

# Audits of Not-for-Profit Organizations: Risk Assessment under Canadian Auditing Standards







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## **DISCLAIMER**

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# Foreword

CPA Canada undertakes initiatives to support practitioners and their clients in the implementation of standards. As part of these initiatives, CPA Canada has prepared this Guide to provide guidance and help auditors perform risk assessment when auditing not-for-profit organizations under Canadian Auditing Standards (CASs).

This Guide provides non-authoritative guidance that has not been adopted, endorsed, approved or otherwise acted upon by the Auditing and Assurance Standards Board, Accounting Standards Board, Public Sector Accounting Board, any CPA Canada board or committee, the governing body or membership of CPA Canada or any provincial Institute/Ordre or the organizations represented by the members of the task force.

An auditor is expected to use professional judgment in determining whether the material in this publication is both appropriate and relevant to their particular audit engagements. This publication is based on CASs as updated in March 2014.

CPA Canada expresses its appreciation to the members of the Task Force, the co-authors Cindy Kottoor, CPA, CA, and Ruth Davis, CPA, CA, and the former project director H el ene Marcil, CPA, CA, for preparing this publication. CPA Canada also thanks the technical reviewers for providing comments on the publication.

April 2014

## Task Force Members

Luke Baxter, CPA, CA	Ernst & Young LLP	
Ruth Davis, CPA, CA	Neverest	Co-author
Richard Flageole, FCPA, FCA		
Patricia Gonsalves, CPA, CA	BDO Canada LLP	
Cindy Kottoor, CPA, CA	Neverest	Co-author
Andrée Lavigne, CPA, CA	CPA Canada	
Hélène Marcil, CPA, CA	CPA Canada	Project director
Eric R. Turner, CPA, CA	CPA Canada	

## Technical Reviewers

Phil H. Cowperthwaite, FCPA, FCA	Cowperthwaite Mehta
Susan J. McIsaac, FCA	McIsaac Darragh
Deryck Williams, FCPA, FCA-IT	Grant Thornton LLP

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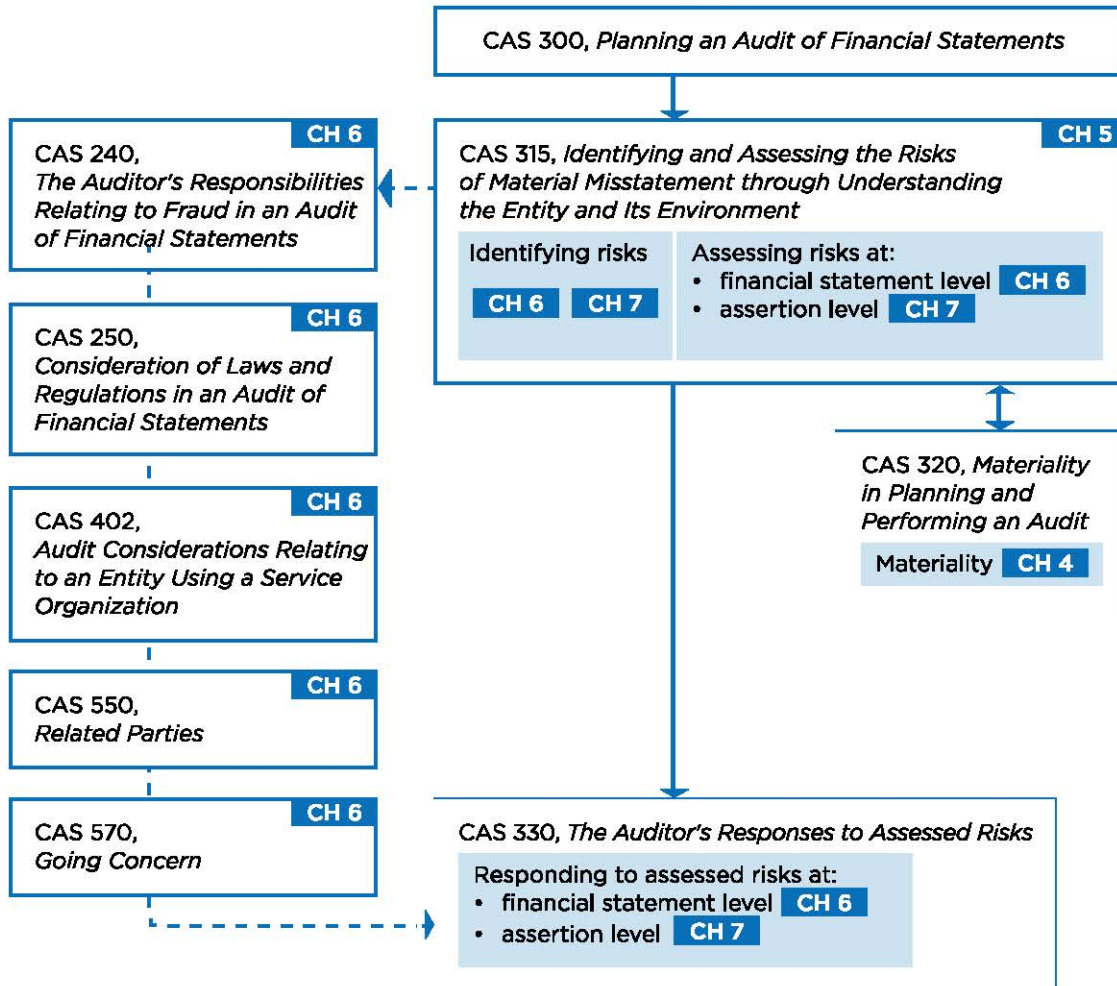
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# 1.0 Introduction

This Guide for auditors addresses many of the key issues that are likely to arise when applying the risk assessment standards set out in Canadian Auditing Standards (CASs) in an audit of a not-for-profit organization (NFPO).

Other CASs expand on how CAS 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*, and CAS 330, *The Auditor's Responses to Assessed Risks*, are to be applied in relation to risks of material misstatement due to error or fraud. The following diagram summarizes some of these other CASs that impact the risk assessment in an NFPO audit and where they are incorporated into the Guide, along with CAS 315 and CAS 330.

**Diagram 1.0-1: Risk assessment standards for the purposes of this Guide**

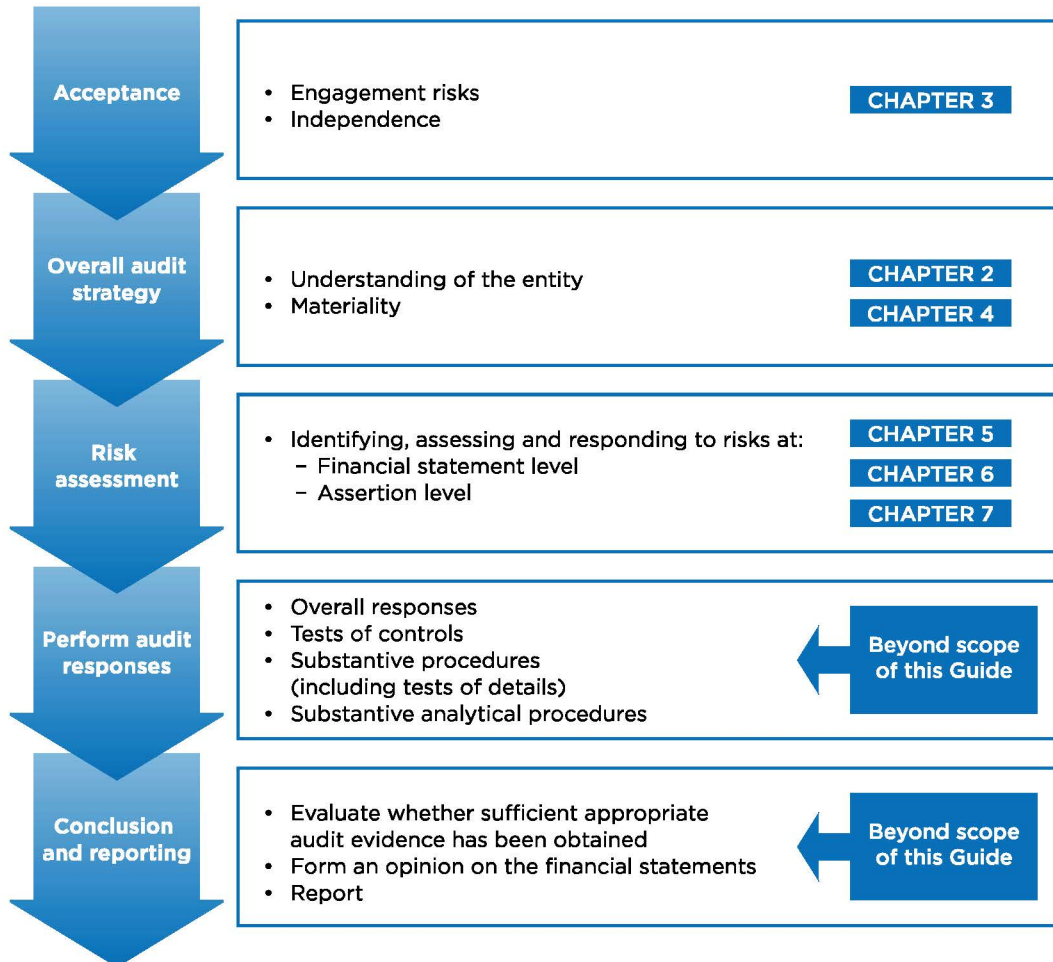
Aiming to help practitioners be more effective and efficient with their risk assessment processes when auditing NFPOs, this Guide provides practical guidance for identifying risks typical of an NFPO audit, along with suggested audit procedures to respond to those risks.

This Guide provides examples of risks and audit responses that may apply to a wide variety of NFPO audits; however, it is not intended to address all the risks and potential audit responses that may be applicable to an NFPO, nor does it consider all types of NFPOs in the examples. An auditor will need to adapt the guidance to

the specific circumstances of their NFPO audit engagements. And, while the Guide provides practical considerations in applying risk assessment requirements, there may be other ways to apply these requirements in particular audit situations that are not covered in these pages. The Guide does not address all CAS requirements applicable to NFPO audits; nor does it cover other Canadian assurance standards (e.g., review engagements standards).

Except for the specific guidance in Chapter 7 on the application of the requirements in the *CPA Canada Handbook—Part III, Accounting Standards for Not-for-Profit Organizations (ASNFPO)*, the guidance provided may apply equally to a broad range of not-for-profit organizations using different financial reporting frameworks.

The following diagram outlines audit procedures that have been addressed in this Guide. Not all aspects of an audit have been considered. This Guide focuses on areas of the audit where considerations unique to the audit of an NFPO apply.

**Diagram 1.0-2: Audit processes addressed in this Guide**

For the client-acceptance phase, some of the engagement risks and independence issues relevant to an NFPO audit are discussed in Chapter 3.

For the overall audit strategy phase, Chapter 4 points out some practical considerations related to materiality.

Risk assessment is introduced in Chapter 5, which also provides some examples of risks that are likely to arise in an NFPO audit. Chapter 6 focuses on risks affecting the financial statements as a whole. Auditors will find in Chapter 7 many scenarios in which risks of material misstatements are identified at the assertion level, along with some practical considerations related to responding to these assessed risks.

## 1.1 Abbreviations Used in This Guide

The following is a list of the abbreviations that have been used in this Guide.

ASNFP	Accounting Standards for Not-for-Profit Organizations
CASs	Canadian Auditing Standards
CH	Chapter
CRA	Canada Revenue Agency
IFRS	International Financial Reporting Standards
NFPO	Not-for-profit organization
TCWG	Those charged with governance





## 2.0 Characteristics of Not-for-Profit Organizations

The very nature of not-for-profit organizations—entities formed for a purpose other than generating profits—means that they operate under different conditions than for-profit organizations, and management might have different biases. This has a significant impact on NFPO audits and how risks are assessed.

To add to the complexity, different types of NFPOs have unique characteristics. While the characteristics of similar organizations can vary, the following table sets out general characteristics that may be relevant for a variety of NFPO types. These characteristics may have an impact on the scope of the audit when it comes to identifying users and related entities, or may affect risk assessment at the financial-statement or assertion level. For example, entities that are also charitable organizations operate under specific regulations established by the Canada Revenue Agency (CRA) and may be subject to a higher level of public scrutiny by donors and media. The specific impacts of these characteristics on risk assessment are explored in more detail in later chapters.

Table 2.0-1: Characteristics of NFPOs

Type of Not-for-Profit	Religious groups	Sport and social clubs	Professional associations	Government-funded public services	Fundraising associations	International aid	Public service organizations	Public institutions	Foundations
<b>Examples</b>	church, temple, mosque	tennis or golf club	medical or legal association	Children's Aid Society	United Way, Rotary	Red Cross	non-profit housing	hospital or museum	private or hospital
<b>Characteristics</b>	Charity designation	✓		✓	✓	✓	✓	✓	✓
	Serves members	✓	✓	✓		✓		✓	
	Serves community	✓	✓		✓	✓	✓	✓	✓
	Serves other charities	✓				✓	✓		✓
	Belongs to provincial, national or international organization	✓	✓			✓	✓		
	Receives government funding (grants, loans, transfer payments)				✓	✓	✓	✓	
	Receives other restricted contributions	✓	✓		✓	✓	✓	✓	✓
	Receives membership and user fees		✓	✓		✓		✓	
	Collects cash donations	✓	✓		✓	✓	✓	✓	✓
	Engages in fundraising activities	✓	✓		✓	✓	✓	✓	✓
	Engages in commercial activities		✓	✓				✓	✓
	Has a significant capital investment	✓	✓				✓	✓	✓
	Engages in political or lobbying activities			✓			✓		

The general characteristics discussed above may not be unique to NFPOs, but they do represent important considerations in gaining an understanding of such entities and how they operate.

## 2.1 NFPO Organizational Structures and Their Control Environment

Not-for-profit organizations are often formed through federal or provincial legislation, resulting in entities incorporated without share capital. In accordance with the relevant legislation, an entity's originating charter sets out its defining purpose, objectives and the community it serves. Furthermore, an NFPO's rules and procedures are set out in its bylaws and policies, which define organizational structures, such as board makeup and responsibilities, and details of membership and reporting structures.

An NFPO's organizational structure generally sets out how strategic and operational decisions are made and how they affect the control environment. An NFPO's structure will vary depending on its type, size and complexity. The following considers how the size of an organization and its governance structure can affect controls at both the financial-statement and assertion level.

**Table 2.1-1: Examples of NFPO governance structure**

Characteristic	Board/Management Structure	Example	Risk Considerations
Very small entity with limited or no paid staff	<p>Volunteer board members fulfill both management and governance roles within the organization</p> <p>Responsibilities may be allocated to committees rather than individuals</p>	Social club or church	<ul style="list-style-type: none"> <li>Less likelihood of having appropriate segregation of duties within the accounting function and, therefore, a greater likelihood of fraud or error occurring</li> <li>Informal risk assessment procedures are often effective as those charged with governance are acquainted with all aspects of operations</li> <li>May be difficult to establish accountability under a committee structure</li> <li>Although decisions are often carefully deliberated, documentation can sometimes be inadequate</li> </ul>

Characteristic	Board/Management Structure	Example	Risk Considerations
Small to medium entity with few staff members	<p>Operations managed by an executive director</p> <p>Board governance may include some involvement in operational decision making</p>	Community-based service organizations such as food banks	<ul style="list-style-type: none"> <li>Segregation of duties within the accounting function unlikely, although there may be improved segregation between management and oversight</li> <li>There may be some documentation of risk policies and procedures; however, risk assessment is still likely to be informal</li> <li>Potential for domineering executive director to increase risk of management override</li> </ul>
Medium to large entities with extensive staff and management teams	<p>Management team fully responsible for operational decisions</p> <p>Governance board focused on policy and strategic decisions</p>	Hospital	<ul style="list-style-type: none"> <li>Accounting duties are more effectively segregated</li> <li>Formal risk assessment procedures likely to exist</li> <li>Longer time cycle for making decisions and implementing strategic changes</li> </ul>

Other risk considerations that are unique to NFPOs include:

- **The board of directors is made up of volunteers:** This could result in relatively short terms of service and frequent turnover of key positions; board members may not have appropriate experience or the time to address governance matters.
- **Resource restrictions:** When compensation packages are not competitive with those in the for-profit world, it might be difficult to attract qualified executives and staff and this may lead to increased turnover.
- **Volunteers carry out the day-to-day operations:** This could result in weak internal controls due to difficulties in enforcing control policies and correcting deficiencies.

While some of the characteristics of an NFPO create challenges, other aspects contribute to a strong control environment. For example, many NFPOs have public accountability requirements that result in formal budgeting processes that strengthen the monitoring function of those charged with governance (TCWG).

In contrast to a for-profit environment, where financial results are the primary driver of success, in a not-for-profit environment, an organization's objectives are generally not financially driven. Instead, an NFPO's objectives, and corresponding performance measures, are focused on measures such as the delivery of services to benefit the needs of a specific community or membership base. While financial measures are still an important consideration, they will not necessarily be the NFPO's primary focus. In many cases, the measurement of an NFPO's success will focus on non-financial data, such as waiting times for various types of medical procedures performed in a hospital, the number of visitors in a museum or the number of clients served in a children's aid centre.

## 2.2 Legislative Environment

The requirement for an audit may be legislated, may come from an entity's charter and bylaws, may result from funding requirements or may simply be the preference of those charged with governance. Legislative requirements may also impose specific financial requirements or compliance with operational guidelines.



**Is the NFPO incorporated under an Act that has been changed or amended?**

The *Canada Not-for-profit Corporations Act* requires all federally incorporated not-for-profit corporations to have applied for a certificate of continuance before October 17, 2014. This was not a simple application. It required a complete review of the organization's articles and bylaws to ensure they conform to the restrictions stipulated in the Act. The act also sets out the

circumstances under which an audit will be a legislated requirement. An auditor should be familiar with the requirements in the *Act* to advise their clients accordingly.



**For further information on the *Canada Not for profit Corporations Act*, see:**

- ***NPO Director Alert—The New Canada Not for profit Corporations Act—Questions for directors to ask—December 2011***
- ***Transition Guide for Federal Not for profit Corporations, Industry Canada***

## 3.0 Engagement Risks and Independence Issues

At the beginning of each audit engagement, an auditor is required to assess the engagement risk in accordance with their firm's quality control standards as well as assess the engagement team's compliance with independence rules.

### 3.1 Engagement Risks

*CAS 210, Agreeing to the Terms of Audit Engagements*

*CSQC 1, Quality Control for Firms That Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*



**What are the engagement risks for your NFPO audit?**

In accordance with a firm's quality-assurance procedures, engagement risk is assessed to determine whether the engagement should be accepted or continued in the upcoming year. The risk assessment should also consider whether the engagement meets the firm's criteria for requiring an engagement-file quality review in compliance with CSQC1. Accordingly, the firm's quality assurance manual should provide criteria applicable to NFPO audit situations to assist in this assessment.

An auditor may identify some of the following risk factors as they assess engagement risks when making engagement acceptance or continuance decisions. These risk factors (not a comprehensive list) may affect the number and nature of users of the financial statements, the complexity of the subject matter or the probability of misstatements, and therefore increase the audit risk:

- national charity with a high profile (e.g., Canadian Cancer Society)
- charity derives a significant portion of its funding from high-profile donation campaigns (e.g., house / car giveaways with extensive advertising campaigns)
- organization operates on a global basis and delivers services worldwide (e.g., CARE Canada)
- has alliances with global organizations and operations in politically sensitive countries (e.g., Red Cross)
- significant deficiencies in the control environment, particularly with respect to tone at the top and financial oversight by management and / or those charged with governance
- significant cash receipts

In accordance with CAS 315 paragraph 7, auditors are required to consider whether information obtained from their client acceptance or continuance process is relevant to identifying risks of material misstatement. If so, risks identified in this assessment are brought forward and addressed in the development of the audit plan.

## 3.2 Independence Issues

*CAS 220, Quality Control for an Audit of Financial Statements*

*CSQC 1, Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*



**Are there any independence issues for your engagement?  
If so, what are your safeguards to mitigate these threats?**



A firm will determine its independence policies in accordance with CSQC1 and the specific rules set out by the provincial Institutes / Ordre.<sup>1</sup> As well, CAS 220 includes a requirement to assess independence for individual audit engagements. While this assessment is documented at the beginning of an audit, the requirement to apply ethical standards applies throughout the entire audit engagement.



**For further guidance on the application of independence rules, see guidance available from respective CPA provincial bodies (for example, the *Guide to Canadian Independence Standard*).**

Some potential areas of concern related to an auditor's independence in a not-for-profit environment are discussed below.

### 3.2.1 Membership in an Organization

Rules of professional conduct restrict members of an engagement team from holding a financial interest in an entity they are auditing. In a not-for-profit environment, where NFPOs do not look for financial gain, professional judgment must be applied in considering whether NFPO membership would impair independence. Members of the engagement team or their immediate families may not hold positions with a client that would let them influence the subject matter of an assurance engagement. Similarly, members of an engagement team, as well as other members of their firm, may not serve as officers or directors of assurance clients.

In general, independence is not considered to have been breached if an engagement team member (or a close family member) is also a member of the organization but not actively involved in its governance. For example, a firm with employees or partners who are also members of a golf course would not be precluded from being appointed the golf course's auditor. The firm's employees or partners would not, however, be able to participate in any form of the golf course's management or governance.

<sup>1</sup> Please refer to your provincial institute / Ordre for further details.

While a member of an organization may be permitted to form part of the engagement team for the organization's audit, there may be other considerations, such as confidentiality, that would make such an arrangement unsuitable. For example, some members of a church congregation might feel uncomfortable if a junior team member was privy to the contributions they make. When an engagement team member is also a member of the NFPO, it may be prudent to have that member's participation on the engagement team acknowledged and approved by those charged with governance prior to commencing the audit.

### **3.2.2 Firm Sponsorship of NFPO Activities**

Rules of professional conduct restrict firms and members of engagement teams from auditing entities with which they have close business relationships, unless those relationships are limited to an immaterial financial interest that is clearly insignificant to the client, the firm and the members involved. In a not-for-profit environment, activities that should be scrutinized for potential independence prohibitions include firm sponsorship of NFPO events and firms making donations to the not-for-profit organization. When a firm's support is significant to the financial viability of an NFPO, the firm will be perceived to be in a position of influence, and, therefore, in a conflict of interest.

### **3.2.3 Donated Audit Services**

A member or firm may not provide an assurance service to a client for a fee that is significantly lower than market value unless the firm can demonstrate that all professional standards have been met in performing the service. The auditor of a not-for-profit organization might want to carry out the audit at no charge or at a discounted rate. The auditor's provincial Institute / Ordre specifies what the auditor is allowed to do in these circumstances. Regardless of the fees charged for the audit, the auditor still has a professional responsibility to conduct the audit with due care, meeting all the relevant standards set out by CASs and other relevant standards.

### **3.2.4 Threat of Self-Review**

A threat of self-review occurs when an auditor performs services that directly affect the subject matter of an engagement. With smaller NFPOs, it is not unusual to have to make a large number of audit adjustments during

the course of the annual audit, resulting in the auditor, in essence, assisting the entity in preparing its financial statements. The question is: at what point does this create a self-review threat to independence? This situation is more common when dealing with smaller organizations that are more likely to lack the expertise on staff or on the board to close out a set of books effectively. The lack of financial expertise will also affect the overall risk assessed for the engagement and influence the auditor's assessment of the control environment.

While assistance with bookkeeping adjustments is considered a threat to independence, it is not a prohibited activity. The auditor applies professional judgment in determining whether the extent of the adjustments could result in an impairment of the auditor's independence and designs procedures to respond to the threat. The following table lists examples of possible self-review threats and examples of safeguards to mitigate them.

**Table 3.2.4-1: Examples of safeguards to mitigate self-review threats**

Possible Review Threats	Examples of Safeguards to Mitigate Self review Threats
<ul style="list-style-type: none"> <li>The auditor has performed bookkeeping for the NFPO client.</li> </ul>	<ul style="list-style-type: none"> <li>Management prepare the source data for all the accounting entries</li> <li>The staff member who performed the bookkeeping services does not participate on the audit engagement team.</li> </ul>
<ul style="list-style-type: none"> <li>The auditor has assisted the NFPO client with the preparation of its financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>Management and those charged with governance review and approve all journal entries prepared by the auditor, as well as changes to the financial statements.</li> </ul>
<ul style="list-style-type: none"> <li>The auditor has provided advice and comments to the client, which resulted in adjustments.</li> </ul>	<ul style="list-style-type: none"> <li>Management review the auditor's advice and comments and undertake their own analysis, considering the organization's circumstances and the applicable financial reporting framework (e.g., ASNFPO).</li> <li>Management develop any underlying assumptions required with respect to the accounting treatment and measurement of the entries.</li> </ul>

The extent of mitigating activities also depends on the nature of the transactions. Transactions that are non-routine and complex are more likely to require additional layers of review than those that are simple and routine. As a minimum safeguard, the adjusting entries must be approved by the appropriate level of management.

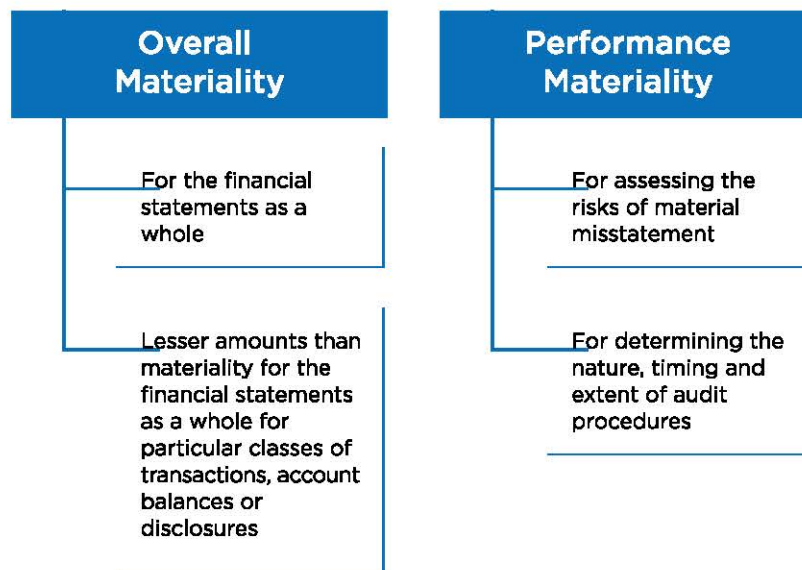
### **3.2.5 Familiarity Threat**

A familiarity threat arises when, by virtue of a close relationship with a client, its directors or employees, an audit firm or a member of the engagement team becomes too sympathetic to the client's interests. The threat of familiarity often arises when clients and professionals know one another and the pool of professionals working on an engagement is small; it can, however, also stem from long-term association with any organization. While only the individuals involved can make an accurate assessment of independence "in fact" with respect to familiarity, it is also necessary to consider whether the firm or individual members of the engagement team would be viewed to be independent "in appearance." When faced with such a threat of independence, auditors should consider implementing safeguards such as rotating the engagement partner on a periodic basis, using a second partner to perform a second-partner review and rotating staff on the engagement.

## 4.0 Materiality Issues

*CAS 320, Materiality in Planning and Performing an Audit*

CAS 320 requires the following levels of materiality:



Materiality is applied in planning and performing an audit, as well as in evaluating the effect of misstatements on the financial statements. An auditor determines materiality using their professional judgment, which is affected by their perception of the information needs of financial statement users. CAS 320 states that materiality is based on the common financial information needs of users as a group and is the amount by which errors or omissions (individually or collectively) could reasonably be considered to affect the economic decisions of users based on their reading of the financial statements.

In an NFPO environment, there is usually a broad range of stakeholders, with multiple potential users, for example:

- government funders
- donors—corporate, individuals or other foundations or NFPOs
- potential donors
- governing bodies and parent associations
- lenders
- members
- clients
- general public

In a not-for-profit environment, materiality is based on a determination of what users will be most sensitive to. Commonly used bases for calculating an NFPO's materiality are the level of expenditures for active organizations and the level of assets for foundations.

It is also necessary to consider qualitative factors in assessing materiality. For example, an NFPO's high-profile capital campaign could result in the financial statements being scrutinized by a larger population of funders, which may have an impact on the auditor's assessment of users' needs.

**Table 4.0-1: Some practical considerations related to materiality**

Materiality Level	Description	Example
Financial statements as a whole	<ul style="list-style-type: none"> <li>• Percentage of total revenues or total expenses may be appropriate for not-for-profit organizations</li> <li>• Other factors commonly applied are percentage of assets</li> </ul>	Common benchmarks and thresholds include: <ul style="list-style-type: none"> <li>• ½% – 2% of total expenses</li> <li>• ½% – 2% of total revenues</li> <li>• 1% – 2% of total assets</li> </ul>
Lesser amounts than materiality for the financial statements as a whole for a particular class of transaction, account balance or disclosure to address the specific needs of a user or group of users	<ul style="list-style-type: none"> <li>• Is a user, or group of users, particularly sensitive to a class of transaction, account balance or disclosure?</li> <li>• An auditor can set a specific (reduced) materiality level just for evaluating the identified class of transaction, account balance or disclosure</li> </ul>	<ul style="list-style-type: none"> <li>• Sensitivity to allocation of expenses across various categories</li> <li>• Donations collected over a specified period will be matched by another donor</li> </ul>

Materiality Level	Description	Example
Performance materiality for purposes of assessing the risks of material misstatement	<ul style="list-style-type: none"> <li>• Used to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole</li> <li>• May be expressed as a percentage of materiality for the financial statements as a whole</li> <li>• Represents the maximum quantitative misstatement in a population that auditor is willing to accept</li> <li>• Involves auditor judgment about expectations of misstatements that could arise in the current period</li> </ul>	<ul style="list-style-type: none"> <li>• Controls are strong, history of no adjustments—auditor may use a higher percentage of materiality for financial statements as a whole</li> <li>• Bookkeeping is weak and adjustments are anticipated—auditor may use a lower percentage of materiality for financial statements as a whole</li> </ul>
Performance materiality for determining the nature, timing and extent of audit procedures	<ul style="list-style-type: none"> <li>• Used by auditor to design appropriate audit responses to identified risks</li> <li>• Is a matter of professional judgment</li> </ul>	<ul style="list-style-type: none"> <li>• A lower threshold is used to audit employee expense reports that have a higher sensitivity to fraud and public scrutiny</li> </ul>





## 5.0 Identifying and Assessing Risks of Material Misstatements in an NFPO Audit – Overview

### *CAS 315, Identifying and Assessing Risks of Material Misstatement*

An auditor performs risk assessment procedures to identify and assess risks of material misstatements in order to design appropriate responses to assessed risks. Regardless of an NFPO's size and complexity, an auditor is required to apply the risk assessment standards and comply with all the relevant CASs.

To identify risks of material misstatements of an NFPO's financial statements, an auditor must perform risk assessment procedures to gather information to help them gain an understanding of the NFPO and its environment, including its internal control. The identified risks must be assessed at the financial-statement level (i.e., those risks that relate pervasively to the financial statements as a whole and potentially affect many assertions) and at the assertion level for significant classes of transactions, account balances and disclosures to provide a basis for designing and performing appropriate audit procedures (audit responses).

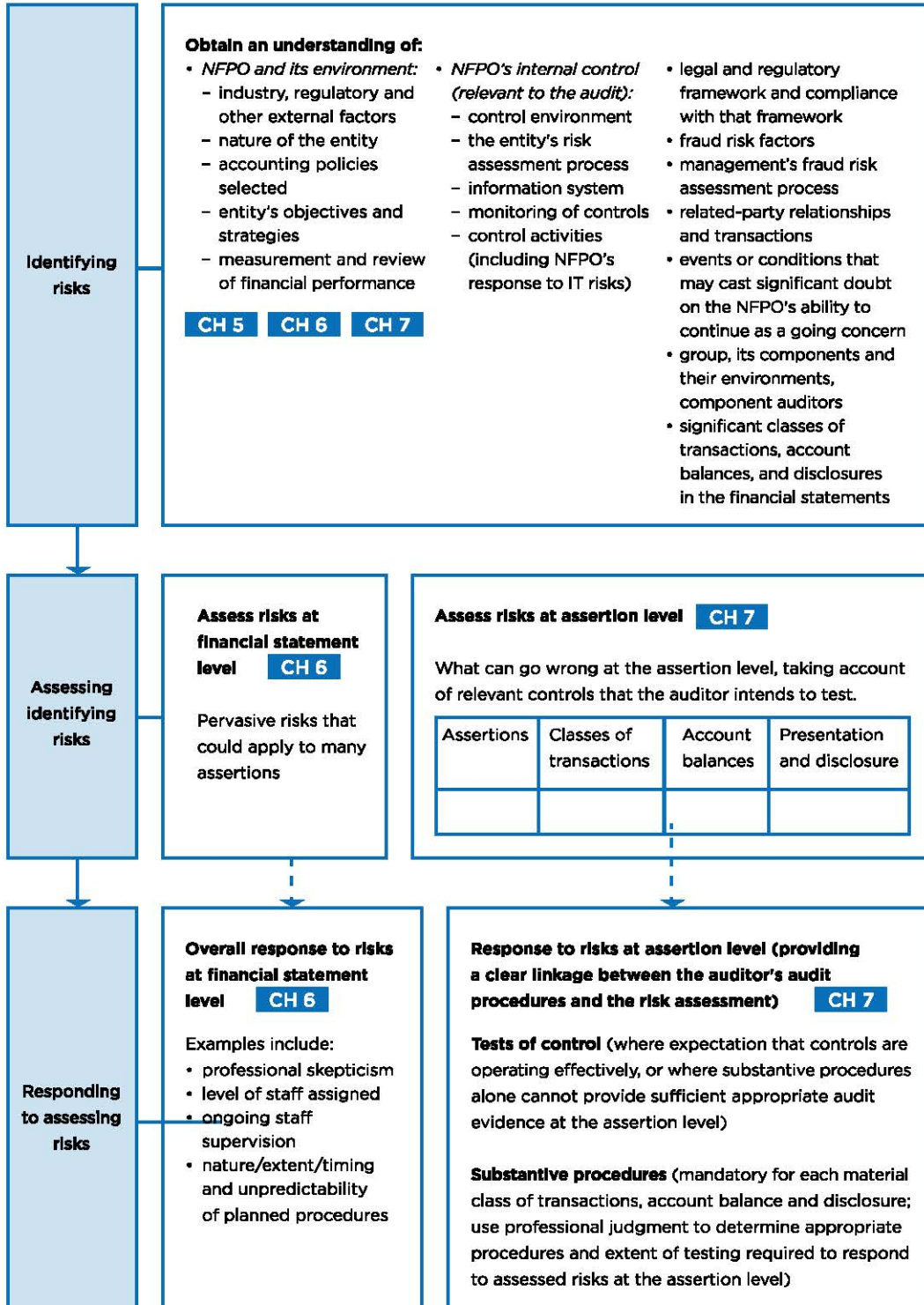
For this purpose, an auditor is required to:

- identify risks through the process of obtaining an understanding of the NFPO and its environment, including relevant controls related to the risks and by considering the classes of transactions, account balances and disclosures in the financial statements

- assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole and, therefore, potentially affect many assertions
- relate the identified risks as to what can go wrong at the assertion level, taking into account the relevant controls they intend to test
- consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatements are large enough to result in a material misstatement

The following diagram summarizes the activities related to risk assessment. It shows the elements that an auditor needs to understand in order to identify risks. Each identified risk must then be assessed. In assessing the identified risks, an auditor determines whether the risks are relevant to the financial statements as a whole, or only to certain financial statement assertions. The auditor then determines how they will respond to the risks and tailor responses using overall responses and specific responses depending on the types of risks assessed.

Diagram 5.0-1: Activities related to risk assessment



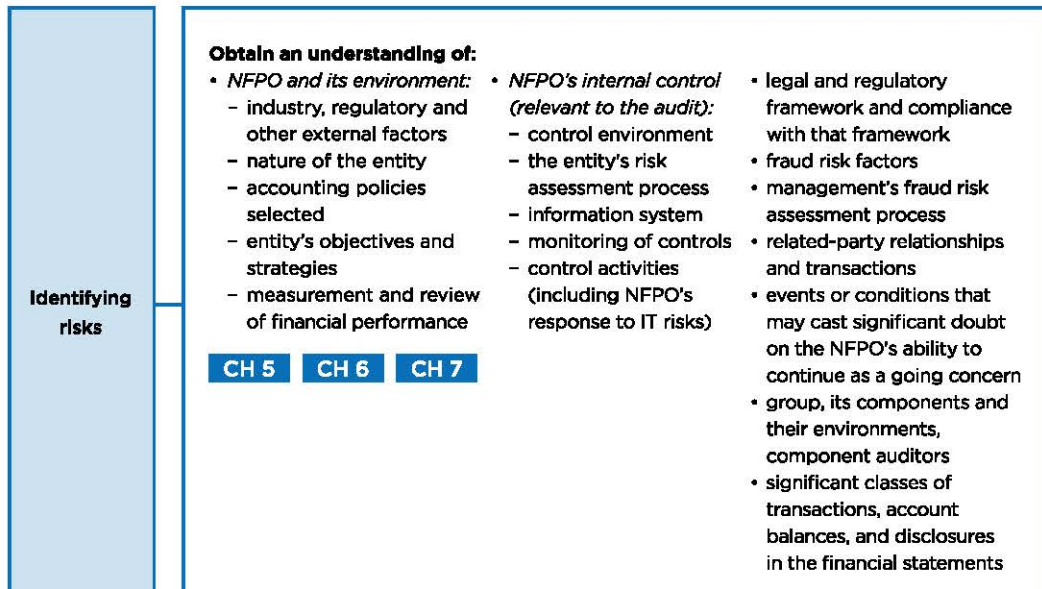


**Are you concerned with audit efficiencies?**

Time and effort expended at the planning stage will likely save time in the end. Identifying areas most likely to result in errors provides focus for the engagement teams and concentrates their efforts on those areas of the audit that are most susceptible to material misstatements. If no focus is provided, there is a good chance they are over auditing areas that have a low probability of errors and potentially failing to respond to specific risks of material misstatements.

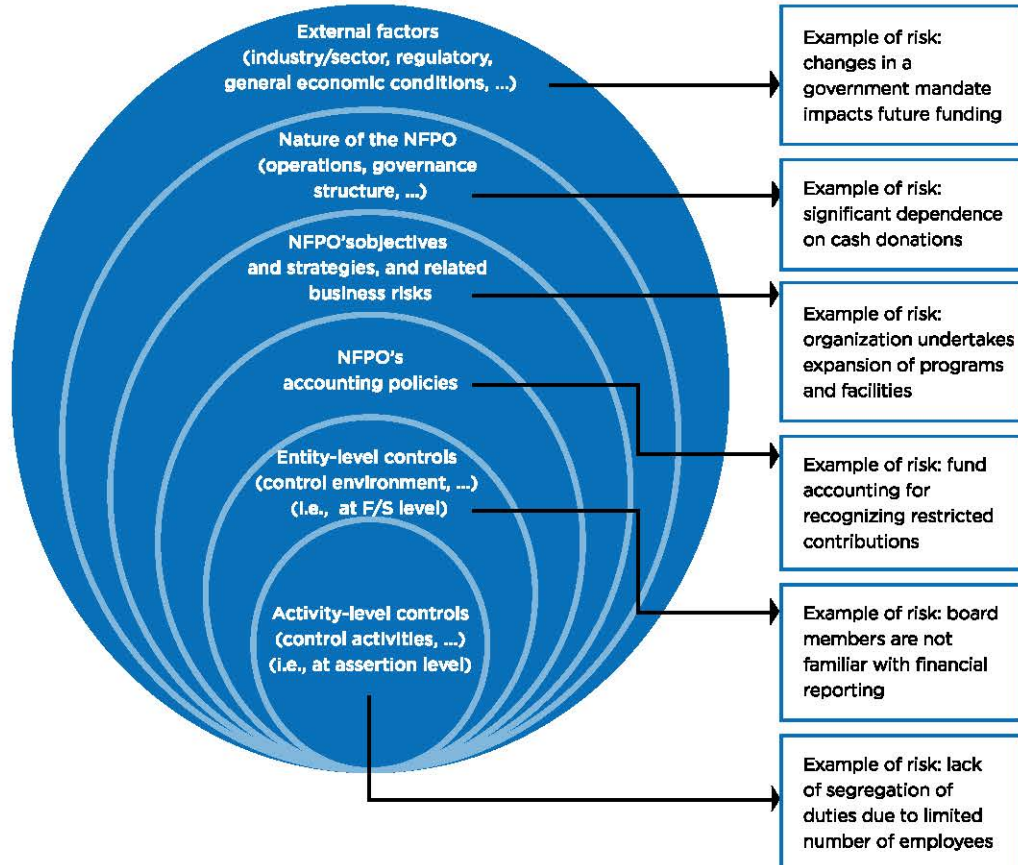
## 5.1 Gaining an Understanding of the NFPO to Identify Risks

Risks of material misstatement are identified through gaining an understanding of the following elements (extract from Diagram 5.0-1: Risk assessment activities):



The diagram below provides some examples of risks that may be identified when gaining an understanding of the different elements above.

**Diagram 5.1-1: Examples of risks identified**



**Chapter 6** examines risks at the financial-statement level, with a discussion of specific audit requirements for identifying risks that can arise due to fraud, laws and regulations, service organizations, related parties and going concern.

**Chapter 7** focuses on risks pertaining to significant accounts, classes of transactions and disclosure at the assertion level. To help an auditor in their risk assessment at the assertion level, eight case studies illustrate

examples of what can go wrong at the assertion level, and identify some factors that may be relevant to risk assessment and some considerations for the audit plan.

## 5.2 Determining Whether Identified Risks Are Significant Risks



**Are there any significant risks that require special audit considerations for the NFPO audit, considering your understanding of the entity?**

As part of the risk assessment, an auditor is required to determine whether any of the risks they have identified are, in their judgment, significant risks. In exercising this judgment, an auditor must exclude the effects of identified controls related to the risk.

In so doing, as per CAS 315 paragraph 28, an auditor is required to consider at least the following:

**Table 5.2-1: Examples of significant risks**

Considerations	Examples of Significant Risks
Risk is a risk of fraud	NFPO board does not have financial expertise NFPO collects large amounts of cash
Risk is related to recent significant economic, accounting or other developments	NFPO is transitioning to a new accounting framework (e.g., ASNFPO)
Complexity of transactions	NFPO has entered into a derivative financial instrument such as an interest rate swap
Significant transactions with related parties	NFPO enters into a partnership program with a similar organization
Degree of subjectivity required in the measurement of financial information related to the risk, especially measurements involving a wide range of measurement uncertainty	NFPO has material pledges and records the receivable
Significant transactions that are outside the normal course of business	NFPO sells land to raise operating funds

If an auditor determines that a significant risk exists, they are required to obtain an understanding of the NFPO's controls, including control activities relevant to that risk. When an auditor concludes that appropriate controls have not been implemented to respond to significant risks, that signals a significant deficiency in internal control. CAS 265 contains communication requirements for circumstances where an auditor identifies such deficiencies.

In designing the audit response to the significant risks assessed, an auditor needs to consider the following:

- When the approach does not include tests of controls and only substantive procedures will be performed, those procedures shall include tests of details (i.e., substantive analytical procedures alone would not be enough)
- If an auditor plans to rely on controls over a risk they have determined to be significant, they are required to test those controls in the current period (i.e., a rotational approach to control testing is not acceptable)

The identification of significant risks does not imply that there are significant control deficiencies within an entity. Identification of significant risks is intended to provide focus to the audit team in formulating the audit plan and is essential to implementing a risk-based audit.

Identifying risks at the financial statement level is further addressed in Chapter 6 and risks at the assertion level for significant account balances and classes of transactions are addressed in Chapter 7.

### 5.3 Entity-Level Controls Specific to NFPOs

In obtaining an understanding of internal control, an auditor is required to specifically acquire an understanding of the following internal control components:

1. control environment
2. entity's risk assessment process
3. information systems, including the related business processes, relevant to financial reporting and communication
4. monitoring controls
5. control activities relevant to the audit

The first four internal control components listed are entity-level controls that relate to the identification of risks at the financial-statement level. The control environment is of particular importance as it sets the foundation for all other components of internal control. The absence of a strong control environment may undermine the effectiveness of other components of internal control.

In documenting the auditor's understanding of controls that are relevant to the audit, the auditor must consider the effectiveness of the design of the controls and whether they have been implemented. While much of this understanding will come from discussions with management and those charged with governance, inquiry alone is insufficient to support the auditor's assessment. An auditor might consider the following examples of controls when obtaining an understanding of internal control at the financial-statement level for an NFPO audit engagement.



*Table 5.3-1: Examples of control environment elements*

Control Environment Elements	Possible Indicators of Strong Controls	Possible Methods for Obtaining Corroborative Evidence for the Implementation of Controls
Effective board members	<ul style="list-style-type: none"> <li>• Competence</li> <li>• Independence</li> <li>• Objectivity</li> <li>• Understanding of the operations</li> <li>• Size of the board appropriate for effective decision-making</li> <li>• Clear roles and responsibilities</li> <li>• Level of board engagement and frequency of meetings</li> <li>• Creation of audit or other committees</li> </ul>	<p>Inspecting board make-up and terms of reference</p> <p>Inspecting board policies for recruitment and acceptance of new members</p> <p>Inspecting board minutes</p> <p>Inspecting audit committee terms of reference and minutes</p>
Tone at the top	<ul style="list-style-type: none"> <li>• Positive attitude and strong commitment of management and board</li> <li>• Communication and enforcement of integrity and ethical values</li> </ul>	<p>Observing attitude and commitment of employees</p> <p>Inspecting Code of Conduct and Conflict of Interest guidelines</p> <p>Observing and inspecting management and board communications to staff and volunteers</p>
Organizational structure	<ul style="list-style-type: none"> <li>• Key areas of authority and responsibility are defined</li> <li>• Appropriate lines of reporting</li> </ul>	<p>Inspecting documents that summarize organizational structure and key authorities</p>
Policies and procedures	<ul style="list-style-type: none"> <li>• Policies are clearly approved, documented and communicated</li> </ul>	<p>Inspecting minutes for board approval, documentation and communication process</p>

**Table 5.3-2: Examples of entity's risk assessment process elements**

<b>Entity's Risk Assessment Process Elements</b>	<b>Possible Indicators of Strong Controls</b>	<b>Possible Methods for Obtaining Corroborative Evidence for the Implementation of Controls</b>
Procedures directed to risk assessment	Management and TCWG keep a watch over external and internal risk factors	Inspecting minutes
Sub-committee to address risk factors affecting the entity	Sub-committee (e.g., an audit committee) meets regularly, meeting minutes are recorded and action items are documented	Inspecting minutes
Entity networks with other NFPOs and/or tracks the industry	Strong relationships with other NFPOs  Participation in industry conferences and events  Subscriptions to industry news and data	Inspecting minutes  Inquiry of management and inspecting communications, information and data

**Table 5.3-3: Examples of information system and communication elements**

<b>Information System and Communication Elements</b>	<b>Possible Indicators of Strong Controls</b>	<b>Possible Methods for Obtaining Corroborative Evidence for the Implementation of Controls</b>
Key business processes relevant to financial reporting	Clear procedures (both automated and manual) for initiating, recording, processing and reporting transactions and related accounting records	Inspecting systems documentation
Controls over maintenance and update of the organization's website	Content is relevant and accurate	Inspecting website
Employee and volunteer handbooks	Handbooks are updated and distributed regularly	Inquiries, inspection and observation of their use

**Table 5.3-4: Examples of monitoring elements**

Monitoring Elements	Possible Indicators of Strong Controls	Possible Methods for Obtaining Corroborative Evidence for the Implementation of Controls
Budget	<ul style="list-style-type: none"> <li>• Set in a timely manner</li> <li>• Approved by TCWG</li> <li>• Variance to actual examined throughout the year</li> <li>• Budget is fixed</li> </ul>	<p>Inspecting board minutes for budget presentation and approval</p> <p>Inspecting board minutes for financial oversight</p>
Internal audit function	<ul style="list-style-type: none"> <li>• Internal audit function exists</li> <li>• Internal audit function is appropriately structured and effective</li> </ul>	<p>Inspecting Internal Audit Charter</p> <p>Inspecting board oversight of internal audit function and review of internal audit findings</p>
Management involvement in day-to-day operations	Evidence of management review and sign-off of key transactions	<p>Reviewing documented evidence of management reviews and sign-offs</p> <p>Inquiring of management about its knowledge of key transactions</p> <p>Inquiring of staff about management's involvement in day-to-day operations</p>
Process for handling complaints	Formal complaints procedure exists, which includes documentation and communication requirements	Inspecting handling procedures and documentation / action taken on complaints, if any

Entity-level controls are further discussed in Chapter 6 and activity-level controls addressing risks at the assertion level are discussed in Chapter 7.



**For further guidance on the auditor's understanding of the entity's internal control relevant to the audit, see:**

- ***Auditing and Assurance Bulletin—Understanding Internal Control Relevant to the Audit—The Function of a Walk through.***



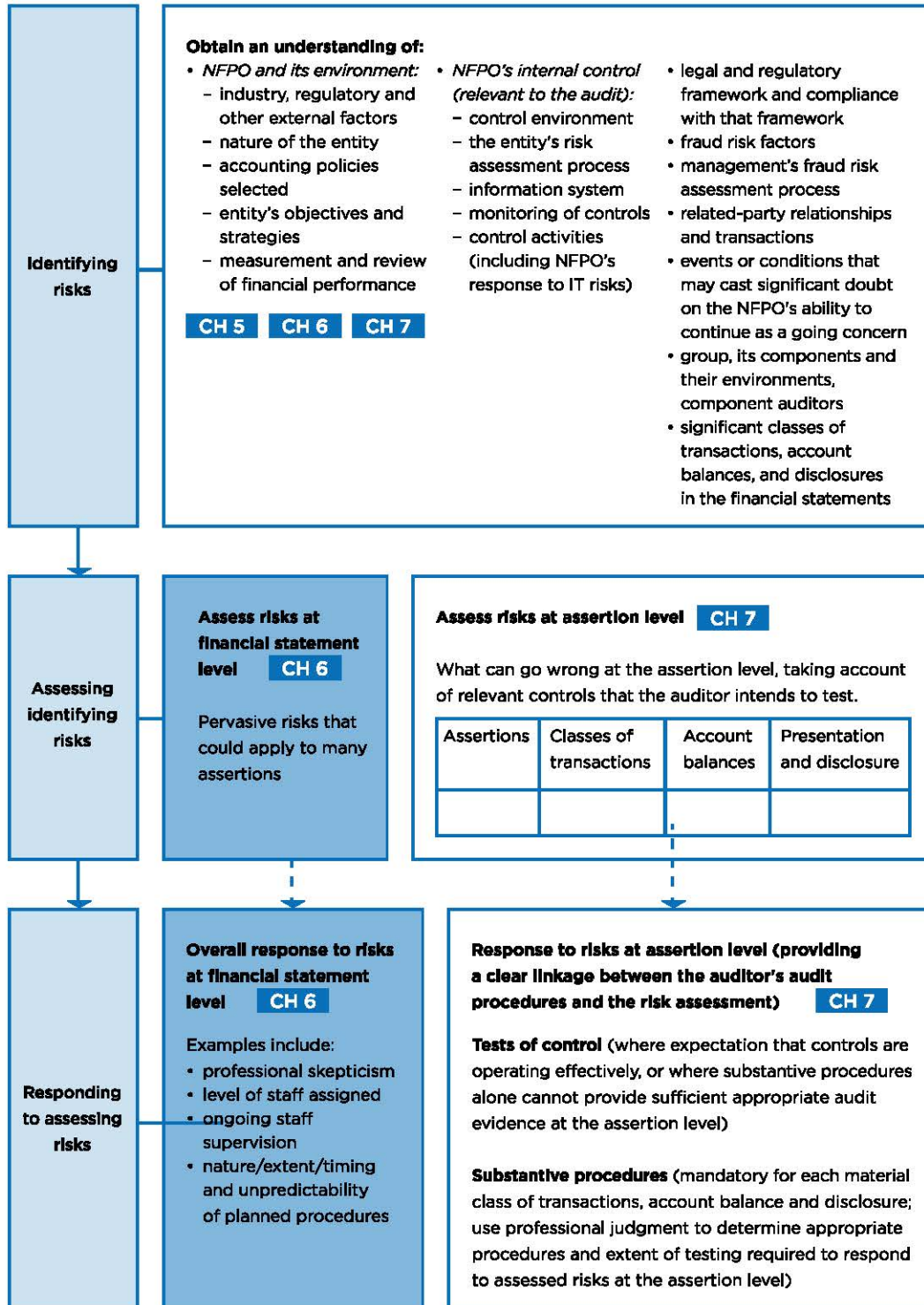
## 6.0 Assessed Risks at the Financial-Statement Level

CASs require an auditor to acquire an understanding of the entities they audit so that they can identify and assess the risks of material misstatements at the financial-statement and the assertion levels to provide a basis for designing and carrying out the required responses to any assessed risks. This chapter examines risks at the financial-statement level, with a discussion of specific audit requirements for identifying risks that can arise due to fraud, laws and regulations, service organizations, related parties and going concern. Chapter 7 focuses on risks pertaining to significant accounts, classes of transactions and disclosure at the assertion level.

Risks of material misstatement at the financial-statement level refer to risks that pervade the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class-of-transactions, account-balance or disclosure level.

The following diagram summarizes the activities related to risk assessment. It shows the elements that an auditor needs to understand to identify risks. Each identified risk must then be assessed. In assessing the identified risks, the auditor determines whether the risks are relevant to the financial statements as a whole, or only to certain financial-statement assertions. The auditor then determines how they will respond to the risks and tailor their responses using overall responses and specific responses depending on the types of risks assessed.

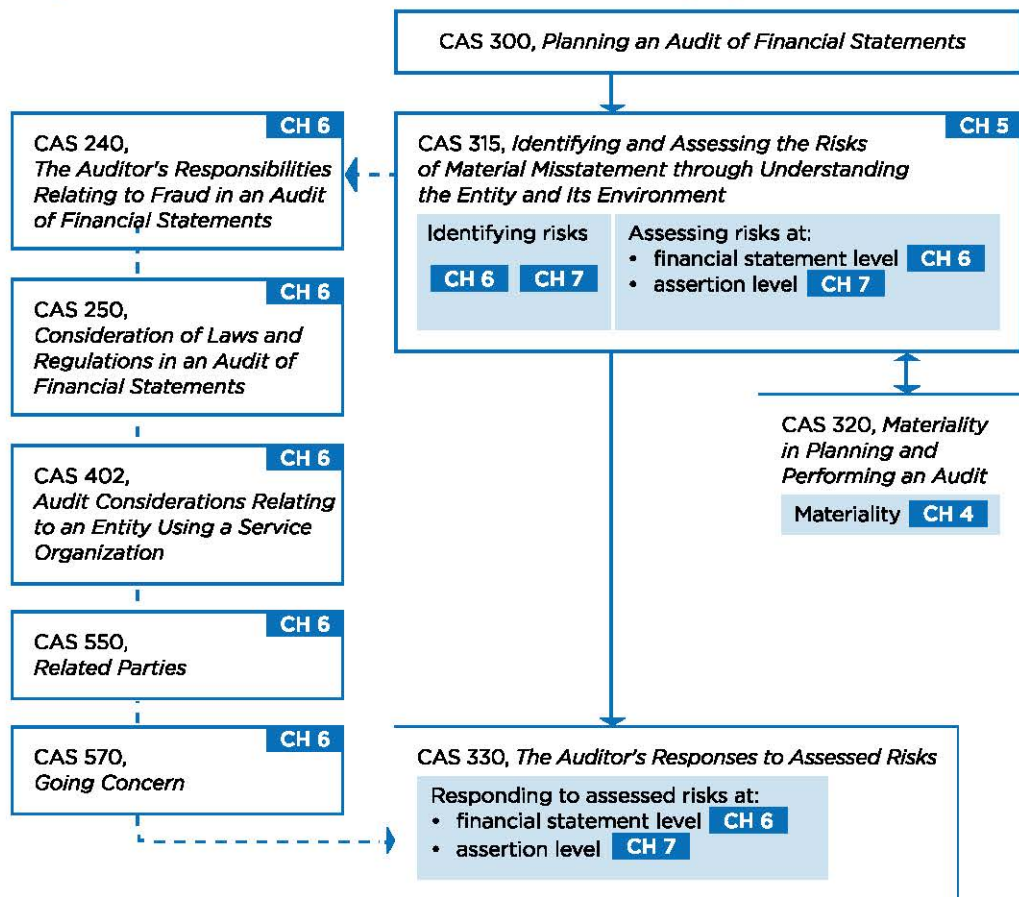
Diagram 6.0-1: Activities related to risk assessment



## 6.1 Risk Assessment Standards

Other CASs expand on how CAS 315 and CAS 330 are to be applied in relation to risks of material misstatement due to error or fraud. The following diagram summarizes some of these other CASs that impact the risk assessment in an NFPO audit and where they are incorporated into the Guide, along with CAS 315 and CAS 330.

**Diagram 6.1-1: Risk assessment standards for the purposes of this Guide**



## 6.2 Risks Related to Fraud

### *CAS 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

CAS 240 expands on how CAS 315 and CAS 330 are to be applied to risks of material misstatement due to fraud, and assists an auditor in designing procedures for detecting such misstatement.

An auditor is concerned with any fraud that may cause a material misstatement in the financial statements. Two types of intentional misstatements are particularly relevant to the consideration of fraud risks:

- fraudulent financial reporting
- misappropriation of assets



**How and where might an NFPO's financial statements be susceptible to material misstatement due to fraud and how might fraud occur?**

### 6.2.1 Engagement Team Discussion

Recognizing fraud risk factors and imagining how fraud can occur are challenging tasks for any auditor. An auditor should use the engagement team discussion as a valuable opportunity to brainstorm how and where an NFPO's financial statements may be susceptible to material misstatements due to fraud.

No matter the size of the audit team, this discussion must occur and be appropriately documented. An auditor, whether working in a larger team or as a sole practitioner, may use checklists of fraud risk factors<sup>2</sup> to assist in brainstorming. When considering fraud in an engagement team discussion, the team participants must carefully set aside any trust in management's and TCWG's honesty and integrity.

<sup>2</sup> CAS 240 Appendix 1 provides examples of fraud risk factors.



Potential topics for discussion at an engagement team meeting:

- potential for managing the bottom line through manipulation of deferred revenues, pre-pays, and accrued expenses to hide surpluses
- nature of potentially restricted contributions and incentives to use funds for other purposes
- significance of travel expenses and extent of transactions processed through expense reports and susceptibility to misuse
- susceptibility of donations to misappropriation (cash and cheques)
- extent of expenditures paid using petty cash or corporate credit cards and appropriateness of controls
- extent to which expenses are allocated across programs and incentives to misallocate expenses to manage surpluses
- comparison of employee pay rates to market rates for similar positions in better funded organizations
- motivations of the entity's management team
- attitudes towards controls

### 6.2.2 Inquiries of Management and Those Charged with Governance

It is important for an auditor to initiate communications with management and those charged with governance early in the audit process. Separate inquiries concerning fraud are required to be made of management and TCWG.

#### **Management**

An auditor must gain an understanding of management's assessment of the risk that the financial statements may be materially misstated due to fraud—and that understanding must include the nature, extent and frequency of such an assessment. The auditor is also required to understand the process by which management identifies and responds to the risks of fraud, including how management communicates, if at all, its views on business practices and ethical behavior to employees. As well, the auditor must ask management whether they have knowledge of any actual, suspected or alleged fraud affecting the entity.

Potential topics for discussions with management:

- nature of funding, including susceptibility to misallocation (considering restricted and unrestricted contributions)
- significant contributions, their intended purposes and potential for misallocation
- nature of programs and allocations among programs
- nature of assets and expenditures and susceptibility to fraud
- management's views with respect to financial pressures

### ***Those Charged with Governance***

An auditor is required to obtain an understanding of how those charged with governance (TCWG) exercise their oversight responsibilities over management's processes for identifying and responding to the risks of fraud in the entity, and the internal control that management has established to mitigate these risks. An auditor is also required to ask them whether they know of any actual, suspected or alleged fraud affecting the entity. These inquiries are made in part to corroborate management's responses to inquiries.

Regardless of the mode chosen to make these inquiries, an auditor should be aware that using open-ended questions encourages an open exchange of comments and ideas. Appropriate documentation of the inquiry includes the name and title of the person interviewed, the date of the inquiry, as well as a summary of the topics covered and information gathered. An auditor may interview certain key members of management and / or the board every year for a particular audit, and then randomly select additional members of management and the board to interview each year, so that they obtain broader insight from their interviews while adding some unpredictability to the testing approach.

#### Potential topics for discussions with TCWG:

- knowledge of management process to assess, identify and respond to risks of fraud
- TCWG's own assessment of fraud risks
- board oversight / action regarding fraud risk factors
- significant changes in policies and bylaws during the year and consideration of changes in the legal and regulatory environment
- strengths and weaknesses of the board, strategies for ongoing governance structure and board makeup
- internal and external challenges facing the organization
- extent of monitoring controls undertaken during the year and results of monitoring activities

### **6.2.3 Unusual or Unexpected Relationships Identified**

An auditor is required to evaluate whether unusual or unexpected relationships that have been identified in performing preliminary analytical procedures, including those related to revenue and expenditure accounts, may indicate risks of material misstatement due to fraud.

For example, if, while performing preliminary analytical procedures, an auditor notices that travel expenses are three times what they were in the prior year, and management has indicated that there has been no substantial change in the general operations of the organization, that may be an indication of risks of material misstatement due to fraud.

### **6.2.4 Examples of Fraud Risk Factors**

As they come to understand an entity, and by having discussions with management and TCWG, an auditor may identify events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud (fraud risk factors). The determination of whether a fraud risk factor exists, and whether it is to be considered in assessing the risks of material misstatement of the financial statements, requires the exercise of professional judgment. These deliberations should be clearly documented, along with the auditor's conclusions after assessing the risks of fraud.

The following table highlights potential fraud risk factors common to not-for-profit organizations at the financial-statement level:

**Table 6.2.4-1: Some potential fraud risk factors at the financial-statement level**

Potential Fraud Risk Factors
<ul style="list-style-type: none"> <li>• financial stability is threatened by economic, industry (sector) or NFPO operating conditions</li> <li>• excessive pressure on management to meet financial or operating requirements or expectations of TCWG or third parties</li> <li>• information indicates that the personal financial situation of some members of management is questionable</li> <li>• one active manager (or executive director) has full access to operations and organizational financial reporting, with minimal or no supervision</li> <li>• lack of segregation of duties: staff or volunteers have the opportunity to perform incompatible functions, such as having custody of assets, authorizing transactions and recording them</li> <li>• the control environment focuses solely on the organization's mission, without regard for financial controls</li> <li>• volunteers are not appropriately supervised</li> <li>• an ineffective board or incompetent management</li> <li>• the board places undue trust and reliance on management</li> <li>• management places undue trust and reliance on employees</li> <li>• no internal audit or other monitoring functions</li> <li>• an attitude that the NFPO's mandate overrides ethical considerations</li> <li>• an attitude that internal controls are not as important or expected in an NFPO</li> <li>• employees having an attitude of entitlement, particularly where their salaries are less than those in the for-profit sector</li> </ul>

An auditor should pay special attention to three conditions that may lead an ordinary person to commit a fraud. When any or all of these conditions are present, there is a heightened risk of fraud.

The three conditions that are generally present when fraud exists are:

1. an incentive or pressure to commit fraud
2. a perceived opportunity to commit fraud
3. an ability to rationalize the fraudulent action

These conditions can be illustrated as a fraud triangle.

*Diagram 6.2.4-1: Fraud triangle*



Fraud risk factors are generally classified according to these three conditions.

The following scenarios are a reminder that fraud can occur in an NFPO and that an auditor needs to be alert to any potential fraud risk factors. The scenarios provide examples of fraud risk factors, including their classification in the fraud triangle.

***Scenario 1***

A researcher at an NFPO spent more than \$100,000 of grant money on household and other personal items, including televisions, computer equipment and furniture.

Although employee expense reports were subject to approval, the entity's expense policies did not in fact restrict the nature of expenses that could be included in employee expense reports or provide spending limits for individual transactions. Expense reports were approved by an administrative assistant for compliance with the entity's policies before being submitted to the program director for final approval. The program director assumed that the expenses were in accordance with the entity's policies and therefore acceptable. In fact there is a lack of control, since the nature of expenses and the spending limits are not defined in the entity's policy; this represents an opportunity to commit fraud [**opportunity**].

The researcher had an opportunity to commit fraud and maintained that the expenses related to a home office were necessary to delivering the research project [**rationalization**].

**Scenario 2**

A warehouse manager at the central warehouse, a trusted long-term employee who was responsible for receiving, sorting and distributing donated food and household items to needy families, stole a material amount of goods over a period of several years.

The organization's accounting policies did not provide for recording donated goods, given the difficulty of valuing such items. Although the organization's policies ensured goods were received by at least two individuals, they did not include measures for tracking goods at the time of receipt at the receiving location. There were no controls around the shipment of goods from the receiving location to the central warehouse [**opportunity**].

The warehouse manager at the central warehouse had an opportunity to commit fraud and had worked with the organization for many years at a below-market rate [**rationalization**].

**Scenario 3**

A local minister stole a material amount of money from his church.

The minister could write cheques against the church's bank account directly, without needing a second signature. Collections of cash were kept in an unlocked office and were not counted until days later. The church's finance committee did not review financial statements. There were no controls over cash [**opportunity**].

The local minister had an opportunity to commit fraud and had gambling habits [**incentive**].

In these scenarios, the following potential fraud risk factors may be present and might have allowed misappropriation of assets:

- Lack of segregation of duties: staff or volunteers perform incompatible functions, such as having custody of assets, authorizing transactions and recording them.
- The control environment focused solely on the organization's mission, without regard for financial controls.
- Employees / volunteers are not appropriately supervised.

- The board is ineffective or management is incompetent.
- Management places undue trust and reliance on employees.
- No internal audit or other monitoring functions (in a large NFPO) are performed.
- An attitude exists that internal controls are not as important or expected in an NFPO.
- Employees have an attitude of entitlement, particularly where their salaries are less than what they would get in the for-profit sector.

Identifying a fraud risk factor does not necessarily mean that a fraud risk exists. An auditor should consider whether management and TCWG have designed and implemented entity-level control elements that will mitigate the fraud risk factors. The following questions point to controls that could have mitigated the fraud risk factors identified above:

- Is there an appropriate segregation of duties between those receiving the contributions and those initiating, approving and recording transactions?
- Is there appropriate monitoring of funds disbursed, with a review of supporting receipts and records?
- Do the entity's policies clearly articulate the requirement to use contributions only for their stated purpose?
- Is the organizational structure appropriate, with key areas of authority and responsibility defined (including appropriate lines of reporting)?
- Does "tone at the top" (management's attitude) display and communicate the need to act with integrity, consistent with the organization's ethical values?
- Do management and TCWG keep a watch over external and internal risk factors, such as the risk of theft or loss due to the high volume of donated goods collected?
- Is management sufficiently involved in the day-to-day operations to periodically detect incorrect / unauthorized transactions?
- Do management and TCWG use an approved budget as a tool to manage operations? Are budget-to-actual variances examined and explained throughout the year?

In each of the scenarios described above, employees defrauded the organization by misappropriating assets for personal benefit.

Fraud may also take the form of deliberately misstating financial results for the organization's benefit, rather than for personal gain. For example, an executive director may overstate expenses to fully utilize government grants in years when there is a funding surplus to ensure that future budgets are not cut. Examples of fraud risk factors at the assertion level are addressed in the case studies presented in Chapter 7.

#### **6.2.4 Overall Responses to Risks of Material Misstatements Due to Fraud**

The following discussion addresses possible overall responses to fraud risks at the financial-statement level and to management override of controls.

##### ***Overall Responses***

Overall responses to fraud risks at the financial statement level could include:

- reinforcing the need to question how management assesses the possibility of error and fraud
- emphasizing the need to maintain professional skepticism
- assigning more experienced staff
- providing more supervision
- adding more unpredictability to audit tests
- changing the nature, timing and extent of audit procedures

An auditor is required also to evaluate whether an entity's selection and application of accounting policies, particularly those involving subjective measurements and complex transactions, might indicate fraudulent financial reporting.

##### ***Management Override of Controls***

Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that might otherwise appear to be operating effectively. Although the level of risk that management overrides controls will vary, the risk is present in all entities. Since these overrides can be unpredictable, they are considered a significant risk.



Irrespective of the outcome of an auditor's assessment of the risks of management override of controls, to effectively address these risks, an auditor is required to:

- Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the NFPO's financial statements:
  - Ask those involved in the financial-reporting process about inappropriate or unusual activity in the processing of journal entries and other adjustments.
  - Select and test journal entries at the end of the reporting period, and consider the need to select and test entries throughout the period.
- Review accounting estimates for potential biases, evaluate whether management's judgments and decisions in arriving at the accounting estimates indicate a possible bias. If they do, then the auditor shall re-evaluate the accounting estimates taken as a whole. (For example, in an NFPO environment, an auditor may recognize that an NFPO's dependence on annual ministry funding may lead to a bias to overstate expenses when the NFPO is under budget, due to the fear that the budget for the following year will be reduced by the unspent amounts. This can result in fictitious expenses being recorded as accruals. Alternatively, an auditor may recognize that entities depending on donations are generally reluctant to report deficits or large surpluses. This can result in an overstatement of assets, particularly with respect to valuation of receivables and prepaid expenses):
  - Perform a retrospective review of management's judgments and assumptions related to significant accounting estimates, such as reviewing the historical accuracy of pledge receivables recorded in prior periods.
- Review significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual:
  - Evaluate whether the business rationale (or the lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets.

## 6.3 Risk Related to Laws and Regulations

### *CAS 250, Consideration of Laws and Regulations in an Audit of Financial Statements*



**Has the NFPO clearly identified the laws and regulations that have a significant impact on its operations?**

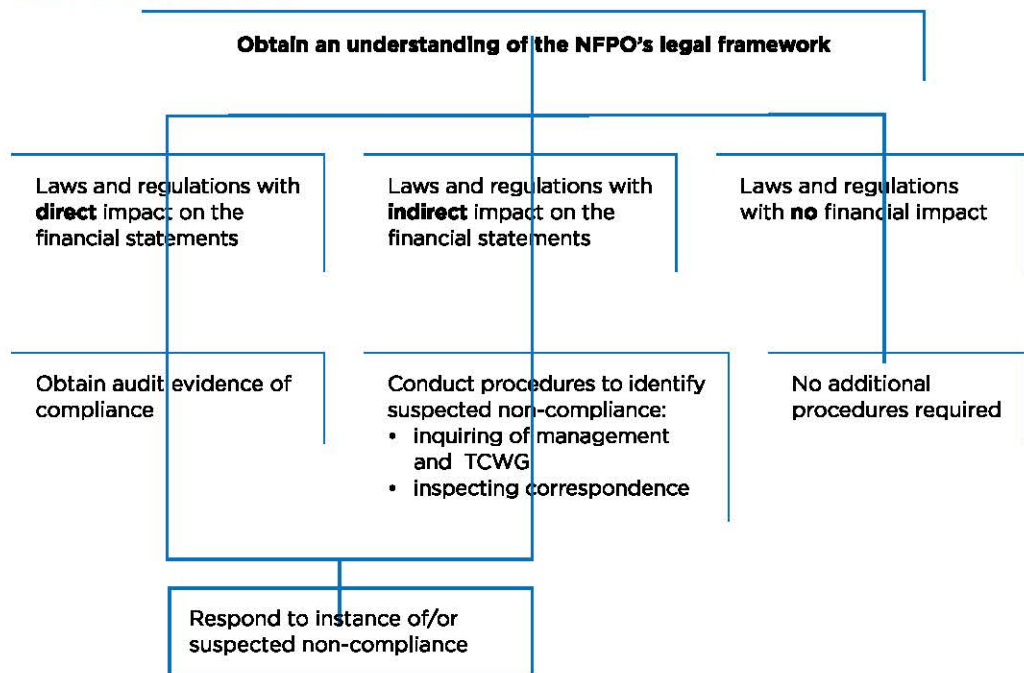
The laws and regulations under which an NFPO operates may have a direct or indirect impact on its financial statements. Key legislative criteria that will govern an organization include the incorporating legislation and government regulations, which will vary by organization. The required audit procedures set out in CAS 250 depend on whether the laws and regulations have a direct or indirect impact on the financial statements. To perform the appropriate audit procedures, it is important to determine in which category a law or regulation belongs.

**Table 6.3-1: Two categories of laws and regulations**

Impact on the Financial Statements	Definition of "Category"	Examples
Direct	Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements	<ul style="list-style-type: none"> <li>Formula in the legislation to calculate an amount recognized in the financial statements (e.g., HST rebates)</li> </ul>
Indirect	Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business or to avoid material penalties	<ul style="list-style-type: none"> <li>Charitable receipting rules</li> <li>Environmental regulations</li> </ul>

The following decision tree outlines the requirements in CAS 250 as per the classification of the laws and regulations (i.e., direct or indirect impact on the financial statements).

**Diagram 6.3-1: Requirements in CAS 250 as per the classification of the laws and regulations**



### 6.3.1 Laws and Regulations with Direct Impact

When laws and regulations fall into the "direct" category, the auditor's responsibility is to obtain sufficient appropriate audit evidence about the entity's compliance with the provisions of those laws and regulations.

The following table provides an example of a legislative and regulatory requirement that has a direct impact on the financial statements of an NFPO.

**Table 6.3.1-1: “Direct” category**

<b>Example of Direct Impact</b>	<b>Potential Impact</b>	<b>Procedures to Assess Compliance</b>
If the NFPO is a Public Sector Body and eligible for an HST rebate, the rebate may be incorrectly calculated	Overstatement or understatement of rebate	Analytical procedures (reasonability test)  Tests of details

### 6.3.2 Laws and Regulations with Indirect Impact

When laws and regulations fall into the “indirect” category, the auditor’s responsibility is limited to performing specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

An auditor is required to perform the following audit procedures to help identify instances of non-compliance with these laws and regulations:

- inquiring of management and, where appropriate, TCWG, whether the entity is complying with such laws and regulations,
- inspecting correspondence, if any, with the relevant licensing or regulatory authorities

Examples of laws and regulations that fall into this category include those listed in the following table:

**Table 6.3.2-1: “Indirect” category**

<b>Example of Indirect Impact</b>	<b>Potential Impact</b>	<b>Procedures to Identify Potential Non Compliance</b>
Charity is authorized to issue donation receipts, which are used to reduce the donor’s taxes	Erroneous or fictitious donation receipts could be issued—could result in CRA withdrawing charitable status of the organization	Inspect donation receipting policies  Inspect correspondence with CRA  Inquire of management and those charged with governance

Example of Indirect Impact	Potential Impact	Procedures to Identify Potential Non Compliance
CRA disbursement quota rules require a certain percentage of non-program-related assets to be paid out annually	Foundations not in compliance with disbursement quota rules may have their charitable status withdrawn by CRA	Inspect management's quota calculation
Failure to file on time an annual information return with CRA	CRA may revoke the charitable status of an organization if the foundation does not comply with this filing rule	Inspect the Charities Directorate website to ensure the return has been filed
Organization provides a service as a result of specific licence	Loss of license could have a significant impact on an entity's ability to provide services	Inspect minutes Inspect correspondence with licensing body
Entity's operations include for-profit components (e.g., concessions and gift shops in a museum) that may jeopardize charitable or NFPO status	Negative assessment by CRA results in loss of charitable or NFPO status	Inspect correspondence with CRA

In the absence of identified or suspected non-compliance, an auditor does not have to perform audit procedures on an entity's compliance with laws and regulations, other than those set out in CAS 250 paragraphs 12 to 16. During the audit, however, they are required to remain alert to the possibility that other audit procedures (e.g., review of minutes or substantive tests of details) could bring instances of non-compliance or suspected non-compliance with laws and regulations to their attention.



**For further guidance on issues related to the Canada Revenue Agency (CRA), see CRA website on Charities and Giving.**

### 6.3.3 Identified or Suspected Non-Compliance with Laws and Regulations

If an auditor becomes aware of information about an instance of non-compliance or suspected non-compliance with laws and regulations, they are required to obtain an understanding of the nature of the act and how it occurred and look for further information to evaluate its possible effect on the financial statements. An auditor must assess the financial impact of non-compliance in determining what additional procedures are necessary to resolve the issue.

Matters relevant to the auditor's evaluation of the possible effect on the financial statements include:

- the potential financial consequences of non-compliance with laws and regulations on the financial statements including, for example, the imposition of fines, penalties, damages, enforced discontinuation of operations and litigation
- whether the potential financial consequences require disclosure
- whether the potential financial consequences are so serious as to call into question the fair presentation of the financial statements, or otherwise make the financial statements misleading

If an auditor suspects there may be non-compliance, they should respond to it properly.

## 6.4 Compliance with Agreements

In the ordinary course of business, it may be necessary for NFPOs to enter into a variety of agreements with various parties, including the government, outsourcers and other third parties.

An auditor should gain an understanding of the nature and content of significant agreements to determine whether there could be a financial impact of entering into the agreements, or with non-compliance with any terms and conditions they might contain.

An auditor would determine what the potential financial-statement impact could be and would design appropriate procedures to address those risks.

**Table 6.4-1: Compliance with agreements (“Indirect” category)**

Example of Indirect Impact	Potential Impact	Procedures to Identify Potential Non Compliance
Funding agreement stipulates organization must be accredited by a governing association	Loss of operational accreditation would result in a loss of funding	Inspect correspondence with governing association  Inquire of management and the board

## 6.5 Risks Related to the Use of Service Organizations

### *CAS 402, Audit Considerations Relating to an Entity Using a Service Organization*



**Does the NFPO use the services of service organizations?**

Examples of areas where NFPOs may use a service organization include processing payroll, online donation and tax receipting, the use of external bookkeeping services and member database management.

When an NFPO uses a service organization, auditors must familiarize themselves with how the NFPO uses these services in its operations and their effect on the NFPO’s internal control relevant to the audit sufficiently to identify and assess the risks of material misstatement and to respond to those risks.

A service organization’s services may be considered part of the NFPO’s information systems, (e.g., when the classes of transactions involved are significant to the NFPO’s financial statements).

Often the NFPO's internal control over the inputs to and the outputs from the service organization will be sufficient to address the risks of material misstatement related to the relevant assertions. In these cases, an auditor will gain an understanding of these relevant controls and may not need to obtain an understanding of the controls at the service organization.

An auditor may find the following NFPO controls over the data sent and received back from the service organization:

- tests of completeness of data
- test checks of accuracy of data
- overall reasonability of data (data analyses)
- test recalculations of data
- segregation of duties of preparing / receiving data from reviewing / testing data

When an NFPO does not have, or cannot put, controls in place, (e.g., over electronic donations / tax receipts) an auditor is required to assess the service organization's controls addressing risks of material misstatements for the relevant assertions. In this case, an auditor may use one or more of the following procedures:

- obtaining and evaluating a report from the service auditor,<sup>3</sup> if available
- contacting the service organization, through the NFPO, to obtain specific information
- visiting the service organization and performing procedures that will provide the necessary information about the relevant controls there
- using another auditor to perform the procedures that will provide the necessary information about the relevant controls at the service organization

CAS 402 contains specific requirements to identify, assess and respond to risks of material misstatement related to the use of services of service organizations.

<sup>3</sup> A service auditor is defined in CAS 402 paragraph 8 d) as "An auditor who, at the request of the service organization, provides an assurance report on the controls of a service organization."



## 6.6 Risks Associated with Related-Party Relationships and Transactions

*CAS 550, Related Parties*



**Are there related party relationships and transactions?**

CAS 550 expands on how CAS 315, CAS 330, and CAS 240 are to be applied to risks of material misstatement associated with related-party relationships and transactions.

An auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from an entity's failure to appropriately account for or disclose related-party relationships, transactions or balances in accordance with the requirements of the applicable financial reporting framework. In addition, an understanding of the entity's related-party relationships and transactions is relevant to the auditor's evaluation of whether one or more fraud risk factors are present, because fraud may be more easily committed through related parties.

In determining the degree of control or significant influence that one entity may be able to exert over another, an auditor must look to organizational structures to establish how strategic investing, operating and financing policies are formulated and the degree to which any one entity can direct or influence the policies of another. This may often be evaluated by reviewing board representation and the number of board members common to two entities. An economic interest can also result in a relationship between two NFPOs, particularly where the assets and activities of one organization are directed to the benefit of the other, as is often the case with foundations.

An NFPO can also have an interest in a for-profit entity. In such circumstances, the consideration of influence would be no different than that used in evaluating relationships in a for-profit environment: an auditor would look at proportionate ownership and financial dependence.

An NFPO may rely on a third party for funding without creating control or significant influence. In evaluating funding relationships, other factors, such as representation on the board of directors or the existence of an economic interest, should be considered.

Factors that may be considered in identifying related-party relationships and transactions in an NFPO context are:

- transactions with board members, management and their immediate family
- board representation common to two entities
- the ability of any one organization to appoint the majority of the NFPO's board members
- assets held for the benefit of another entity
- services exchanged or provided free of charge for the benefit of another entity
- entity charter/bylaws restricting future operations for the benefit of another entity
- NFPOs with national and local chapters

It is the auditor's responsibility to remain alert throughout the audit engagement for any new or previously undetected related-party relationships and / or transactions.

CAS 550 contains specific requirements to identify, assess and respond to risks of material misstatement associated with related-party relationships and transactions.



#### **Do you have a group audit? <sup>4</sup>**

***The CAS 600 definition of a group is significantly broader than one might think, and the applicability of CAS 600 is not limited to audits involving a parent company and subsidiaries. Before concluding that CAS 600 does not apply, an auditor needs to consider whether an NFPO's financial statements include the financial information from more than one component. If they do, those components will constitute a group for the purposes of CAS 600.***

<sup>4</sup> **FAQ for Auditors—Are You Sure You Don't Have to Apply CAS 600?** This publication helps an auditor determine whether CAS 600 applies to their situation.

## 6.7 Going-Concern Considerations

### CAS 570, *Going Concern*

The auditor's responsibility is to:

- obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going-concern assumption in the preparation of the financial statements
- conclude, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, and
- determine the implications for the auditor's report

Going-concern issues may affect all NFPOs, large or small.



**Have you identified any events or conditions that may cast significant doubt on the NFPO's ability to continue as a going concern?**

The following are examples of events or conditions that, individually or collectively, may cast significant doubt on an NFPO's ability to continue as a going concern: NFPO's ability to continue as a going concern:

- **A community church:** The auditor may discover a significant decline in membership due to the aging of existing parishioners and the lack of new parishioners joining the church.
- **A golf club:** The auditor may discover that the golf course and the clubhouse are deteriorating considerably, and that both would require a significant infusion of funds to repair and refurbish.
- **A government-funded NFPO:** The auditor may discover that the government has provided formal documentation of its decision to significantly cut or fully eliminate future funding.

For a not-for-profit organization, a history of revenues received in excess of costs of the organization's service-delivery activities and ready access to financing may demonstrate that the going-concern basis of accounting is appropriate without detailed analysis. In other cases, the management of a not-for-profit organization may need to consider a wide range of factors

related to the cashflow required to continue providing services and to discharge its stewardship responsibilities. These factors would include other potential funding arrangements.

It may be helpful for an auditor to include the following points in discussions with management and those charged with governance:

- the reliability of the budget and cashflow forecast for the coming year, based on past experience and the certainty of inflows and outflows
- where the NFPO relies for a significant part of its funding on one or more major donors or granting authorities, whether it would be practical to obtain a letter of confirmation directly from such funders as to their future plans of support for the NFPO
- any foreseeable shortfalls on future revenues that would need to be made up by voluntary donations of cash or other resources to meet the forecasted expenditures
- the level of unrestricted reserves available for use
- catastrophic events and, in particular, events that may damage the reputation of the entity
- extremely divisive organizational politics
- any threat to charity status or special operating licenses required to continue as a going concern

An auditor is required to remain alert throughout their audit for audit evidence of events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

In the absence of identified events or conditions, that may cast significant doubt on an entity's ability to continue as a going concern, an auditor does not have to perform audit procedures other than those set out in paragraphs 10 to 15 of CAS 570.



**If you have identified events or conditions that may cast significant doubt on the NFPO's ability to continue as a going concern, does a material uncertainty exist?**

If an auditor identifies events or conditions that may cast significant doubt on an entity's ability to continue as a going concern, they are required to obtain sufficient appropriate audit evidence to determine whether or not a material uncertainty exists by performing additional audit procedures, including consideration of mitigating factors. These procedures include:

- asking management to assess the NFPO's ability to continue as a going concern, if it has not yet performed this assessment
- evaluating management's plans for future actions in response to its going-concern assessment, whether the plans are feasible in the circumstances and whether they are likely to improve the situation
- if the NFPO has prepared a cashflow forecast, evaluating the reliability of its underlying data and assumptions
- considering whether any additional facts or information have become available since the date on which management made its assessment
- requesting written representations from management and, where appropriate, those charged with governance, on their plans for future action and the feasibility of these plans

CAS 570 contains other requirements when a material uncertainty exists.



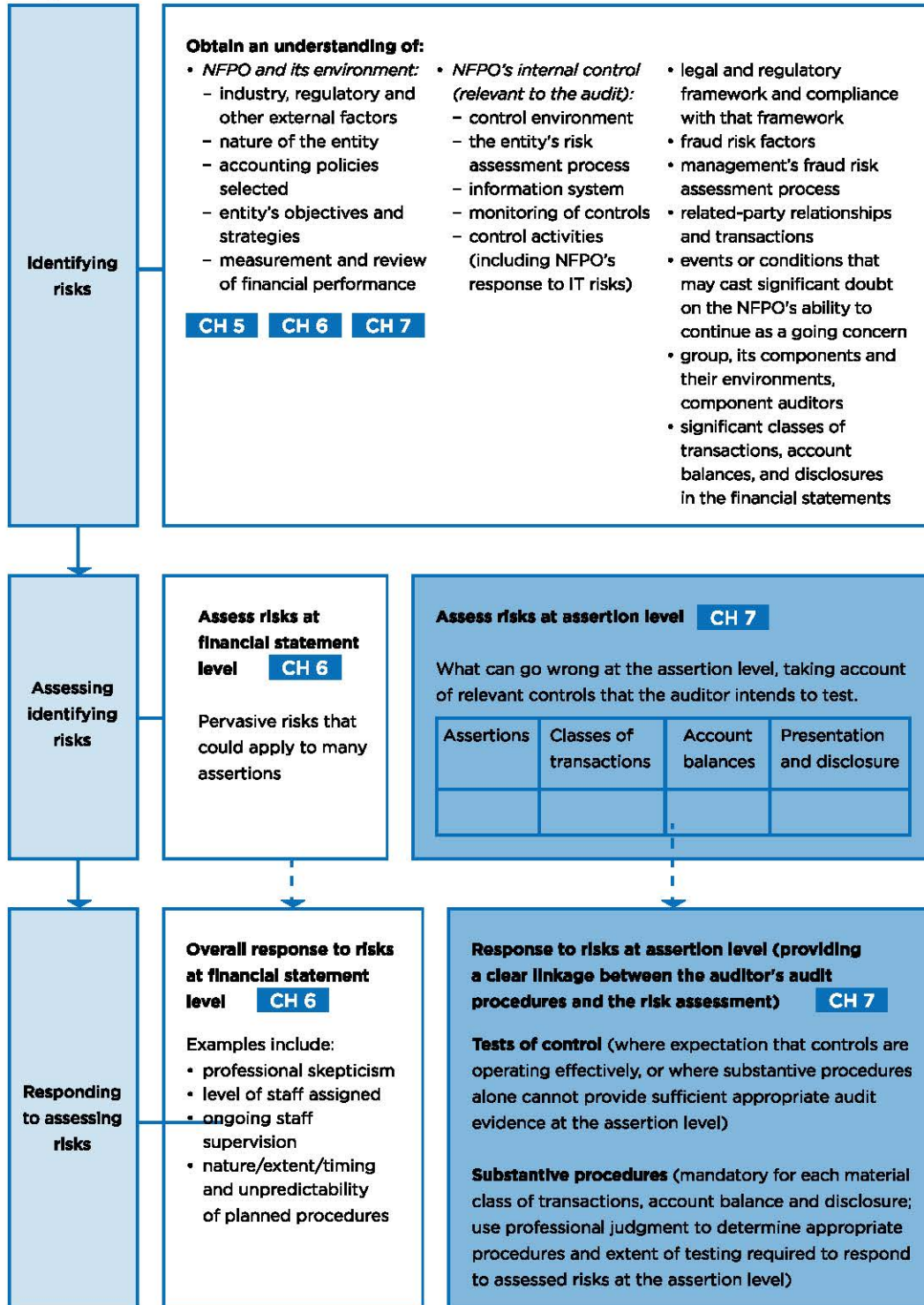
## 7.0 Assessed Risks at the Assertion Level

CASs require an auditor to acquire an understanding of the entities they audit so that they can identify and assess the risks of material misstatements at the financial-statement and the assertion levels, to provide a basis for designing and carrying out the required responses to any assessed risks. The challenge in every audit is to identify, assess and respond appropriately to risks that could lead to material misstatements whether due to fraud or error.

The previous chapter focused on risks at the financial-statement level. This chapter focuses on risks pertaining to significant accounts, classes of transactions and disclosure at the assertion level. To help an auditor in their risk assessment at the assertion level, eight case studies illustrate what can go wrong at the assertion level, and suggest factors that may be relevant to risk assessment and some considerations for the audit plan.

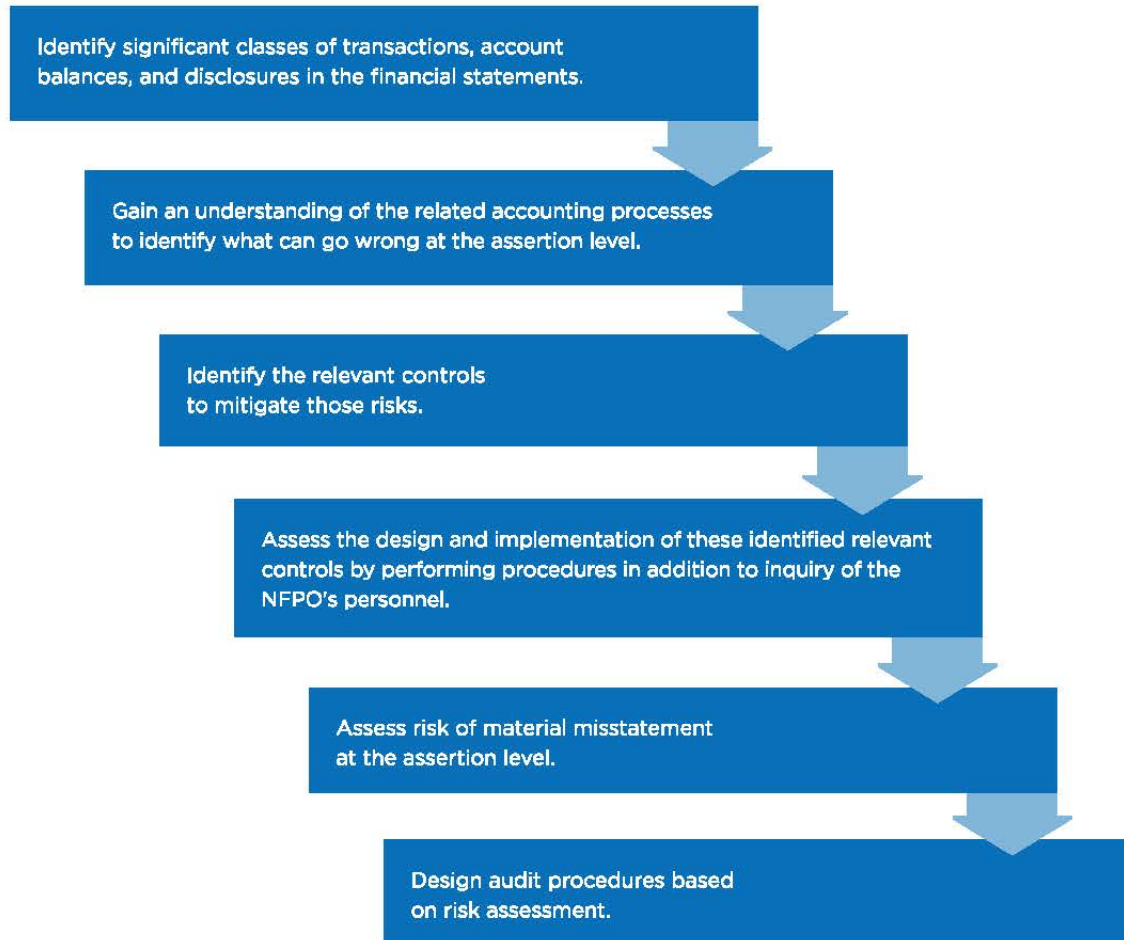
The following diagram summarizes the activities related to risk assessment. It shows the elements that an auditor needs to understand to identify risks. Each identified risk must then be assessed. In assessing the identified risks, an auditor determines whether the risks are relevant to the financial statements as a whole, or only to certain financial-statement assertions. The auditor then determines how they will respond to the risks and tailor their responses using overall responses and specific responses, depending on the types of risks assessed.

Diagram 7.0-1: Activities related to risk assessment





In assessing risks at the assertion level, an auditor considers the processes the NFPO uses to initiate, authorize and record transactions. An auditor is required to obtain an understanding of the relevant controls for the accounting processes that are significant to the financial statements, including evaluating the design of those controls and determining whether they have been implemented. Accounting processes relevant to the audit will depend on the organization's activities. For example, processes for approving employee and director expense reports will probably not be relevant when reimbursements are limited to nominal mileage expenses, but will likely be relevant where extensive travel across Canada is involved.

**Diagram 7.0-2: Risk assessment process at the assertion level**

**For further guidance on the auditor's understanding of an entity's internal control relevant to the audit, see:**

- ***Auditing and Assurance Bulletin—Understanding Internal Control Relevant to the Audit—The Function of a Walk through***



**Does your audit plan provide a clear linkage between the assessed risks at the assertion level and the nature, timing and extent of the audit procedures?**

**Irrespective of the assessed risks of material misstatement, have you designed the substantive procedures to be performed for each material class of transactions, account balances and disclosure?**

## **7.1 Selected Issues Related to Risks at the Assertion Level in an NFPO Audit**

This Guide provides examples of situations that may have an impact on relevant assertions<sup>5</sup> for classes of transactions, account balances and disclosures, such as restricted contributions, cash donations, donations-in-kind, pledges and fundraising activities. Case studies are used to illustrate what can go wrong at the assertion level, and which factors could be relevant to risk assessment and considerations for the audit plan. These do not necessarily apply to every situation. If any considerations in an audit engagement differ from those in the case study, an auditor may reach a different conclusion than the one shown.

Although accounting considerations are beyond the scope of this Guide, Appendix B provides an overview of revenue recognition issues in a not-for-profit environment and Appendix C provides a discussion of fund accounting and accounting for contributions. Accounting issues may impact risk assessment and therefore a thorough understanding of the underlying accounting concepts is necessary to effectively audit an NFPO.

Please note that in the following case studies, contributions may take the form of government funding, grants, donations and some forms of fundraising.

<sup>5</sup> Refer to Appendix A for a list of relevant assertions in an NFPO audit.

**Table 7.1-1: Topics examined in case studies**

<b>Restricted Contributions</b>	<b>Case Study 1:</b> High volume of contributions (restricted and unrestricted)
	<b>Case Study 2:</b> Capital campaign directed to the general public, with matching government grants (restricted contributions)
<b>Cash Donations</b>	<b>Case Study 3:</b> Capital campaign involving fundraising activities (cash donations)
<b>Pledged Contributions</b>	<b>Case Study 4:</b> Capital campaign involving multi-year pledges
<b>Donations in Kind</b>	<b>Case Study 5:</b> Donations in kind for a community art centre
<b>Membership Fees</b>	<b>Case Study 6:</b> Professional association with significant membership revenues
<b>Expenses by Program</b>	<b>Case Study 7:</b> Government grants provided to fund annual programs
<b>Fundraising Expenses</b>	<b>Case Study 8:</b> Fundraising expenses

**Note:** For the purposes of the case studies, assume that an auditor has evaluated the design of the relevant controls and determined that they have been implemented. Accordingly, the case studies describe examples of possible tests of controls. An auditor may, however, determine that the suggested procedures are not appropriate in their circumstances or that other procedures would be more appropriate; professional judgment is required.

## 7.2 Risk of Material Misstatement Due to Fraud at the Assertion Level

While Chapter 6 addressed fraud considerations for the financial statements as a whole, risk of material misstatement due to fraud can also have an impact on risk assessments at the assertion level for specific accounts and classes of transactions. In some cases, the audit response may be the same, regardless of whether a risk arises from deliberate or unintentional errors. In other cases, specific procedures may be necessary to respond to the nature of certain risks related to an account balance or a specific transaction stream.

The following table provides examples of fraud risk factors common to not-for-profit organizations at the assertion level:

**Table 7.2-1: Examples of fraud risk factors common to NFPO**

<b>Circumstances That May Increase the Susceptibility of Fraud</b>	<b>Potential Fraud Risk Factors</b>	<b>Risk of Material Misstatement Due to Fraud</b>
Large amounts of donations in cash and cheques	Opportunity for misappropriation of cash and cheques	Unrecorded donations
Donations and grants with a restricted purpose	Incentive for using restricted contributions for other purposes.	Misallocation of restricted contributions
Special fundraising arrangements, such as a matching grant from a specific party	Incentive for overstating donations to maximize matching grant	Fictitious or misallocated donations
In-kind donations valued at fair value.	Incentive and opportunity for overstating fair value (and corresponding donation receipt to donor)	Overstatement of donations
Multiple government-funded programs with requirement to repay unspent funding	Incentive and opportunity for allocating expenses from one program to another to eliminate surplus	Misallocation of expenses
Significant administration expenses	Pressure to maintain a low administrative-to-program expense ratio	Misallocation of administrative expenses
Significant fundraising expenses	Pressure to maintain a low ratio of fundraising expenses to fundraising revenues	Misallocation of fundraising expenses
Many purchases made with cash or corporate credit cards.	Opportunity for making unauthorized expenses	Overstatement of expenses
Significant volume of expenses processed through employee expense reports	Attitude of entitlement for being reimbursed for personal expenses as additional compensation	Overstatement of expenses

Risks of material misstatement due to fraud are significant risks. Therefore, when an auditor identifies these risks, they are required to obtain an understanding of the NFPO's related controls, including control activities relevant

to those risks. They must design and perform further audit procedures whose nature, timing and extent respond to the assessed risks of material misstatement due to fraud at the assertion level.

Examples of risks of material misstatement due to fraud at the assertion level are addressed throughout the case studies in this chapter.

### 7.2.1 Presumption of Fraud Risk in Revenue Recognition



**You must presume that there are fraud risks related to revenue recognition. If you have concluded that this presumption does not apply in a particular case, have you included the reasons for that conclusion in your audit documentation?**

CAS 240 deems that there are risks of fraud in revenue recognition. Risks must be assessed for significant types of revenue, revenue transactions and assertions. For example, the risk related to government funding may be much different than the risk related to user fees. Refer to Appendix B for a discussion on sources of revenues for an NFPO.

In some circumstances, it may be possible to rebut the presumption that there are risks of fraud in revenue recognition. For example, when an organization receives annual funding for only one program that is deposited directly into the organization's bank account, there is no risk of material misstatement related to misappropriation of cash and it is unlikely that the restricted contribution will be misallocated.

An auditor is required to include in the audit documentation why they rebutted this presumption (i.e., the reasons for their conclusion).

### 7.3 Risks Related to Restricted Contributions

A unique characteristic of contributions is that they can be subject to externally imposed restrictions that specify the purpose for which contributed resources are to be used or, in the case of endowment funds, that the contributed assets be maintained permanently. Restricted contributions could be misstated in that they might be incorrectly recorded as unrestricted contributions, or that the related expenditures might not be made as stipulated.

Restricted contributions can come from many sources, including individuals, corporations, governments and other not-for-profit organizations. An NFPO's financial reporting system should provide for the recording and reporting of restricted and unrestricted contributions, including the identification and nature of any restrictions.

Externally imposed restrictions may or may not be formally documented by the contributors. Restricted contributions received from a government funder or an established foundation will generally include a contract or written document outlining the purpose and time frame for using the contributions. On the other hand, a local service club donating money for replacing computers may communicate its intention orally only. Restrictions may also be implied by the purpose for which an organization solicits a contribution. Such implicit restrictions bind the organization to use the resources contributed for the purposes specified.

Most likely area of risk for restricted contributions is:

- Restricted contributions are recorded inaccurately, (e.g., restricted amounts could be recorded as unrestricted contributions (completeness) or recorded to the wrong restricted fund (allocation / accuracy)).

Relevant controls related to restricted contributions may include:

- formal review process that includes verification of the correct allocation of contributions
- electronic donation process designed to automatically capture donors' intentions (e.g., electronic donation forms include a check-box for specific purposes)

### **Case Study 1: High Volume of Contributions (Restricted and Unrestricted)**

This case study examines the situation where an NFPO solicits donations to be used for multiple purposes. Fundraising is conducted through two distinct processes: an automated online process and a manual mail-in process. In both cases, donations are directed to project A, B or C (restricted contributions) or to the “area with the greatest need” (unrestricted contributions). This case examines how the different transaction processes may affect risk assessment.

#### **Case Facts**

The organization carries out a number of fundraising campaigns that solicit contributions for both general (unrestricted) and specific (restricted) purposes. Contributions can be made online or mailed in, and both processes generate a material amount of contributions even though, at an average amount of \$50, the contributions are individually insignificant.

#### **Online Contribution Process**

The accounting systems are highly automated and allow for online contributions and electronic receipting that serves to confirm the stipulated purpose and amount of the contribution with the donor. Receipts are issued electronically at the time contributions are processed [control] and contributions (through credit card or PayPal) are deposited directly to the bank, less applicable processing fees [control]. Bank receipts are balanced to online summary reports daily [control]. Based on the coding of the receipt, the contributions are automatically recorded in the general ledger under account numbers unique to the purpose of the contribution [control].



***Mail-In Contribution Process***

Mail-in contributions are accompanied by a contribution form that sets out various options for directing the contribution. The receptionist opens the mail, agrees the cheque amount to the contribution form and records the details of the cheque in a daily cheque log, which is used to compile the daily bank deposit [**control deficiency—receptionist could misappropriate cheques and commit altered-payee cheque fraud**]. The receptionist processes credit card payments based on the details provided on the contribution form. The credit card transaction summary and the cheque log are attached to the contribution forms and submitted to accounting for processing. An accounting clerk prepares the bank deposit slip from the daily cheque log and the bank deposit is made by the general manager [**control**].

There is a separate account in the general ledger for each project (restricted contributions) as well as an account for general contributions (unrestricted contributions). The accounting clerk enters the contribution forms into an Excel spreadsheet to compile batch totals by type of contribution (e.g., Project A, B, C and unrestricted contribution) that are then posted each day into the general ledger by journal entry [**control deficiency—no independent review of compilation**]. The clerk then reconciles the batch totals from the journal entry to the daily deposits and the credit card summary [**control**].

**Factors that may be considered in assessing risks and designing the audit plan include (this list is not comprehensive)**

### Online contributions process

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Contributions are not recorded (completeness).</li> <li>Restricted contributions are recorded incorrectly (accuracy / allocation).</li> </ul> <p><b>What are the relevant controls?</b> IT controls are integrated into the automated contribution system:</p> <ul style="list-style-type: none"> <li>Receipts are issued electronically at the time contributions are processed.</li> <li>The contributions collected from credit card or PayPal are deposited directly to the bank, less applicable processing fees.</li> <li>The contributions are automatically recorded in the general ledger under account numbers unique to the purpose of the contribution.</li> </ul> <p>Relevant controls include the application controls embedded in the donation system and controls over the IT environment to ensure effective day-to-day administration of the donation system and appropriate controls for periodic upgrades and changes to the system.</p>	<p>The guidance of CAS 315 paragraph A141 states that, where routine business transactions are subject to highly automated processing, with little or no manual intervention, it may not be possible to perform only substantive procedures for dealing with that risk.</p> <p>In this case, evidence of the donor's intention is only documented electronically. A control reliance approach would likely be necessary.</p> <p>In testing the automated process, a relatively small sample could provide sufficient evidence that the accounting process is operational, provided there are no changes to the accounting system during the period. Automated controls in the application system could be tested through observation and re-performance.</p> <p>The IT environment will also be relevant to the audit, and relevant controls should be tested. This would include testing IT administrative controls such as individual access, data backups and IT project management controls related to upgrading and implementing changes to application systems.</p>
<p><b>What are the identified risks?</b> Cash is not deposited in the bank account by the credit card companies or PayPal (completeness)</p> <p><b>What are the relevant controls?</b> Bank receipts are balanced to online summary reports daily.</p>	<p>The balancing of bank receipts to the online summary reports represents a manual monitoring control. This will need to be tested for operating effectiveness and continuity on a sample basis.</p>

**Mailed-In contributions process**

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Contributions are not recorded (completeness).</li> </ul> <p><b>What are the relevant controls?</b> The receptionist is in a position to divert contributions as she is the only individual to receive and record the contribution. She has the opportunity to misappropriate cheques and alter the payee to redirect the deposit. The risk could be mitigated by ensuring that two people open the mail and record the daily cheque log. In smaller organizations, mail could be placed in a slotted safe and opened when two people are available.</p> <p style="text-align: center;"><b>Potential fraud risk</b></p>	<p>The auditor needs to assess the magnitude of the potential misstatement and consider the reporting implications of not being able to obtain sufficient and appropriate audit evidence around the completeness of donations.</p> <p>Assuming this is a material transaction stream, the auditor would likely qualify their opinion with respect to completeness of donation receipts.</p>
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Restricted contributions are recorded incorrectly (accuracy / allocation).</li> </ul> <p><b>What are the relevant controls?</b> The accounting clerk could record the contribution in the wrong column of the Excel spreadsheet used to compile the entry to record contributions to the various projects. The error could be unintentional or deliberate. For example, there may be an incentive to divert funds from a popular program that is amply funded to a less popular and perhaps underfunded program.</p> <p style="text-align: center;"><b>Potential fraud risk</b></p>	<p>The absence of controls will mandate that a substantive approach be adopted to test the accuracy of donation coding.</p> <p>The auditor could test for accuracy by selecting a sample starting with the contribution forms and tracing transactions through the Excel spreadsheet to the corresponding general ledger entry to ensure that the contributions were properly recorded to the correct project.</p> <p><b>Fraud considerations:</b> In determining whether there is a risk of material misstatement due to fraud, the auditor should evaluate whether there are other fraud risk factors present, such as management incentives and pressures to misallocate or misappropriate donations. If such a risk exists, the audit response may include expanding the sample size for the test of details.</p>
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Cash is not deposited in the bank account (completeness).</li> </ul> <p><b>What are the relevant controls?</b> The accounting clerk reconciles the batch totals from the journal entry to the daily deposits and the credit card summary.</p>	<p>The auditor may decide to take a control-reliance approach to reduce substantive testing. This is a manual control that will need to be tested using a sample for operating effectiveness and continuity</p>



### Is payee cheque fraud risk really relevant?

*Increased automation in the manner in which cheques are deposited and processed by banks has made it easier to manipulate the name on a cheque and deposit it to the wrong account, particularly in smaller dollar transactions. Do not assume that cheques are “safe.”*

## Case Study 2: Capital Campaign Directed at the General Public, with Matching Government Grants (Restricted Contributions)

This case study examines the situation where an NFPO receives government grants to match contributions raised in a public capital campaign. The matching component creates a fraud risk factor because there is an incentive to overstate capital campaign contributions to receive additional grants.

### Case Facts

A local charity has decided to build an addition to its existing facility and is appealing to the public for donations. If certain targets are met within a stipulated period, the donations raised by the public campaign will trigger matching government grants. The capital fundraising campaign features several fundraising events, as well as a direct-mail campaign and a specific target campaign led by the director of membership and public relations. The organization's policy is to record contributions with no supporting directions from the donor as unrestricted contributions.

### Systems Description

The organization has only a few administrative staff. The accounting manager is responsible for all aspects of financial reporting and some accounting processes, such as preparing bank reconciliations, making month-end adjustments and reviewing general ledger details.

All contributions from the direct mail campaign are received with an accompanying pledge form. The administrative assistant records all capital campaign contribution pledges in an Excel spreadsheet, which itemizes details of the donors and their contribution [**control deficiency—no independent review of compilation**]. The Excel spreadsheet is reconciled to deposits and to the general ledger by the accounting manager [**control**].

The organization also receives unsolicited contributions throughout the year, usually through cheques received in the mail. Management has determined that, for the duration of the capital campaign, all unsolicited donors contributing more than \$30 will be contacted by phone to determine whether the donation is intended for general purposes or for the capital campaign. The amount of unsolicited contributions is expected to be material.

**Factors that may be considered in assessing risks and designing the audit plan include (this list is not comprehensive):**

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Fictitious contributions are recorded to maximize the matching grant (existence).</li> </ul> <p><b>What are the relevant controls?</b> Reconciliation of Excel spreadsheet to deposits will ensure that erroneous entries to the listing will be identified. Cash controls are also relevant to ensure that fictitious deposits do not exist on the bank reconciliation.</p>	<p>The government agency funding the matching grant may look at the NFPO's financial statements as the basis for determining the grant. This may require that materiality for capital campaign contributions be set at a lower amount than materiality for the financial statements as a whole as the funding agency may have a lower tolerance for misstatement than other users.</p> <p>The auditor should review the agreement between the funding agency and the NFPO to understand the potential impact of the agreement on the entity's accounting policies and financial statements and to take it into account in the audit plan.</p>
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>To maximize the matching grant, contributions intended for other purposes are recorded as capital campaign contributions (accuracy / allocation).</li> </ul> <p><b>What are the relevant controls?</b> Contributions intended for other purposes could be misallocated to the capital campaign and not be detected because of a lack of monitoring controls. This absence of controls is also a fraud risk factor.</p> <p style="text-align: center;"><b>Potential fraud risk</b></p>	<p>To test existence, a sample of transactions should be drawn from the general ledger detail and traced back to the Excel spreadsheet and the supporting documentation to ensure it has been appropriately classified. The combination of reduced materiality level and higher risk would result in a larger sample size than it would be if there were no matching grant.</p> <p>The lack of audit trail for unsolicited general donations would require the auditor to confirm directly with donors to verify their intentions.</p> <p><b>Fraud consideration:</b> The auditor should discuss specific risks with management and those charged with governance to identify unique controls that may have been implemented in response to the risk of overstatement of capital donations. The audit team's risk discussion should also include this fraud risk, and team members should take particular care in executing tests of details and evaluating results.</p>

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Contributions are not recorded (completeness).</li> </ul> <p><b>What are the relevant controls?</b></p> <p>As identified in <b>Case Study 1</b>, having a single person dealing with the receipt of contributions would increase the risk of misappropriation.</p> <p style="text-align: center;"><b>Potential fraud risk</b></p>	<p>Impact on the audit would be similar to that described in the <b>Case Study 1</b>.</p>

## 7.4 Risks Related to Cash Contributions

In many cases, NFPOs conduct fundraising activities involving cash (i.e., in cash or by cheque) contributions for which a clear audit trail may not exist, thereby increasing risk of material misstatement from unrecorded contributions. When an audit trail cannot be established, the auditor may need to qualify the audit report because the completeness of revenue from fundraising activities is not susceptible to satisfactory audit verification. This modification does not absolve an auditor of the responsibility to test other relevant assertions relating to cash contributions.

Most likely area of risks for cash contributions:

- Contributions could be misappropriated through theft or lost (completeness)

Relevant controls related to cash contributions may include:

- Use of pre-numbered receipts
- Cash collections should always be counted by at least two people.
- Cheques collections should always be compiled by at least two people.
- Cash-and-cheques boxes should be locked and secured.

### **Case Study 3: Capital Campaign Involving Fundraising Activities (Cash Donations)**

This case considers how different fundraising activities involving the collection of cash can affect the audit. This case will consider cash collections related to charity events, raffles and coin drives. Assume that all the transactions streams highlighted below are material to the organization.

#### **Case Facts**

A local charity conducts annual fundraising events that includes a:

1. gala dinner
2. silent auction
3. cash donation appeal at public community events, with canvassers passing out information about the charity and asking for loose-coin donations

#### **Systems Description**

Fundraising activities are tracked as follows:

- **Tickets for the gala**

Tickets for the gala are pre-numbered and sold through a network of individuals, with ticket distribution and subsequent collection of payments tracked by the organizing committee. The organizing committee then submits the receipts of the payments made (cash and cheques) to the administrative assistant for deposit. On the date of the event, unsold tickets are collected and promotional tickets identified to provide a final count of tickets sold. The accounting clerk records the revenues in the general ledger. The accounting manager then reconciles the number of tickets sold to revenues in the general ledger account [**control**].



- **Silent auction**

Silent-auction donations are tracked on an Excel spreadsheet as donations are received and sorted into items for the auction. On the night of the sale, the final bid for each lot is recorded in the Excel spreadsheet, along with the payment method, which includes cash, cheque and credit card payments. Cash is collected and counted by two individuals on the night of the event and submitted to the administrative assistant for deposit. Sales from the silent auction are reconciled back to cash deposits and the general ledger account by the accounting manager [**control**].

- **Cash canvassing**

Cash canvassing activities take place at community events such as festivals and parades. Two-person teams distribute flyers advertising the organization's services and collect donations of loose change using pre-numbered sealed collection cans. The cans are collected at the end of each event and reconciled to the number of cans issued to ensure all cans are collected [**control**]. A two-person team unseals the cans, counts the contents and compiles the cash deposit [**control**]. The cash deposit is made by the administrative assistant the following day and the accounting manager records the transaction.

**Factors that may be considered in assessing risks and designing the audit plan include (this list is not comprehensive):**

### 1. Fundraising through ticket sales related to the gala

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>• Ticket sales are not recorded, cash is misappropriated (completeness).</li> </ul> <p style="text-align: center;"><b>Potential fraud risk</b></p> <p><b>What are the relevant controls?</b></p> <p>The accounting manager's reconciliation of tickets sold to recorded revenues provides a monitoring control. Segregation of duties is achieved as the individual recording the balance in the general ledger does not have custody of the tickets and does not collect cash.</p>	<p>The auditor may conclude that the completeness assertion can be tested through reliance on the accounting manager's reconciliation.</p> <p>Alternatively, the ticket sales may be verifiable through substantive analytical procedures based on the number of available seats and the sale price of the ticket. For example, if the event sold out, ticket sales could be estimated based on the total number of tickets and the sale price for each ticket.</p> <p><b>Fraud risk considerations:</b> Fundraising events generally result in tickets being distributed through an extensive network of individuals. When there is a significant number of tickets or tickets are not pre-numbered, it would be unlikely that controls could be implemented to provide assurance over completeness.</p>

### 2. Silent auction collections

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>• Silent auction sales are not recorded, cash is misappropriated (completeness).</li> </ul> <p style="text-align: center;"><b>Potential fraud risk</b></p> <p><b>What are the relevant controls?</b></p> <p>Tracking of silent-auction items provides an inventory listing of amounts available for sale and can provide a basis for ensuring the completeness of sales by reconciling the sales listing to the general ledger.</p> <p>The acceptance of cheque or credit card payments also provides an audit trail of the payments.</p>	<p>The auditor may conclude that the completeness assertion can be tested through the reliance on the accounting manager's reconciliations. The accuracy of the compilation would be tested by comparing entries to the supporting bid sheets.</p> <p><b>Fraud considerations:</b> If the reconciliations are not deemed to be reliable, there may be no other procedures the auditor could perform to obtain sufficient appropriate audit evidence. A qualification for completeness of fundraising revenues would likely be required in the auditor's report.</p>

### 3. Cash collections derived from coin drives at public events

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Cash collections are misappropriated (completeness).</li> </ul> <p style="text-align: center;"><b>Potential fraud risk</b></p> <p><b>What are the relevant controls?</b></p> <ul style="list-style-type: none"> <li>Collection containers are secured and monitored for completeness (pre-numbered, sealed collection tins are collected at the end of each event and are reconciled to the number of tins issued, to ensure that all tins are collected).</li> <li>Adequate segregation of duties is achieved by ensuring that cash is handled by two-person teams at the collection point and in separating the compilation of the deposit from recording the deposit in the accounting records.</li> </ul>	<p>The reconciliation of the tin-can count and the control over the cash count may provide a sufficient audit trail for concluding on the completeness assertion with respect to cash collections. For example, in a large event the auditor may attend the cash count to observe the controls in place.</p> <p><b>Fraud considerations:</b> In the absence of controls, it would be unlikely that audit procedures could be designed to provide sufficient appropriate audit evidence for the completeness assertion. The auditor's report may require a qualification.</p>

## 7.5 Risks Related to Pledges

A pledge is a promise to contribute cash or other assets to an NFPO. Like any other receivable, a pledge can be recognized only if it meets the recognition criteria (i.e., the amount to be received can be reasonably estimated and its ultimate collection is reasonably assured). Whether or not a pledge will be collected often depends on factors outside an organization's control, such as current economic conditions and the continued goodwill and ability to pay of those making the pledge.

In many cases, pledges would not meet the criteria for recognition and, therefore, would not be recognized until the pledged assets are actually received. Organizations that hold large, annual fundraising campaigns might, however, be able to establish reliable estimates of the realizable value of pledges based on historical results. An organization would consider the recurring nature of pledges and, where relevant, the length of time before pledges fall due in assessing whether there is reasonable assurance about what proportion of outstanding pledges will be collected. The uncertainty associated with pledges due more than a year from the reporting date would often be so great as to preclude their recognition.

Bequests are a special form of contribution realized on the death of a donor when the estate is settled. Given the considerable uncertainty regarding both the timing of the receipt and the amount that will actually be received, the recognition criteria will not be satisfied and the bequest will not be recognized until the amount and timing can be reasonably estimated. For example, because of the uncertainty of their timing, designated life insurance proceeds are generally not recognized until they are received.

The most likely area of risk for pledges:

- uncollectable pledges recognized as contributions (occurrence of revenue and valuation of pledge receivables)

Relevant controls related to pledge receivables may include:

- monitoring activities, such as reviewing aged receivables, to ensure the assumptions used are reasonable

## Case Study 4: Capital Campaign Involving Multi-Year Pledges

### Case Facts

An organization's capital campaign is the responsibility of the director of membership and public relations and consists of a direct-mail campaign and targeted donor requests. The campaign solicits donation pledges over a three-year period. Larger pledges from corporate sponsors have been formally documented in letters of agreement and supported by credit checks [control]. Other pledges are documented through a negative confirmation letter the organization has prepared that sets out the terms of the pledge and requests donors to advise the organization if the information is incorrect.

Donations from the direct-mail campaign are received with an accompanying pledge form. Targeted donations are supported by a pledge commitment, which the membership and public relations director submits to the accounting clerk once all of the required sign-offs have been obtained. The accounting clerk records all capital donation pledges in the receivables module of the accounting system. Annual pledges are set up as separate receivables, with due dates relating to the annual anniversary date of the pledge [control].

Subsequent collections are recorded through the receivables module. On a monthly basis, the controller reviews the aged-receivables listing to identify slow-paying donors that require follow up [control] and the receivables general ledger detail to ensure all manual adjustments to receivables are approved [control]. At period-end, an allowance for uncollectable pledges is recorded by applying management's realization rates to future receivables. The accounting clerk prepares the initial calculations, which the controller then reviews and approves [control].

When recording revenues related to pledges receivable, management determines the realization rate for pledges receivable based on information obtained by polling other local organizations that have conducted similar capital campaigns in the community. Management believes that the criteria to establish recognition of the pledges receivable have been met. The compilation of the realization rates is then reviewed with the finance committee [**key control**].

***Factors that may be considered in assessing risks and designing the audit plan (this list is not comprehensive):***

<b>Risk Assessment Considerations (Inherent and Control Risks)</b>	<b>Impact on the Audit Plan</b>
<p><b><i>What are the identified risks?</i></b></p> <ul style="list-style-type: none"> <li>• Pledges are recognized as revenues even though they may not be collectable (existence of revenues, valuation of receivables).</li> </ul> <p><b><i>What are the relevant controls?</i></b></p> <ul style="list-style-type: none"> <li>▪ Management has determined appropriate criteria for establishing reasonable rates for estimating collectability. The finance committee reviews the rates.</li> <li>• Credit checks are performed for corporate donors.</li> </ul>	<p>The auditor will need to assess the reasonableness of management's assumptions in determining realization rates, and whether the underlying data is a relevant base for the current situation.</p> <p>Because there are credit checks on corporate sponsors, the auditor may determine that corporate pledges are more reliably collectable than donations from the general public, and may undertake different approaches to testing the two classes of pledges receivable.</p> <p>The auditor should consider management's experience with establishing reliable estimates based on historical information.</p>

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>• Pledges are not collected in a subsequent period (completeness).</li> </ul> <p><b>What are the relevant controls?</b> The controller's monthly review of aged receivables provides a monitoring control over collection processes to ensure steps are taken to collect overdue accounts.</p> <p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>• Pledge payments are misappropriated.</li> </ul> <p style="text-align: center;"><b>Potential fraud risk</b></p> <p><b>What are the relevant controls?</b> The controller's review of the general-ledger details provides a monitoring control to ensure that adjustments are authorized.</p>	<p>The auditor would assess aged receivables against subsequent collections in considering potentially impaired accounts.</p> <p><b>Fraud considerations:</b> While the segregation of duties is inappropriate, the controls established by the controller's oversight of adjustments may be sufficient to mitigate the fraud risk to an acceptable level. The auditor should review the receivables general ledger for unusual credit activities.</p>

## 7.6 Risks Related to Donations in Kind

In the normal course of operations, an NFPO may consume a significant amount of resources that could include contributed services and materials. Often these contributions are not recorded because of record-keeping and valuation difficulties. For example, services contributed to board and committee work and to support fundraising events may not be recognized, because they cannot be reasonably estimated.

When an NFPO receives contributed services or materials, and its accounting policy provides for the recognition of such items, they should be recognized (at their fair value) only when that amount can be reasonably estimated and when the materials and services are used in the normal course of the organization's operations and would otherwise have been purchased.

The most likely areas of risk for donations in kind:

- Donated materials and services may not be recognized in accordance with the entity's accounting policies (completeness).
- Donated materials and services could be recognized at incorrect values (valuation).

Relevant controls related to donations in kind may include:

- processes for immediate recording of donated materials
- supervision of donated materials to prevent theft
- segregation of duties between receipt of goods and bookkeeping
- policies and processes for valuation of donated items

In assessing risks relating to gifts in kind, an auditor should consider whether an entity has implemented formal valuation processes for determining fair value.



#### **Are you going to need an expert for your audit?**

##### ***Areas commonly requiring an expert include:***

- ***defined benefit plans requiring valuations from actuaries***
- ***asset retirement obligations requiring estimations of restoration costs***
- ***appraisal values for gifts in kind***

***In assembling the engagement team for an NFPO audit, an auditor may find they need to engage an individual or an organization in a field of expertise other than accounting or auditing to assist them in obtaining sufficient appropriate audit evidence (CAS 620 will apply). The NFPO itself may also hire experts to determine the amounts of certain items in its financial statements (CAS 500 will apply).***



### **Case Study 5: Donations in Kind for a Community Art Centre**

This case explores audit issues that can be triggered by donations in kind contributed to an NFPO.

#### ***Case Facts***

A community art centre has a mission to support the local arts community through education and promotion. It offers art classes to schools and the general public. The centre receives contributions of art supplies from various sources that are used in delivering educational programs.

#### ***System Description***

The education director manages the contributions of art supplies. Supplies are used in the normal course of the centre's business and it is the centre's policy to value these items to provide a true representation of the full costs of its programs. The education director logs donated supplies and assesses values based on catalogue market prices. The valuation is sometimes less than list price, as donated supplies may not always be of the same quality as purchased supplies because retailers often donate products that are nearing or past their expiry dates. Donations of supplies (often left-over materials from student projects) may be dropped off directly at the studio without the education director's knowledge. At year-end, a count is performed to record all items on hand.

**Factors that may be considered in assessing risks and designing the audit plan include (this list is not comprehensive):**

**Donations of supplies:**

Risk Assessment Considerations (Inherent and Control Risks)	Impact on the Audit Plan
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Supplies are overstated in value, resulting in overstatement of revenues and expenses (valuation).</li> </ul> <p><b>What are the relevant controls?</b> None identified.</p>	<p>The valuation of supplies would likely be tested through tests of details relating to inventory costing. The auditor will need to consider whether an assessment was made of both the condition and fair value of the supplies.</p>



**Is the entity you are auditing a charitable organization?**

**Charitable organizations are granted the ability to infer tax benefits to contributors by the issuance of charity receipts. Non compliance with CRA requirements can result in significant negative consequences, including loss of their charitable status that could impair the organizations' ability to continue operations. Donation receipting rules are tricky, particularly where services are involved. Ensure that you are familiar with the requirements.**

**For information on donation receipting, go to the CRA website, click on the "Charities and giving" tab and look for the "Gifting and Receipting" section.**

## 7.7 Risks Related to Other Revenues

In a not-for-profit environment, the term "other revenue" often refers to payments received in exchange for a benefit conferred. This includes payments such as user fees, rents and sponsorships. Audit approaches to assessing risk and designing audit procedures would not differ from approaches taken for similar types of revenues in for-profit organizations.

Most likely areas of risks for other revenues:

- user fees, such as fee for service, tuitions and admissions, will not be charged or collected (completeness, valuation)
- other revenues, such as parking and food services, will not be recorded (completeness)
- membership dues may not be invoiced, or may be recognized in the incorrect period (completeness, allocation)

Relevant controls related to other revenues may include:

- segregation of duties between provision of service and collection of fees
- automated processes to ensure transactions are posted and recorded accurately
- monitoring controls such as review of receivables and budget to actual analysis

### **Case Study 6: Professional Association with Significant Membership Revenues**

This case examines some of the issues associated with other revenues in the context of a professional association.

#### ***Case Facts***

A professional association with a June year end charges dues to its members along with other pay-for-use charges. All memberships renew at the end of the calendar year, which does not coincide with the organization's year end. Members joining the association are charged a pro-rated amount in their first year (e.g., a member joining in November will be charged for two months in the first year). Dues vary for different types of memberships, with student and senior members receiving a discounted rate.

**System Description**

The membership database retains historical information for each member and is used to generate renewal notices, which are sent out to all active members by either email or regular-mail reminder, based on the member's preference. Once the invoices have been generated, a data file is prepared and downloaded to the organization's accounting system through a customized electronic interface, and payments are then processed in the accounting system's receivables module [control].

Payments can be made online with a direct deposit or credit card payment, or mailed in with a cheque or credit card payment. Online payments are interfaced with the accounting system via a daily upload. The receptionist and bookkeeper log the mailed-in payments. The bookkeeper prepares the deposit, reconciles cheques to the mailed-in log and updates the receivables module. The accountant reviews the aged receivables listing monthly to ensure overdue amounts are pursued [control].

Changes in a member's status are communicated to member-service representatives, who are responsible for updating and maintaining the information in the membership database. Student memberships change to regular membership when students receive their certificate of association. Senior memberships are updated by the system based on the member's date of birth.

The membership database is an off-the-shelf program that was customized for the organization's needs when it was implemented several years ago. The custom interface between the membership database and the accounting system was designed by a third-party consultant who works with the internal IT department to ensure that updates to the membership program are compatible with the interface. The accounting system is an off-the-shelf program with no customizations.

At year end, the accountant records the deferred membership fees as a year-end adjusting entry.

**Factors that may be considered in assessing risks and designing the audit plan (this list is not comprehensive):**

**IT considerations for processing membership fees**

<b>Risk Assessment Considerations (Inherent and Control Risks)</b>	<b>Impact on the Audit Plan</b>
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Membership revenues are not recorded appropriately in the system (completeness, accuracy).</li> </ul> <p><b>What are the relevant controls?</b> Automated controls within the membership database ensure that members are charged the correct amounts. The interface updates the financial records.</p>	<p>Because membership fees are invoiced by the membership database, it is a component of the accounting system. An error in the IT system affecting transaction processing will affect every relevant transaction. Therefore, a control-reliance approach is warranted and controls over the IT application systems and the IT environment should be tested.</p> <p>In testing automated controls over membership fees in the system, a small number of test transactions may be sufficient to establish that the controls are effective.</p> <p>Changes to the IT system may have a pervasive impact on automated controls. The auditor should be alert to any changes or updates made to the IT systems from the time the system controls were last tested.</p>
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Membership fees are not collected (valuation of receivables).</li> </ul> <p><b>What are the relevant controls?</b> Monitoring controls over aged receivables would provide oversight of the collections process.</p>	<p>Given that the risk of non-collection is specific to the period-end date, the auditor will likely not rely on controls but will perform tests of details over aged receivables.</p>

**Deferred revenues related to membership fees**

<b>Risk Assessment Considerations (Inherent and Control Risks)</b>	<b>Impact on the Audit Plan</b>
<p><b>What are the identified risks?</b> Deferred revenues are inaccurately recorded (accuracy).</p> <p><b>What are the relevant controls?</b> None identified.</p>	<p>The accountant's calculations will likely not be subject to specific monitoring controls other than the review of overall financial reporting by TCWG. As the calculations are entered only once a year, the auditor will likely respond with specific procedures to test underlying data and re-compute the amounts.</p>

## 7.8 Risks Related to Expenses

When an organization accepts a restricted contribution, it enters into a duty of care to ensure that the contribution is used for the purposes stipulated by the restriction. Whenever an auditor encounters restricted contributions, there is an inherent risk that the funds may be used for a purpose other than what was intended, or may not be used at all.

Risks of material misstatement of expenses also arise due to increased public scrutiny. For example, extravagant travel expenses and inappropriate contract tendering can significantly damage an entity's reputation and its ability to secure funding in the future. An auditor may need to design audit responses specific to the sensitive account balances that may otherwise be considered immaterial.

The amount of fundraising and administrative expenses, particularly in the case of charities, can influence donors' perceptions of an NFPO's effectiveness in delivering its programs. This creates a management bias to minimize such costs. When auditing charities, an auditor should be sensitive to how expenses are coded and allocated when coming to a conclusion on the fair presentation of the costs associated with fundraising and administrative activities.



**Are employee expense reports a significant transaction stream for the organization?**

***Expenses on employee expense reports often give rise to reputational risk as there is greater sensitivity to reimbursement of inappropriate expenses. Ensure this has been considered in assessing risk at the assertion level.***

### 7.8.1 Expenses Related to Restricted Contributions

The nature of a contribution can create incentives to inaccurately record expenses. For example, consider ministry funding of programs delivered by an NFPO (e.g., a service agency). This type of funding is often provided based on pre-approved budgets containing stipulations that unspent amounts be refunded to the ministry. Furthermore, subsequent budgets may be based on historical levels of expenditures. The agency risks reduced funding in the future if it does not spend its entire allotted budget in the current year. These factors may create pressures to overstate accruals at period-end when budgets have not been fully utilized.

Where ministry funding is for multiple stand-alone programs delivered by a single agency, there is a further risk related to the allocation of expenses. Expenses for programs running at a deficit could be redirected to programs running at a surplus to “fund” the deficit programs. When an organization manages multiple programs, it must allocate administrative expenses across those various programs. The way these expenses are allocated may also be susceptible to manipulation.

**Most likely areas of risks for program expenses:**

- expenses do not match the appropriate restricted contributions.
- program expenses are understated and prepaid expenses overstated (because the program is in deficit).
- program expenses and accrued liabilities are overstated (because the program is in surplus).
- inappropriate pro-rating of expenses allocated across programs.

**Relevant controls for program expenses may include:**

- program expenses related to restricted contributions included in the entity's annual budget and monitored on a periodic basis
- purchasing policies that provide for expenditure limits by job function
- controls over the authorization of purchases
- monitoring controls over expenditures
- monitoring of financial position and actual results to budget by TCWG

### **Case Study 7: Government Grants Provided to Fund Annual Programs**

This case explores the risks associated with disbursing restricted contributions and examines how ministry restrictions can create management bias. The case also examines issues related to allocating expenses across multiple programs.

#### **Case Facts**

An organization receives annual funding from a provincial ministry to run five programs operating out of three locations. Each program is funded by a specific, unique budget and any surplus (i.e., any unused funding) must be repaid to the ministry on an individual program basis. Although the NFPO can request that a surplus from one program be used to fund a deficit in another, this must be approved by the ministry. The organization is centrally structured, but because the programs are delivered from several locations, certain program and administrative expenses must be allocated across programs. The ministry reviews budget-to-actual results on a quarterly basis. Annually, budgets are created for each program and approved by both the board and the ministry [**control**].

#### **System Description**

Program expenses consist mainly of wages, with lesser amounts relating to occupancy costs, program supplies and consulting services. The accounting manager books period-end adjustments for accrued expenses on a quarterly basis to coincide with internal reporting to the board.

Direct program expenses are authorized by each program's director. Invoices are approved by the program directors before being submitted to accounting for payment. Program directors cannot approve expenses for other programs.

Direct wage allocations are based on the programs to which individual employees are assigned. Where employees work on multiple programs, their time is pro-rated across the various programs. An Excel Spreadsheet is used to create payroll entries and calculate



allocations for individual employees across different programs. The allocations are determined by program directors and the executive director when programs are renewed and/or staffing changes occur. The allocations are communicated to the accounting manager, who ensures the payroll worksheet is updated for the most recent rates [control]. The administrative assistant updates the payroll entries in the Excel spreadsheet.

The administrative team consists of the executive director, an accounting manager and an administrative assistant. Administrative expenses, which include wages, office and IT charges and consulting services, are charged to the programs based on the proportion of an individual program's direct wages over total direct wages. Occupancy charges are allocated based on the pro-ration of the total square footage by program. The treasurer reviews the allocation rates on an annual basis when the budget is prepared [control]. The accounting manager books allocation entries for administrative and occupancy costs on a quarterly basis.

The program directors or accounting manager may authorize expenditures to certain limits. Expenditures in excess of those limits (e.g., significant capital expenditures and long-term contracts) require the approval of the executive director or the board [control]. There is no purchase-order system in place. Expenditures are subject to monitoring controls when the invoices are submitted for payment in that all expenses are paid by cheque, and all cheques require two signatures, of which one must be either the executive director or the treasurer. The cheque stub includes posting information that identifies account allocations. Supporting documentation is attached to the cheques before they are submitted for signature [control].

Program directors review actual expenditures to budget on a monthly basis and discuss results with the executive director. The financial position and budget-to-actual results are presented to the board of directors on a quarterly basis [control].

**Factors that may be considered in assessing risks and designing the audit plan (this list is not comprehensive):**

**Program expenses**

<b>Risk Assessment Considerations (Inherent and Control Risks)</b>	<b>Impact on the Audit Plan</b>
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Expenses are coded to the wrong program (either in error or deliberately to manage surpluses and deficits in the individual programs) (accuracy/allocation).</li> </ul> <p style="text-align: center;"><b>Potential fraud risk</b></p> <p><b>What are the relevant controls?</b></p> <ul style="list-style-type: none"> <li>Budgets are utilized to establish overall spending limits.</li> <li>Expense policies set out levels of authorization.</li> <li>Disbursements are subject to monitoring controls when cheques are signed.</li> <li>Board oversight exists for monitoring expenditures and financial results.</li> </ul>	<p>The auditor should be familiar with ministry funding agreements, including specific accounting guidelines. Management bias should be evaluated based on the preliminary operating results of the programs (i.e., programs in deficit and in surplus).</p> <p>Where tests of details are performed, the auditor should be alert to inappropriate account code allocations. For a recorded expense, consideration should also be given as to whether the invoice details are consistent with the nature of the expense code and the program involved.</p> <p><b>Fraud considerations:</b> The team meeting should consider management bias and identify specific accounts that may be more susceptible to misstatement.</p>
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Allocated expenses are manipulated to move surpluses to program with deficits (accuracy / allocation).</li> </ul> <p><b>What are the relevant controls?</b></p> <p>Allocations are determined through various levels of review. The methodology for applying allocations (e.g., as a percentage of direct wages) is consistently applied from year to year.</p>	<p>Allocations should be applied in a consistent manner. The auditor should understand the methodology and ensure it is consistently applied. As it is unlikely that relying on controls will reduce the level of work required to test the allocations, the auditor would likely not adopt a control-reliance approach.</p> <p>Allocations are normally tested by ensuring the accuracy of the inputs and recomputing the calculations.</p>

## 7.8.2 Fundraising Expenses

Fundraising expenses include costs associated with specific fundraising events, such as galas and golf tournaments, and costs associated with fundraising activities, such as direct-mail campaigns. In some cases, these activities can be combined with other NFPO activities, such as putting a donation form on the back of a newsletter containing resource and background information about the organization. In smaller organizations, boards often take on fundraising activities and the expenses comprise direct costs only. In larger organizations, designated staff might manage larger-scale fundraising activities.

External users of financial statements, particularly donors, often evaluate the extent of administrative and fundraising expenses as a measure of the organization's efficiency in meeting its mandate. External users also have an interest in how the fundraising costs compare to fundraising revenues.

Most likely areas of risks for fundraising expenses:

- Fundraising expenses are not properly recorded (accuracy / allocation).
- Fundraising expenses are not appropriately disclosed when the entity reports its expenses by function (presentation).
- Fundraising revenues and expenses are reported on a net basis when they should be reported at gross (presentation).

Relevant controls related to fundraising expenses may include:

- controls over the authorization of purchases
- monitoring controls over expenditures
- monitoring of financial position and actual results to budget by TCWG



**For further guidance on fundraising, refer to the CRA's Guide *Fundraising by Registered Charities*.**

### **Case Study 8: Fundraising Expenses**

This case considers some of the complexities associated with identifying and recording expenses for fundraising activities, particularly when they are embedded within an organization's other activities.

#### **Case Facts**

A charitable organization has a mandate to provide support programs for individuals affected by a medical disorder and to promote general awareness of the condition among the public. The NFPO employs a director of development who has the dual responsibilities of executing the organization's marketing efforts to ensure fundraising targets are met and to incorporate public education into the organization's communications. Fundraising and public education costs are separate line items on the financial statements, with both line items being material to the financial statements. The NFPO decided to classify its expenses by function.

Organizational activities to achieve fundraising and educational goals include:

- Operating information booths at local community events to promote awareness and donations. The booth is staffed by resource personnel from the centre who are knowledgeable about the clinical matters that the center deals with. Donations may be collected, with corresponding donation receipts issued immediately.
- Operating an annual lottery with the assistance of an external marketing company. The organization pays a fixed fee plus a percentage of net proceeds for the marketing company's services.

***System Description***

The director of development co-ordinates the marketing and fundraising activities. This director reports to the executive director. The board of directors includes a sub-committee responsible for the oversight of marketing activities. A marketing budget is prepared annually that includes fundraising targets (revenues and costs). Actual results to budget are reviewed by the sub-committee on a quarterly basis, or after the end of each significant fundraising activity [control].

For accounting purposes, costs associated with specific activities are accumulated into specific accounts in the general ledger. Activities related to public education and fundraising are reported as separate line items in the financial statements. Appropriate authorization and approval has been established for the processing of transactions [control]. The accounting manager meets with the director of development at the end of each marketing activity to assess allocations between public education and fundraising [control]. The director of development's wages are split among the activities, based on the approved allocation by the finance committee.

**Factors that may be considered in assessing risks and designing the audit plan (this list is not comprehensive):**

**Fundraising expenses**

<b>Risk Assessment Considerations (Inherent and Control Risks)</b>	<b>Impact on the Audit Plan</b>
<p><b>What are the identified risks?</b></p> <ul style="list-style-type: none"> <li>Fundraising costs are allocated to other functions within the organization (accuracy / allocation).</li> </ul> <p><b>What are the relevant controls?</b></p> <ul style="list-style-type: none"> <li>Fundraising costs are budgeted annually and subject to periodic review by TCWG.</li> <li>Transactional controls are in place to ensure purchases are appropriately authorized and appropriately processed.</li> <li>Management reviews of activities to determine allocations among functions.</li> </ul>	<p>All of the activities listed above may be considered to contain elements of fundraising and public education, although, in the case of the booth, the fundraising component may be considered immaterial and, in the case of the lottery, the public education component may be negligible. Allocating costs between fundraising and educational objectives may be highly subjective and supporting evidence may be difficult to obtain. For the direct-mail marketing materials, the relative cost of the educational component compared to the fundraising component could be used as a basis for the allocation.</p> <p>Where activities are recurring in nature, allocations would be expected to be prepared in a consistent manner. Audit procedures should include recalculation to assess mechanical accuracy and comparability with allocation rates used in prior periods.</p> <p>As the allocations are prepared by management, which may have a bias to report expenses as public education rather than fundraising expenses, a control-reliance approach would likely not be appropriate.</p>

## APPENDIX A

# Assertions

Even though only certain assertions are discussed in this Guide, all relevant assertions need to be addressed in the audit of an NFPO. These assertions are summarized in the following table.

Assertions	Short Form	Nature of Transaction or Event	Account Balances at the Period End	Presentation and Disclosure
Occurrence / existence	E	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and net assets exist.	Disclosed events, transactions, as well as other matters, have occurred and pertain to the entity.
Completeness	C	All transactions and events that should have been recorded have been recorded.	All assets, liabilities and net assets that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.

Assertions	Short Form	Nature of Transaction or Event	Account Balances at the Period End	Presentation and Disclosure
Accuracy	A	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	—	—
Cut-off		Transactions and events have been recorded in the correct accounting period.	—	—
Classification		Transactions and events have been recorded in the proper accounts.	—	—
Classification and understandability		—	—	Financial information is appropriately presented and described, and disclosures are clearly expressed.
Rights and obligations		—	The entity holds or controls the rights to assets, and liabilities are the obligation of the entity.	Disclosed events, transactions and other matters have occurred and pertain to the entity.
Valuation and allocation / Accuracy and valuation	V	—	Assets, liabilities, and net assets are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.	Financial and other information is disclosed fairly and at appropriate amounts.



## APPENDIX B

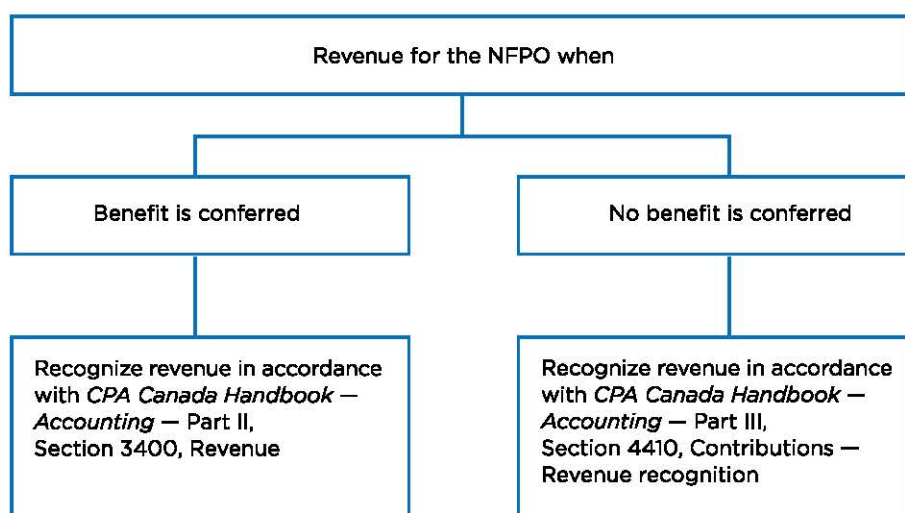
# Sources of Revenues for an NFPO

An NFPO's sources of revenues can be designated into two broad categories: contributions and other revenues. Contributions are a type of revenue unique to NFPOs, defined as "a non-reciprocal transfer to a not-for-profit organization of cash or other assets or a non-reciprocal settlement or cancellation of its liabilities." Examples of contributions are donations, government funding, grants and forgivable debt. Contributions can be directed to the general purposes of the organization or may be restricted to specific purposes; regardless, they do not confer a benefit to the contributor.

Other revenues result from reciprocal transfers of assets or, in other words, transactions in which an NFPO confers a benefit in exchange for a payment. Common sources of revenues for an NFPO include parking charges, user fees and sponsorships.

Payments to an NFPO are not always clearly differentiated between these two categories. For example, fees paid by members of an NFPO sports club clearly confer a benefit to members through their participation in the club; however, membership fees for charitable organizations that confer marginal benefits to their members, such as a discounted entry fee, may be considered to be more in the nature of a contribution.

The following decision tree depicts categorizing and recording revenues:



## **APPENDIX C**

# Fund Accounting, Restricted Fund Method and Deferral Method

Fund accounting is a method of segregating resources into categories (i.e., funds) to identify both their source and use. An organization's objectives in applying fund accounting include:

- demonstrating accountability and stewardship of the entity's resources
- determining financial condition
- planning and budgeting purposes
- evaluating organizational and managerial performance
- determining and forecasting cashflow(s), and
- facilitating communications

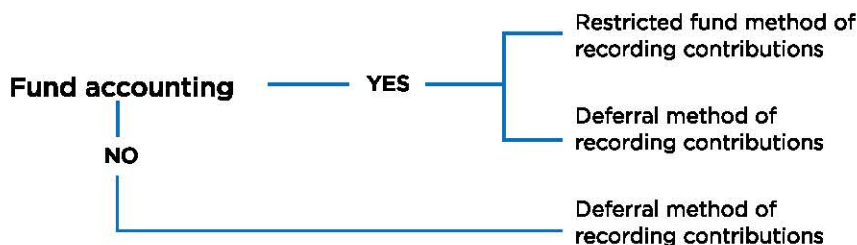
Funds are defined in either an organization's by-laws or its policies. In either case, they should set out the intended purpose for each fund and identify the person in the organization who has responsibility and authority for the funds.

The following table lists examples of restricted funds and their purposes.

Name of Fund	Possible Purpose of the Fund	Nature of Restriction
Capital fund	To report contributions and expenses related to the construction of a facility, often accompanied by a targeted fundraising campaign	External
Reserve funds	To allocate resources to be set aside for unanticipated expenditures or to ensure continued cash flows during periods of deficit arising from fluctuations in the economy	Internal
Bequest or trusts funds	To segregate special classes of contributions that are designated to the custody of a special committee or board (e.g., trustees)	External
Research funds	To report special projects that may have distinct purposes and specific funders and partners	External / Internal
Scholarship funds	To report contributions, investment income and expenses attributable to scholarship distributions	External
Endowment funds	To report contributions, investment income and allocations resulting from endowment fund donations intended to be held as the NFPO's capital for an extended period of time	External

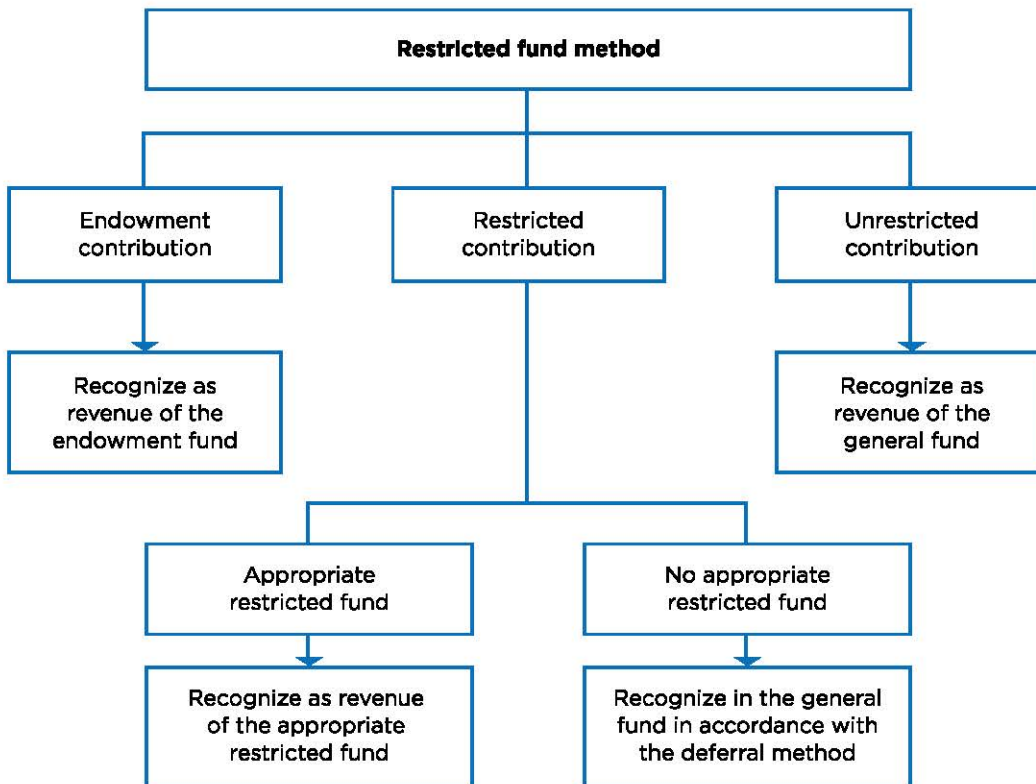
The requirement for fund accounting could be imposed externally by funders or by internal restrictions reflecting strategic decisions of the NFPO's board.

The decision for private NFPOs to apply fund accounting according to *CPA Canada Handbook - Accounting*, Part III has a direct impact on revenue recognition, as the application of the restricted fund method of accounting for contributions is available as an option only to organizations that have implemented fund accounting. When an NFPO chooses not to apply fund accounting, by default it must account for contributions using the deferral method.



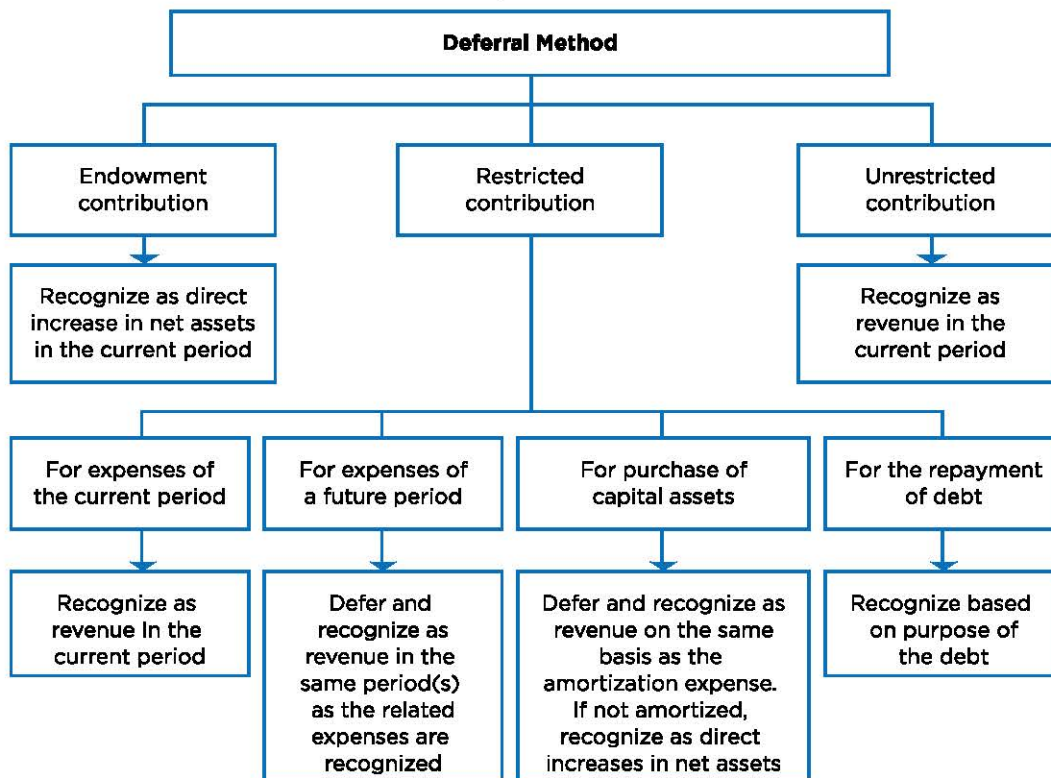
## Restricted Fund Method of Accounting for Contributions

The following decision tree summarizes the requirements in *CPA Canada Handbook—Accounting*, Part III, Section 4410, Contributions—Revenue Recognition, for the restricted fund method of accounting for contributions.



## Deferral Method of Accounting for Contributions

The following decision tree summarizes the requirements in *CPA Canada Handbook—Accounting*, Part III, Section 4410, Contributions—Revenue Recognition, for the deferral method of accounting for contributions.



## Fund Reporting—Interfund Transfers and Balances

Transfers between restricted and / or unrestricted funds during a reporting period do not result in increases or decreases in an NFPO's economic resources as a whole and, therefore, they are reported in the statement of changes in net assets rather than in the statement of operations. Allocations of revenues and expenses between funds made when an organization first recognizes the revenues or expenses are not considered to be transfers. Under the restricted fund method, however, unrestricted revenues would be recognized initially in the general fund and would only be allocated to restricted funds by way of interfund transfer.

Judgment needs to be exercised in determining the level of disclosure to provide for interfund transfers. For example, it may not be necessary to disclose individual transfers. It may be appropriate to aggregate and disclose as a single amount any interfund transfers that are similar in nature.

Interfund transfers should be presented in the statement of changes in net assets. The amount and purpose of interfund transfers during the reporting period should be disclosed. The amounts, terms and conditions of interfund loans outstanding at the reporting date should be disclosed.

When an NFPO presents its financial statements using a multi-column format, interfund loans and advances would be presented in individual funds and eliminated in the totals column of the statement of financial position. When using a single-column approach, the only disclosure of interfund loans and amounts receivable would be made in the notes to the financial statements.
















## APPENDIX D

# FAQs for Auditors

The following table provides a summary of all the questions that were addressed in this Guide:

Section	Question
2.2 Legislative environment	 Is the NFPO incorporated under an Act that has been changed or amended?
3.1 Engagement risks	 What are the engagement risks for your NFPO audit?
3.2 Independence issues	 Are there any independence issues? If so, what are your safeguards to mitigate these threats?
5.2 Determining whether identified risks are significant risks	 Are there any significant risks that require special audit considerations for the NFPO audit, considering your understanding of the entity?
6.2 Risks related to fraud	 How and where might an NFPO's financial statements be susceptible to material misstatement due to fraud and how might fraud occur?
6.3 Risks related to laws and regulations	 Has the NFPO clearly identified the laws and regulations that have a significant impact on its operations?
6.5 Risks related to the use of service organizations	 Does the NFPO use the services of service organizations?

Section	Question	
6.6 Risks associated with related-party relationships and transactions		Are there related-party relationships and transactions?
6.7 Going-concern considerations		Have you identified any events or conditions that may cast significant doubt on the NFPO's ability to continue as a going concern?
		If you have identified events or conditions that may cast significant doubt on the NFPO's ability to continue as a going concern, does a material uncertainty exist?
7.2.1 Presumption of fraud risk in revenue recognition		You must presume that there are fraud risks related to revenue recognition. If you have concluded that this presumption does not apply in a particular case, have you included the reasons for that conclusion in your audit documentation?

## **APPENDIX E**

# Other Resources Relevant to Auditing NFPO Financial Statements

### **Available on the CPA Canada website, at [cpacanada.ca](http://cpacanada.ca):**

- *Reporting Implications of New Auditing and Accounting Standards*
- *Client Briefing for Auditors—The Importance of Effective Two-Way Communication between the Auditor and the Client (i.e., Those Charged with Governance)*
- *FAQ for Auditors—Questions Auditors Frequently Ask When Implementing CAS Requirements Related to Communications with Those Charged with Governance*
- *Implementation Tool for Auditors—Communications between the Auditor and Those Charged with Governance: What, When and How?*
- *FAQ for Auditors—Are You Sure You Don't Have to Apply CAS 600?*
- *Tool for Auditors—Group Auditors' Involvement with Component Auditors: What, When and How?*
- *Audit Client Briefing—How Can Group Management Promote Effective Group Audits?*
- *Implementation Tool for Auditors—Auditing Accounting Estimates under CASs: What, Why and How?*
- *Anatomy of a 12-Hour Audit of Micro-Entities Using International Standards on Auditing*
- *A Guide to Financial Statements of Not-for-Profit Organizations: Questions for Directors to Ask*
- *Improved Annual Reporting by Not-for-Profit Organizations*

- Auditing and Assurance Bulletin—*Understanding Internal Control Relevant to the Audit—The Function of a Walk-Through*
- *Practical Ways to Improve the Exercise and Documentation of Professional Skepticism in an ISA Audit*

### Webinars

- *Practitioner's Pulse Webinar—A Quick Summary of Key Developments Affecting Your Practice*

### Other Resources

- Canada Revenue Agency (CRA) website on Charities ([www.cra-arc.gc.ca/chrts-gvng/chrts/menu-eng.html](http://www.cra-arc.gc.ca/chrts-gvng/chrts/menu-eng.html))
- CRA's Guide *Fundraising by Registered Charities*
- *Guide to Canadian Independence Standard (2009 Update)* ([www.albertacas.ca/docs/governing-documents/guide\\_to\\_new\\_independence\\_as\\_at\\_2009.pdf?sfvrsn=2](http://www.albertacas.ca/docs/governing-documents/guide_to_new_independence_as_at_2009.pdf?sfvrsn=2))
- *Transition Guide for Federal Not-for-Profit Corporations*, by Industry Canada ([www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/h\\_cs04954.html](http://www.ic.gc.ca/eic/site/cd-dgc.nsf/eng/h_cs04954.html))





**CPA**

**CHARTERED  
PROFESSIONAL  
ACCOUNTANTS  
CANADA**

277 WELLINGTON STREET WEST  
TORONTO, ON CANADA M5V 3H2  
T. 416 977.3222 F. 416 977.8585  
[WWW.CPACANADA.CA](http://WWW.CPACANADA.CA)