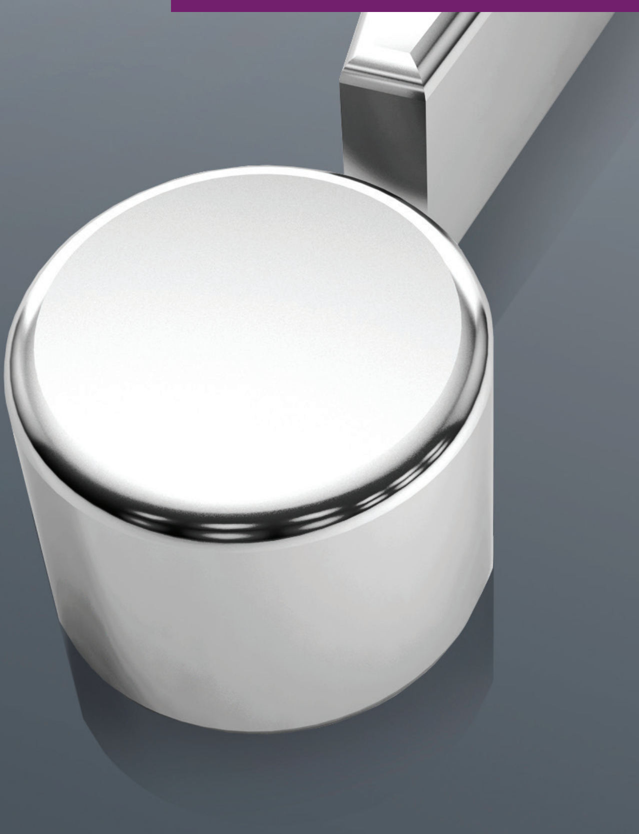
AICPA

Audit Risk Alert

2018 | Not-for-Profit Entities Industry Developments

Strengthening Audit Integrity
Safeguarding Financial Reporting



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Notice to Readers

This Audit Risk Alert (alert) replaces *Not-for-Profit Entities Industry Developments—2017*.

This alert is intended to provide auditors of financial statements of not-for-profit entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication,* as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply generally accepted auditing standards.

In applying the auditing guidance included in an *other auditing publication*, the auditor should, using professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

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Feedback

The Audit Risk Alert *Not-for-Profit Entities Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's alert, please feel free to share them with us. Any other comments you have about the alert also would be appreciated. You may email these comments to A&APublications@aicpa-cima.com.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits of not-for-profit entities (NFPs) and can be used by an entity's internal management to identify issues significant to the industry. It also provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which NFPs operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements, and it delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. For developing issues that may have a significant impact on NFPs in the near future, see the section, "On the Horizon," for information on these topics, including guidance that either has been issued but is not yet effective or is in a development stage. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert. Additionally, the AICPA Audit Risk Alert *General Accounting and Auditing Developments—2017/18* explains important issues that affect all entities in all industries in the current economic climate. Refer to the section, "Publications," in this alert for product numbers and additional information about *General Accounting and Auditing Developments—2017/18*.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. Auditors obtain audit evidence to draw reasonable conclusions on which to base their opinion by performing the following:

- Risk assessment procedures
- Further audit procedures that comprise
  - — tests of controls, when required by generally accepted auditing standards (GAAS) or when the auditor has chosen to do so
  - — substantive procedures that include tests of details and substantive analytical procedures

.03 The auditor should develop an audit plan that includes, among other things, the nature and extent of planned risk assessment procedures, as determined under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.[1] AU-C section 315 defines *risk assessment procedures* as the audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and relevant assertion levels. As part of obtaining the required understanding of the entity and its environment, paragraph .12 of AU-C section 315 states that the auditor should obtain an understanding of the industry, regulatory, and other external factors, including the applicable financial reporting framework, relevant to the entity. This alert assists the auditor with this aspect of the risk assessment procedures and further expands the auditor's understanding of other important considerations relevant to the audit.

[1] All AU-C and AT-C sections can be found in AICPA *Professional Standards*.

Economic and Industry Developments

The Current Economy

.04 When planning and performing audit engagements, an auditor should understand both the general and specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, real estate values, and labor market conditions are likely to affect an entity's business and, therefore, its financial statements.

Key General Economic Indicators

.05 The following key economic indicators illustrate the state of the U.S. economy during 2017 and entering into 2018.

.06 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as the economy slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.5 percent in the fourth quarter of 2017 (second estimate), compared to an increase of 3.2 percent in the third quarter of 2017 (third estimate), resulting in an estimated overall increase in GDP of 2.3 percent for 2017, compared to a rate of 1.5 percent in 2016.

.07 From December 2016 to December 2017, the unemployment rate declined from 4.7 percent to 4.1 percent, the lowest rate since December 2000. An unemployment rate of 4.1 percent represents approximately 6.6 million people. This does not include the 4.9 million workers holding part-time jobs at the end of 2017 who seek but cannot find full-time employment. In December 2007, there were 4.7 million workers in that category. Also excluded are the 1.6 million people who have either given up looking for work because they have not been able to find employment, or people who have had a job in the past year but are not currently employed and haven't looked for work in the past 4 weeks.

.08 The year 2017 was marked by historically low unemployment rates and record highs in the U.S. stock markets. The Federal Reserve raised the federal funds rate three times in 2017, citing strength in the U.S. economy and labor market. Although inflation remains low at less than 2 percent, and will continue to be monitored, additional federal funds rate increases are anticipated in 2018.

.09 The Federal Reserve noted in its December 13, 2017 press release that the

> [c]ommittee expects that economic conditions will evolve in a manner that will warrant gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run.

The State of NFPs

.10 The NFP sector continues to play a large role in the world economy. Currently, more than 1.5 million NFPs are registered with the IRS. Contributions to these entities in 2016 exceeded $390 billion. Total revenues in the sector exceeded $2 trillion, and assets topped $5 trillion. According to U.S. Department of Labor statistics, 24.9 percent of the U.S. adult population, or 62.6 million people, did volunteer work for NFPs during the year ending September 2015, putting in a total of more than 3 billion hours. According to Giving USA, all 9 sectors of recipient organizations identified (religion; education; human services; giving to foundations; health; public-society benefit; arts, culture, and humanities; international affairs; and environment and animals) experienced growth in the amount of giving received in 2016; and individuals led the way, increasing their giving by 3.9 percent in 2016. Trends continue to show that donor-advised funds are increasingly popular, with contributions into donor-advised funds growing to $23.3 billion in 2017, according to the National Philanthropic Trust's 2017 Donor-Advised Fund Report. With the adoption of new individual federal tax legislation in 2018, donor-advised funds may become more popular as individuals consider clustering their donations, giving every other year to take advantage of the higher standard tax deductions in off-giving years.

Succession Planning and Leadership Gaps

.11 Baby boomers (those born between approximately 1946 and 1964) are retiring in staggering numbers and are expected to continue to do so over the next decade. As this large demographic exits the workforce, NFPs likely will be faced with leadership gaps and potential instability in C-suite ranks. Succession planning has never been more top-of-mind as a key risk for boards and executive teams, especially in the nonprofit industry, given the mission-driven activities, personal relationships, and fundraising responsibilities of many NFP executives.

.12 To position NFPs favorably in times of transition, an effective and proactive succession planning process needs to be in place. Some best practices to consider include the following:

- Identify the key positions that need to be addressed; not all will have equal impact.
- Assess the risk of turnover for each of the key positions.
- Define key competencies (that is, a "wish list").
- Assess internal talent.
- Refresh the NFP's list of external connections.
- Create a leadership development program.
- Develop an internal cross-training program.

Delegation of Authority to Management

.13 Members of an NFP's board of directors are bound by a duty of care that includes a responsibility for overseeing all activities that advance the NFP's effectiveness and sustainability. Exercise of this oversight role naturally requires that certain responsibilities and authorities be delegated by the board to management. Examples of powers that may be delegated to management include spending in excess of the approved budget, addressing the media on behalf of the organization, negotiating agreements on behalf of the organization, designating net assets, and opening bank accounts.

.14 When determining which powers to delegate to management, it is prudent for the board to be strategic and intentional based on the size and complexity of the organization and assess the risks each delegation poses to