

Not-for-profit entities in USA - key audit considerations

With the increased recognition of the significant efforts needed for Environmental, Social & Governance (ESG), the Not-For-Profit (NFP) sector has been playing a crucial role in building and laying down a roadmap for achieving the ESG goals and creating public awareness. Considering the significant growth in NFP organizations viz. charities, foundations, educational institutions, and healthcare providers in the USA, their contribution to various societal causes has been remarkable. As these entities continue to expand, with the much-needed resources being donated to them by various sections of society, including government grants and aids, the need for financial accountability, transparency, and adherence to regulatory requirements has become equally fundamental. Audits and auditors play a key role in achieving this objective, by providing assurance that financial statements are accurate and comply with generally accepted accounting principles (GAAP). They also help identify potential fraud, mismanagement, and operational inefficiencies, ensuring that resources are used efficiently and effectively to further the organization's mission.

Key Audit Areas

While conducting audits in NFP entities, auditors should exercise caution in several areas, including:

- **Internal Controls:** Auditors should thoroughly assess an NFP's internal control systems to ensure they are adequate and functioning properly. Weak internal controls can lead to errors, fraud, and mismanagement, making this a crucial area of focus.
- **Grants & Donations:** NFPs' major source of revenue is from government grants, donations by entities or individuals, and charitable events hosted by the organization. While being careful about the accounting treatment as per GAAP, the auditors should also be wary of the source and nature of funds received from private entities and individuals who want to be anonymous to detect any potential money laundering activities using the NFP.
- **Defined End-use:** NFPs often receive donations with specific restrictions on how the funds can be used. Auditors must ensure that these funds are appropriately tracked, allocated, and reported to maintain donor trust and comply with regulatory requirements. This includes verifying that the NFP has procedures in place to identify, record, and monitor donor-imposed restrictions, and that the NFP is using the funds in accordance with those restrictions.

- **Related Party Transactions:** NFPs may engage in transactions with related parties, such as board members or affiliated organizations. Such transactions should be carefully scrutinized to ensure they are conducted at arm's length and do not result in undue benefits or conflicts of interest. This includes reviewing the nature and terms of related party transactions, assessing whether they are fair and reasonable, and evaluating whether they have been properly disclosed in the financial statements.
- **Regulatory Compliances:** NFPs are subject to various federal, state and local laws and regulations. Auditors must ensure that these entities comply with applicable rules, including tax laws, fundraising regulations, and grant requirements.
- **In-Kind Contributions:** Apart from monetary contributions, NFPs also receive contributions in kind viz. goods and services from a variety of sources. Auditors are tasked with examination of these contributions, ensuring that the valuation of the asset or service is accurately assessed. This scrutiny is vital as it guarantees that the fair value of in-kind contributions is properly accounted for in the financial statements.
- **Revenue Recognition:** Auditors should carefully evaluate NFP's revenue recognition policy to ensure they are in line with US GAAP. This is particularly important for NFPs that receive donations, grants, and other forms of revenue with specific conditions or restrictions including end-use or time period of utilization.
- **Expenses and Functional Allocation:** Within the framework of not-for-profit accounting, organizations must allocate expenses across different functional categories, including program services, management and general operations, and fundraising activities. Auditors play a crucial role in verifying that these allocations are not only reasonable but also precisely reflect the organization's diverse array of activities. By scrutinizing these allocations, auditors help ensure that resources are effectively utilized in alignment with the organization's mission, demonstrating accountability and transparency in financial management.
- **Net Assets Classification:** Not-for-profit entities are required to categorize their net assets into three distinct classifications: unrestricted, temporarily restricted, and permanently restricted. Auditors play a critical role in validating the accuracy of these classifications and ensuring that any alterations in net assets are accurately documented and reported. By reviewing these classifications, auditors provide assurance that financial statements accurately reflect the organization's financial position and compliance with regulatory standards.
- **Going Concern:** A significant aspect of audit of any entity, this holds equal importance while giving an assertion by the auditor. Evaluating the viability of a not-for-profit organization as a going concern and assessing its ability to sustain operations into the foreseeable future are key steps to be undertaken by the auditor. This assessment involves thorough consideration of various factors, including the organization's financial stability, funding sources and prevailing economic, social and political conditions. By conducting this evaluation, auditors provide stakeholders with valuable insights into the organization's financial health and sustainability, enabling informed decision-making and strategic planning.

Conclusion

As the NFP sector experiences ongoing growth, auditors must uphold unwavering diligence in key audit areas while exercising caution in potential areas vulnerable to mismanagement or fraud. The oversight of the auditors plays a crucial role in enabling NFPs to preserve public trust, adhere to regulatory mandates and effectively pursue their mission of continuing betterment of society and its values.

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