 | 10 (30.0%) |
| Disclaimer | 463 | 151 | 613 (24.6%) |
| Qualified | 4 | 5 | 9 (55.6%) |
| Adverse and Qualified | 4 | 0 | 4 (0.0%) |
| Disclaimer and Qualified | 1 | 0 | 1 (0.0%) |
| Unqualified | 4,835 | 7,181 | 12,016 (59.8%) |
| Total ^a ($\chi^2_{(1)} = 301.9, p=0.00$) | 5,314 | 7,340 | 12,654 (58.0%) |

^a Chi-square test compares unqualified opinions to the total of all other types of opinions.

Table 5 - Audit Findings by Type of CPA Firm

| Type of Auditor | Big-5 Audit | Large | Specialist | All Other | Total |
|--|-------------|--------|------------|-----------|--------|
| Percentage of clients classified as low risk auditees ($\chi^2_{(3)} = 21.9$, $p=0.00$) | 63.45% | 58.89% | 56.93% | 57.28% | 58.01% |
| <u>Type of A-133 Audit Conducted</u> | | | | | |
| Single Audit | 1,450 | 747 | 3,733 | 6,324 | 12,254 |
| Program Audit | 63 | 7 | 207 | 123 | 400 |
| ($\chi^2_{(3)} = 106.7$, $p=0.00$) | 1,513 | 754 | 3,940 | 6,447 | 12,654 |
| <u>Financial Statement Opinion (Organization as a whole)</u> | | | | | |
| Adverse | 0 | 0 | 2 | 2 | 4 |
| Disclaimer | 3 | 0 | 8 | 8 | 19 |
| Qualified | 25 | 21 | 152 | 308 | 506 |
| Unqualified | 1,485 | 733 | 3,778 | 6,129 | 12,125 |
| Total ^a ($\chi^2_{(3)} = 33.3$, $p=0.00$) | 1,513 | 754 | 3,940 | 6,447 | 12,654 |
| <u>Going Concern Language in Opinion Letter</u> | | | | | |
| Number of audits | 10 | 10 | 37 | 79 | 136 |
| Percentage of audits | 0.66% | 1.33% | 0.94% | 1.17% | 1.07% |
| ($\chi^2_{(3)} = 4.9$, $p=0.18$) | | | | | |
| <u>Reportable Condition Disclosed by Auditor</u> | | | | | |
| Number of audits | 67 | 163 | 114 | 1,641 | 1985 |
| Percentage of audits | 4.43% | 21.62% | 12.42% | 17.33% | 15.68% |
| ($\chi^2_{(3)} = 209.7$, $p=0.00$) | | | | | |
| <u>Reportable Conditions Considered a Material Weakness</u> | | | | | |
| Number of audits | 15 | 41 | 33 | 492 | 581 |
| Percentage of reportable conditions | 22.39% | 25.15% | 28.95% | 29.98% | 29.27% |
| ($\chi^2_{(3)} = 66.1$, $p=0.00$) | | | | | |
| <u>Material Noncompliance Disclosed by Auditor</u> | | | | | |
| Number of audits | 19 | 9 | 20 | 330 | 378 |
| Percentage of audits | 1.26% | 1.19% | 2.18% | 3.48% | 2.99% |
| ($\chi^2_{(3)} = 31.3$, $p=0.00$) | | | | | |
| <u>Type of Audit Report on Major Program Compliance</u> | | | | | |
| Adverse | 3 | 0 | 3 | 7 | 10 |
| Disclaimer | 41 | 19 | 191 | 516 | 613 |
| Qualified | 0 | 0 | 3 | 9 | 9 |
| Adverse and Qualified | 0 | 0 | 1 | 4 | 4 |
| Disclaimer and Qualified | 0 | 0 | 0 | 1 | 1 |
| Unqualified | 1,469 | 735 | 3,742 | 8,933 | 12,017 |
| Total ^a ($\chi^2_{(3)} = 31.8$, $p=0.00$) | 1,513 | 754 | 3,940 | 9,470 | 12,654 |

^a Chi-square test compares unqualified opinions to the total of all other types of opinions.

Table 6 - Compliance with the Single Audit Act - The Impact of Size

| Size determined by median total federal awards and total assets, respectively | Large Awards | Small Awards | Large NPOs | Small NPOs |
|---|---------------------------------|--------------|---------------------------------|------------|
| <u>NPO Risk</u> | | | | |
| Low Risk | 3,775 | 3,565 | 3,931 | 3,409 |
| Not Low Risk | 2,552 | 2,762 | 2,396 | 2,918 |
| Total | 6,327 | 6,327 | 6,327 | 6,327 |
| Low Risk as Percentage of Total | 59.67% | 56.35% | 62.13% | 53.88% |
| | $(\chi^2_{(1)} = 14.3, p=0.00)$ | | $(\chi^2_{(1)} = 88.4, p=0.00)$ | |
| <u>Financial Statement Opinion (Organization as a whole)</u> | | | | |
| Adverse | 3 | 1 | 3 | 1 |
| Disclaimer | 4 | 15 | 7 | 12 |
| Qualified | 283 | 223 | 310 | 196 |
| Unqualified | 6,036 | 6,088 | 6,007 | 6,118 |
| Total ^a | 6,327 | 6,327 | 6,327 | 6,327 |
| | $(\chi^2_{(1)} = 5.1, p=0.02)$ | | $(\chi^2_{(1)} = 24.3, p=0.00)$ | |
| <u>Going Concern Disclosed by Auditor</u> | | | | |
| Number of audits | 62 | 74 | 60 | 76 |
| Percentage of audits | 0.98% | 1.17% | 0.95% | 1.20% |
| | $(\chi^2_{(1)} = 1.1, p=0.30)$ | | $(\chi^2_{(1)} = 3.0, p=0.09)$ | |
| <u>Reportable Condition Disclosed by Auditor</u> | | | | |
| Number of audits | 863 | 1,124 | 987 | 1,000 |
| Percentage of reports | 13.64% | 17.77% | 15.60% | 15.81% |
| | $(\chi^2_{(1)} = 40.7, p=0.00)$ | | $(\chi^2_{(1)} = 54.1, p=0.00)$ | |
| <u>Reportable Conditions Considered a Material Weakness</u> | | | | |
| Number of audits | 248 | 331 | 273 | 306 |
| Percentage of audits | 3.92% | 5.23% | 4.31% | 4.84% |
| Percentage of reportable conditions | 28.74% | 29.45% | 27.66% | 30.60% |
| | $(\chi^2_{(1)} = 11.8, p=0.00)$ | | $(\chi^2_{(1)} = 36.9, p=0.00)$ | |
| <u>Material Noncompliance Disclosed by Auditor</u> | | | | |
| Number of audits | 180 | 198 | 171 | 204 |
| Percentage of audits | 2.84% | 3.13% | 2.70% | 3.22% |
| | $(\chi^2_{(1)} = 0.9, p=0.32)$ | | $(\chi^2_{(1)} = 11.2, p=0.00)$ | |
| <u>Type of Audit Report on Major Program Compliance</u> | | | | |
| Adverse | 7 | 3 | 8 | 2 |
| Disclaimer | 332 | 282 | 316 | 298 |
| Qualified | 2 | 7 | 3 | 6 |
| Adverse and Qualified | 2 | 2 | 2 | 2 |
| Disclaimer and Qualified | 1 | 0 | 1 | 0 |
| Unqualified | 5,983 | 6,033 | 5,997 | 6,019 |
| Total ^{ab} | 6,327 | 6,327 | 6,327 | 6,327 |
| | $(\chi^2_{(1)} = 4.1, p=0.04)$ | | $(\chi^2_{(1)} = 0.8, p=0.37)$ | |

^a Chi-square test compares unqualified opinions to the total of all other types of opinions

ENDNOTES

¹ For example, the Internal Revenue Service has recently strengthened both the accessibility of nonprofit financial information and created intermediate sanctions that may be imposed without withdrawing tax-exempt status from a charitable organization.

² Freeman and Shoulders (2000) and Gross, Larkin and McCarthy (2000) provide a concise overview of the single audit act (Chapter 20 and Chapter 31, respectively).

³ We first tried matching using the EIN and year, but this resulted in only 1,272 matched observations. The difference in the number of matches may be due to errors in the EIN field distributed in the 1999 Core File.

⁴ NCCS' "cleaning" includes checking (and correcting) mathematical errors and contacting organizations with obvious outliers (such as a report of zero assets by a university). (Interview with NCCS staff, January 8, 2002).

⁵ At the time of this study, the Big-5 accounting firms were (listed alphabetically) Arthur Andersen, Deloitte & Touche, Ernst & Young, PriceWaterhouseCoopers, and KPMG.

⁶ The full list of the 2001 Accounting Today top 100 firms was found on the Electronic Accountant web site at <http://electronicaccountant.com/html/t100y2k/tocp3.htm>.

⁷ Governmental auditors performed only 15 audits (0.12% of total). These audits represent 15 auditees and 7 auditors.

⁸ The terminology used by auditors is somewhat confusing. An unqualified opinion is the best and it is sometimes referred to as a "clean" opinion. A qualified opinion indicates some reservations on the part of the auditor but not enough for an adverse opinion, that is, an opinion that the financial statements are not fairly stated or do not conform to GAAP. A disclaimer means that the auditor did not express an opinion at all.

⁹ A "reportable condition" is anything "including the identification of material weaknesses, identified as a result of the auditor's work in understanding and assessing the control risk during the audit." (OMB Circular A-133, A-5).

¹⁰ These criteria include audit findings in the previous period, length of time since the last audit, the life cycle of the federal program (first and last years may be higher risk), the auditor's professional judgment of risk, and whether the OMB has made the program eligible for low-risk status.