AN ANALYSIS OF THE DIFFERENCES IN AUDIT PROCESSES USED IN THE AUDIT OF NONPROFIT AND PROFIT ORGANISATIONS

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ABSTRACT

Nonprofits constitute a large part of collective behaviour in society. Presently there is little formal research addressing the role of audits in nonprofit organisations. Before models can be developed for the production of nonprofit auditing information, it is necessary to examine the present conduct of nonprofit audits. The Australian Accounting Research Foundation - Legislation Review Board has released a position paper on the Association Incorporation Acts in Australia - the most frequently used legal form for nonprofit organisations. The Board is addressing the issue of financial statement reporting including audit. This is coinciding with the investigations resulting from the collapse of the National Safety Council (Victorian Division), (NSC). The NSC, a nonprofit organisation formed as a company limited by guarantee, is in liquidation and the auditors are being sued for damages resulting from their alleged failure to perform their duties adequately.

The Criminology Research Council of Australia has provided a grant for this research to investigate the process by which the audit of nonprofit organisations is conducted and whether it differs from the process used in profit organisations. The research involves the collection of accounting information for 22 Queensland charities. The auditors of these organisations were requested to complete questionnaires addressing their overall approach to the audit of nonprofit organisations. For eleven of these nonprofit organisations, a matched (by annual revenue) profit organisation signed by the same auditor was compared using attributes of the audit process. Attributes tested were the use of engagement and management letters, materiality, components of audit risk, extent of compliance testing, staffing levels, and time spent. The results indicate that parts of the audit process used are statistically different for nonprofit and profit organisations. These differences should be taken into account by legislators in drafting of new legislation and by the auditing profession in evaluating audit risk.

INTRODUCTION

Nonprofit organisations are formed to provide a service without seeking profit. Their role in society is vital and yet very little research is devoted to them. They include charities, hospitals, schools, health insurers, sporting groups and mutual benefit societies. Using the Australian Bureau of Statistics' (ABS) Business Register, it can be estimated that there are at least 18,000 nonprofit organisations that employ people in Australia. Birkett (1985) has suggested there are as many as 100,000 nonprofit organisations.

Nonprofit organisations are being expected to play a greater role in providing services and opportunities that were once offered by governments. In welfare services direct welfare provision is not always being provided by the government. Rather it is contracted out to organisations to deliver or handed over to them, funded by private donations and user pays. For example, sports is no longer dependant on the government but organises itself through commercial sponsorships, poker machine revenue etc.

When the government does provide grants or contracts out, it requires that the organisation account for their grants. There is an underlying need for accountablity to the Parliament and measurement of the efficiency of nonprofit organisations in the utilisation of funds. One of the accountability and efficiency tools is the audit. As the public is asked to give more it is crucial that trust in the organisations is maintained. One of the principal means of ensuring trust is the conduct of an audit.

It is now very rare for organisations to obtain any grants from government, foundations or commercial sponsorships unless they are incorporated and audited. A whole range of government departments especially those providing grants rely on the Associations Incorporation Act's requirement for an audit. For example, an organisation cannot obtain an art union licence of any minor amount unless it is incorporated. Similar restrictions apply to poker machines, liquor licences, and grants from family services or housing commission. There is a reliance on the audit to ensure the fidelity of the organisation. Is this expecting too much of the audit? Is the audit designed for this? What are the costs to auditors?

Despite government departments placing a heavy reliance on audits supervised by the Justice Department, there are limited resources allocated to this task. For example, there are 3 staff supervising 4,000 charities and 11 supervising 11,500 incorporated associations. Only 5 words were written about the Act in their 76 page 1992 annual report.

The majority of nonprofit organisations are required by legislation to be audited on an annual basis, however, there are no specific auditing guidelines provided by the accounting profession in Australia. The Australian Accounting Research Foundation is currently drafting standards in this area. At present little is known about how the audits of nonprofit organisations are conducted and whether there are any significant differences between the audits of profit and nonprofit organisations. The purpose of this study is to examine this issue by collecting data from the auditors of nonprofit organisations on key variables and undertaking a comparison with profit organisations audited by the same auditor.

This study provides findings on the use of engagement and management letters, materiality levels, components of audit risk, extent of compliance testing, staffing levels, and time spent. Information of this nature has not previously been reported.
The data provides insights into how audits on nonprofits are conducted in practice and adds to the development of theories regarding risk assessment and audit planning.

The results of this study will be useful to policy makers for nonprofits, including the Professional Accounting Bodies and the Legislators, to the auditing profession in support of their claim that the audit of "all" nonprofit organisations places an enormous burden on their resources and to users of the financial statements as to the reliance to be placed on these audits.

Data Availability and Motivation for Research

There is not a readily available source of reliable data in Australia to facilitate research. In the United States information is available through publications (Hodgkinson & Weitzman 1989), the Internal Revenue Service (IRS) and the AAFRC Trust for Philanthropy which has collected reliable data on giving for almost 40 years. In the United Kingdom the Charities Commission is the sole source of reliable data and is restricted to those charities who choose to register. However, even with these data bases, audit is not always required in these countries and there has been little research in the audit area to date.

This study was part of a larger examination of organisations in Queensland that were registered under the Queensland Charitable Collections Act. The Act requires any organisation that seeks donations from the public to register as either a community purpose organisation or a charity unless the organisation was a religious denomination. There are approximately 1,000 charities and 3,000 community purpose organisations. The sample was drawn from files held by the Justice Department on charities with an annual revenue greater than $100,000 (to allow for matching with audited profit organisations).

Lyons (1991) identifies several areas for future research in the nonprofit sector and states that "further research is needed to feed directly into the development of public policy".

Policy for the account preparation and audit of nonprofits is being addressed by the Australian Accounting Research Foundation - Legislation Review Board which has released a Position Paper on the Association Incorporation Acts. It is currently calling for comment on the paper. The position paper addresses the financial reporting issues facing incorporated associations, the most commonly used legal form for nonprofit organisations. As part of the conceptual framework it is suggested that, "A fundamental premise of the framework is that the purpose for which financial reports are prepared should determine their form and content."

In the USA the Report of the Nonprofit Quality Reporting Project (1991) recommended that "Leading nonprofit organisations, the accounting profession, agencies that evaluate nonprofits, associations of chief executive officers and chief financial officers of nonprofits, and governmental bodies should join in a national program to raise nonprofits' consciousness of the importance of complete and accurate reporting of financial and programme data in order to maintain public confidence in, and support of, nonprofit organizations."

McGregor-Lowndes (1990,p.4) states "The regulation of nonprofit enterprise whether structured under the Companies Acts or other Acts requires serious examination. There is a gross regulatory default in the area and confidence in the veracity of nonprofits is crucial to their performance of a beneficial role in our society. Nonprofit organisations last only as long as the public and state have confidence...The opportunity for fraud and anti-social behaviour does not stop when an organisation does not distribute its funds to members."

This paper aims to assist in the development of policy relating to nonprofit organisations. The accounts of nonprofits and the assurance provided by an audit are a key factor in the regulation of nonprofits. It could be argued that the accounts and audit of nonprofits play a crucial role in the theoretical existence of nonprofits.The performance of an audit provides protection for members, donors, and interested parties that the funds have been used and controlled as per the organisation's objectives. The audit attests to the integrity of the management committee in the performance of their duties and confirms the financial statements prepared by them.

There are no professional guidelines in Australia for either the preparation or the audit of financial statements of nonprofits. Guidelines do however exist overseas. In Australia it would be appropriate for the profession to apply the general audit guidelines to the audit of nonprofit organisations. There is little information available as to the adequacy of general guidelines for these organisations.

The collapse of the National Safety Council (Victorian Division) (NSC) has generated keen interest among auditors of nonprofit organisations in Australia. The liquidator of the NSC has lodged a statement of claim against the partners of Horwarth and Horwarth - auditors. The statement of claim cites the general auditing standard issued by the joint professional accounting bodies, AUS1, and various practice statements as detailed authority for allegations of the failure of the auditors to adequately perform their duties. It is alleged that as a result of the auditors' failure to discharge their duties "the truth was not revealed". A failure to comply with general auditing standards was and frequently is used as a basis for litigation (Cambridge Credit, 1986).

Walker (1990) in his summation of the statement of claim concludes, "Auditing standards and statements of auditing practice may have been intended to provide guidance to auditing practitioners. They are also providing guidance to liquidators and lawyers." Of further concern is the use of audit manuals in court decisions. In the Supreme Court of New South Wales in *Columbia Coffee & Tea Pty Limited v Churchill 1992* ("Columbia Coffee") the Judge used statements found in the **auditor's audit manual** as a basis for the decision. Many audit firm's audit manuals would include references to the conduct of "all" audits, not just audits of profit organisations. The auditors of nonprofit organisations would be expected to undertake an audit of a nonprofit organisation using the same principles and standards as for a profit organisation. The policy makers are in need of guidance as to the appropriateness of the current guidelines and direction for future areas of need. There has been no published work in Australia which deals significantly with the audit of nonprofit organisations.

Whilst the detection of fraud is not the main purpose of an audit, The Australian Statement of Auditing Practice AUP16 asserts that an auditor has a duty to organise an audit so as to have a reasonable expectation of detecting material misstatements resulting from fraud or error. AUP16 and AUP12 are cited in the statement of claim lodged against the auditors of the NSC. It is contended tha the auditors had a duty to report findings of fraud and error to the board of the company on a timely basis and to inform the board of any failure of the company to maintain an adequate system of internal control. This decision was further supported in the AWA suit against its auditor in 1991. There was a failure for the partners to effectively communicate their concerns to the AWA board. Nonprofit organisations are frequently lacking in adequate systems of internal control.

Nonprofit organisations have a record of non compliance with legislative requirements. For example, the New South Wales Bureau of Crime Statistics and Research (1978) commented that while nonprofit companies account for only 1.76 per cent of the corporate register, they accounted for one in ten of the corporate investigations. McGregor-Lowndes (1990) found that nonprofit corporations had over 52 percent default rate on lodging annual returns and this was confirmed by an internal investigation by the Victorian Commission for Corporate Affairs. McGregor-Lowndes, McDonald and Dwyer (1993 forthcoming) found a default rate in annual return lodgement of charities was approximately 30% in 1989 and 1992. Oleck (1988) asserts that in the USA, 11 Billion dollars is taken by charity swindlers every year, being America's fourth largest crime industry.

There is an urgent need for the profession and legislators to consider the nature of the audit of nonprofit organisations and to address the formulation of policy to protect the nonprofit organisation, the members, the benefactors and the auditors.

The remainder of the paper is divided into five sections: The first deals with a review of the auditing requirements and related research in the nonprofit area in Australia the United States and England. The second section outlines the hypotheses to be tested in analysing the differences in the audits of nonprofit and profit organisations. The third section describes the methodology used and the fourth section outlines the results and the fifth the conclusions. Special attention is given to areas of future research and problems and limitations of the study.

SECTION 1: AUDITING REQUIREMENTS OF AUSTRALIA, THE UNITED STATES OF AMERICA AND ENGLAND

Australia

Nonprofit organisations can be structured using various frameworks : a loose association of members, a company limited by guarantee, an incorporated association, a charitable trust or under special legislation for Friendly Societies, Credit Unions, Hospitals and religious organisations. The majority are formed as a company limited by guarantee or an incorporated association - which in the majority of cases require an audit of the financial statements. Nonprofits are often required to comply with other legislation such as taxing statutes, for example The Income Tax Assessment Act, or fundraising legislation, for example, The Collections Act 1966.

Each State in Australia has differing legislation with regard to Incorporated Associations. There is a push towards unification which will significantly improve the comparability of nonprofit organisation's affairs. In Queensland, the Associations Incorporation Act 1981 (AIA) was drafted to administer associations which are formed or carried on for any lawful object or purpose but not for the pecuniary gain of its members. There are now 11500 registered associations and continues to grow at nearly 2000 registrations a year.

Incorporated Associations have become the most popular structure for nonprofit organisations in recent years. Section 40 of AIA requires that the management committee presents an audited statement prepared by a person who is a member of the Institute of Chartered Accountants in Australia or the Australian Society of Certified Practicing Accountants or person approved by the Director General of the Justice Department.

Section 31 directs that all charities have their accounts audited by an approved auditor. Part VIII of the regulations to the Collections Act sets out detailed accounting requirements of charities. Subsection 3 of section 31 gives the auditor for the purpose of the audit "the powers conferred by this Act on an inspector." These are extremely wide powers and identical to those exercised by police officers and department appointed inspectors. The clear intention of the legislation is to give auditors full powers for them to act a surrogate departmental investigators.

The Corporations Law requires an audit of the financial statements of companies limited by guarantee. The requirements are the same as for any company under the Corporations Law.

The taxation legislation may exempt some nonprofits from taxation and does not require the lodgement of financial statements.

United States of America

In the USA nonprofit organisations may be formed under various legal structures. The accounting and auditing requirements are determined by the taxation legislation and the professional accounting body. Pressure is also imposed by granting bodies, in particular the Government, both State and Federal and by private groups monitoring their accountability for example, The Evangelical Council for Financial Accountability (ECFA) and The Better Business Council.

The Revised Model Nonprofit Corporation Act (1988) issued by the Committee on Nonprofit Corporations Section of Corporation, Banking and Business Law, American Bar Association has been released. Section 16.01(b) requires the corporation to maintain "appropriate accounting records". Appropriate records should allow the financial statements to be prepared in a fashion which fairly presents the financial condition and results of operations of the corporation. There is no requirement that accounting records be kept in accordance with generally accepted accounting principles. There is no requirement for an audit.

The basic methods for ensuring accountability of nonprofits in the USA lie with the Attorney General. Until 1969, annual reports were only required by private foundations. Since that time all organisations are subject to reporting requirements. This was required under the Tax Reform Act of 1969. "Reliance on the Tax laws as the primary source of regulation is not likely to change" (Fremont-Smith 1989 p85).

The tax status of nonprofit organisations is that of tax exempt. The federal tax laws discourage nonprofits from owning non-related profitable assets and their tax exempt status can be lost if too much of their income is derived from ancillary or commercial sources. The organisations are required to submit financial statements to maintain their tax exempt status. There has been debate as to whether this tax exemption should be continued (Bittker and Radhart, 1976). Hansmann (1989) argues that "there are strong reasons for the organizational law of nonprofits (in particular nonprofit corporation law) ... to impose a uniform set of relatively strict fiduciary constraints on all nonprofits...-and moreover to treat them essentially the same as for-profits firms". An audit is not required under the taxation laws.

The American Institute of Certified Public Accountants (AICPA) has issued a formal statement of position entitled Accounting Principles and reporting Practices for Certain Nonprofit Organizations, Draft 1978 approved as a final statement Financial Accounting Standards Board (1980). This statement does not require an audit and applies to all nonprofit organisations with the exception of those for which the AICPA has issued specific Audit Guides.

They are: Hospitals (1972), Colleges and Universities (1973), Voluntary Health and Welfare Organizations (1974), and State and Local Government Units (1974). Even where there are guidelines imposed by Audit Guides " The accounting principles and financial statements required in the current Audit Guides... are quite different from those found in business." (Anthony 1991, p387).

Despite the lack of legislation requiring an audit of nonprofits, many organisations have established audit committees to monitor financial reporting and internal controls and this is endorsed by the AICPA. This may be as a result of organisations applying for government grants and foundations being required to submit audited financial statements.

Further pressure is imposed in fund raising activities by monitoring organisations such as the ECFA. The ECFA lists as two of the questions a prospective giver should ask a Charity before giving is "Are the financial records audited annually by Certified Public Accountants?" and "Is a copy of the audited financial statements available to anyone who requests it?"

Surprisingly, given the lack of legislation requiring an audit and the high tendency to provide audited financial statements, a thorough search of the literature has not revealed any debate as to the need for audit reports for nonprofit organisations nor any comparison between the audits of non profit and profit organisations in the USA.

England

In England a nonprofit organisation may be constituted as a trust, company, unincorporated association, friendly society, industrial, or a provident society. The diversity of legal form has led to a diversity of accounting practices. In recent years there has been concern that the system under which charities in particular operate is in need of review.

There is now an obligation under the Charities Act 1992 for the accounts of a charity with revenue or expenses (or both) exceeding £100,000 to be audited. In some instances the trust instrument may require this to be done for charities with lower revenue. Statutory authorities may impose further requirements on those incorporated for example under the Companies Act (1985) an audit is required.

Two reports addressed this issue: The report of the Public Accounts Committee (PAC), "Monitoring and Control of Charities" and a report by Sir Philip Woodfield, "Efficiency Scrutiny of the Supervision of Charities"- The Woodfield Report. In January, 1988 the Home Secretary announced the Governments acceptance of the Woodfield Report. A White paper to translate the recommendations of the Woodfield report into legislative proposals was presented to Parliament by the Secretary of State for the Home Department in May 1989, "Charities: a Framework for the Future".

The PAC believed that the risk of abuse under the previous Charities Legislation was unacceptable and called for prompt and vigorous action to improve matters. The Woodfield Report confirmed the concerns of the PAC and recommended that based on a graduated structure for accounts , "that large charities should in the future be required to submit professionally audited accounts and that the accounts of intermediate charities should be independently examined. Only for small charities would an examination of some kind be recommended but not obligatory." (Secretary of State 1989).

The new legislation reasoning for not requiring the professional audit of all charities was that the potential cost would be prohibitive for the charity. The solution recommended is to link the auditing requirements to the proposed "banding" requirements for the submission of accounts. The bandings are based on level of revenue for the year and set at £100000.

The use of banding has its own inherent difficulties in that charities will be in a position to restructure their affairs to ensure they remain in the band not requiring professional audit. There was significant pressure from the Professional Accounting Body prior to the amendments to the legislation as it believes it would be impossible to service adequately the number of charities that would be involved. In particular, since a large number of these are undertaken in an honorary capacity, the financial resources involved would be prohibitive for the professional firms.

The Institute of Chartered Accountants in England and Wales issued "Auditing Guidelines on Charities" 1981 and a Statement of Recommended Practice Number 2 (SORP 2) 1985. Charities are encouraged to say in their accounts whether they comply with SORP 2 or not. Again, there is no debate in the literature on the need for audited financial statements nor comparison of the audits of nonprofit and for profit organisations.

SECTION 2: HYPOTHESES TO BE TESTED

As stated in the introduction, the purpose of the paper is to determine if there is any difference in the audit processes used by auditors of nonprofit and profit organisations. The following questions are of interest: Do the audit procedures and extent of testing vary significantly between profit and non profit organisations? Do inherent or control risks exhibit significant differences? Do auditors of nonprofit organisations place different emphasis on compliance or substantive testing than do auditors of profit organisations?

The audit process in this paper is operationalised by use of the Auditing Practice Statements (AUP's). In Australia there are no specific audit guidelines for nonprofit organisations and therefore both nonprofit and profit audits should be conducted using the same processes as outlined in the AUP's.

There are currently thirty-three AUP's. Not all of these are examined. For example, AUP18 deals with The Audit Implications of Equity Accounting and AUP20.1 deals with Audit Evidence Implications of Externally Managed Superannuation Funds, neither of these may be applicable for the audit of nonprofit organisations. To enable comparison, this paper has restricted comparison to a number of key areas covered by the AUP's and relevant to a broad set of organisations.

The areas chosen for analysis are:

- use of engagement letters AUP9
- use of management representation letters AUP25
- the setting of materiality limits AUP27
- the assessment of audit risk AUP24, AUP27 and AUP30
- the collection of audit evidence AUP12, AUP13 and AUP14.

Various measures of each of these will be used.

Engagement letters AUP9

An engagement letter is sent by the auditor to the client and documents and confirms "the acceptance of the appointment, the objective and scope of the audit, the extent of his responsibilities to the client and the form of any reports".(AUP9, Para 2).
The engagement letter is a relatively standard document and therefore rather than its content, the measure of interest is the frequency of issue. AUP9 paragraph 7, states that a new engagement letter may be warranted when there is a change in management. Nonprofit organisations in many cases change their management committee on an annual basis whereas profit organisations tend to have more stable boards. It would be predicted therefore that nonprofit organisations should need to be issued with engagement letters more frequently than profit organisations. The objective of the paper is to determine if there is any difference based on frequency of issue in the last five years.

HYPOTHESIS 1

Engagement letters
H0: $u_{ENP\text{-}EP} = 0$
H1: $u_{ENP\text{-}EP} \neq 0$

Where:

ENP = the number of engagement letters issued by the auditor of the nonprofit organisation in the last five years.

EP = the number of engagement letters issued by the auditor of the matched profit organisation in the last five years.

Management representation letters AUP25

"The possibility of misunderstanding between the auditor and the management is reduced when oral representations are confirmed in writing. Furthermore, written representations from management should be obtained to confirm oral representations given to the auditor on matters material to the financial statements when other sufficient appropriate evidence cannot reasonably be expected to exist." (AUP25, para 10). It would be predicted that management representation letters would be required more frequently in nonprofit organisations since they have regular changes in management and the likelihood of misunderstanding may be higher. Again this test is to determine if there is a difference in the frequency of issue of management representation letters in the past five years. Content of the letters would be of interest and will be an area for further study (see future research projects at the end of the paper).

HYPOTHESIS 2

Management representation letters
H0: $u_{MRNP\text{-}MRP} = 0$
H1: $u_{MRNP\text{-}MRP} \neq 0$

Where:

MRNP	=	the number of management representation letters issued by the nonprofit organisation in the last five years.
MRP	=	the number of management representation letters issued by the matched profit organisation in the last five years.

Materiality limits AUP27

"The assessment of what is material is a matter of auditors' professional judgement that is influenced by auditors' perceptions as to who are or likely to be, the users of the financial information, and the information needs of users." (AUP27, para 7). On average, are the materiality levels set for nonprofits different from the levels set for profits? Given the nature of the users of the financial information of nonprofits it would be anticipated that they would be more sensitive to errors and misstatements with a lower threshold required for materiality. AUP27 para 19 states "There is an inverse relationship between the acceptable materiality level and the level of audit risk." It would follow therefore that if the materiality levels are higher, then the risk levels are lower. Risk is examined in the next section.

Materiality in dollars is an appropriate measure for the profit and loss account since the organisations are matched on the basis or revenue. However, the balance sheet materiality level needs to be expressed as proportion of the total assets due to the large differences in asset base relative to the revenues earned between nonprofit and profit organisations. Australian Accounting Standard AAS5 looks at materiality based on profits (or revenue) and assets. The comparison of materiality levels in this study are based on the materiality levels set by the auditors for balance sheet accounts and profit and loss accounts for the 1991 financial year. This hypothesis addresses the issue of whether there is any difference in the level of materiality set by auditors for nonprofit and profit organisations. The lower the level of materiality set by the auditor the less error they are prepared to accept. In general it would be expected that holding other factors constant the lower the materiality level the greater the extent of testing required.

HYPOTHESIS 3

Materiality limits
H0: $u_{MLNP-MLP} = 0$
H1: $u_{MLNP-MLP} \neq 0$

Where:

MLNP = the materiality level set by the auditor of the nonprofit organisation for the 1991 year.

MLP = the materiality level set by the auditor of the matched nonprofit organisation for the 1991 year.

Assessment of audit risk AUP24, AUP27 and AUP30

AUP24 "Audit Sampling" states:

> "In planning the audit, the auditor uses professional judgement to assess the level of audit risk that is appropriate.
>
> Audit risk includes:
>
> (a) the risk that material errors will occur (inherent risk);

(b) the risk that the entity's system of internal control will not prevent or [detect] such errors (control risk); and

(c) the risk that any remaining material errors will not be detected by the auditor (detection risk)."

AUP27 and AUP30 elaborate on the specific aspects of risk and their relationship in an audit. An auditor should gain an understanding of all risk factors at the financial statement level in determining an overall audit strategy. As part of an investigation of audit strategies, it is essential to determine if there is an underlying difference in the assessment of risk for nonprofit and profit organisations. This is performed at an overall inherent and control risk level and at the individual component level for control risk, for example control risk for receipts, payments, accounts receivable, non current assets, payroll and payables.

To assess <u>inherent</u> risk the auditors uses professional judgement to evaluate factors such as the management integrity, experience and knowledge, and pressures exerted upon them; the nature of the client's business and its economic and competitive conditions including accounting practices common to the industry. McDonald (1992, p18) found in a study of 242 charities found that "board members are; older people (often women), without formal educational qualifications and limited experience of organisational management or board processes, whose existing or pre-retirement occupational roles bear little relevance to the tasks at hand. Furthermore, the majority spend only limited amounts of time per month engaged in organisational activities, and tend to stay on their boards for some years." Given this profile it would be expected that the inherent risk for nonprofits would be higher than for profit organisations.

The <u>internal control</u> risk is the risk that the internal control system can not be relied upon in formulating an audit opinion. The internal control system is comprised of the overall control environment, which includes the overall attitude and actions of management regarding controls and their importance and the policies and procedures established to provide the entity's objectives will be achieved. Internal control deals with providing reliable data and with safeguarding assets and records. In a nonprofit organisation there are frequently unpaid full time and part time staff with limited policies for internal control particularly in the areas on cash receipts. It would be expected that the internal control risk for nonprofits would be higher than for profit organisations.

HYPOTHESIS 4

Inherent risk

H0: $u_{IRNP\text{-}IRP} = 0$

H1: $u_{IRNP\text{-}IRP} \neq 0$

HYPOTHESIS 5

Control risk

H0: $u_{CRNP\text{-}CRP} = 0$

H1: $u_{CRNP\text{-}CRP} \neq 0$

Where:

IRNP = the assessment of the inherent risk made by the auditor for the nonprofit organisation.

IRP = the assessment of the inherent risk made by the auditor for the matched profit organisation.

CRNP = the assessment of the control risk made by the auditor for the nonprofit organisation.

CRP = the assessment of the control risk made by the auditor for the matched profit organisation.

Collection of audit evidence AUP14 and AUP13

AUP14 "Audit Evidence" amplifies the principle outlined in AUS1 (para.21) which states:

> "21. The auditor should obtain sufficient appropriate audit evidence through the performance of compliance and substantive procedures to enable him to draw reasonable conclusions therefrom on which to base his opinion on the financial information."

The audit evidence in total should enable the auditor to form an opinion on the financial statements. The question of interest is whether auditors of nonprofit organisations place different emphasis on compliance or substantive testing than do auditors of profit organisations? To assess this, the amount of audit testing performed using compliance procedures will be considered as an absolute amount as well as expressed as a proportion of the total testing using compliance and substantive procedures. The level of compliance testing is dependent upon the assessment of control risk made by the auditor. The lower the control risk the greater the emphasis that will be placed on compliance testing with a reduction in the amount of substantive testing required. Other factors such as the level of inherent risk and materiality levels will moderate this relationship.

HYPOTHESIS 6

Compliance testing

H0: $u_{CTNP-CTP} = 0$

H1: $u_{CTNP-CTP} \neq 0$

Where:

CTNP = the hours spent on compliance testing of the nonprofit organisation.

CTP = the hours spent on compliance testing of the matched profit organisation.

In conjunction with this, is consideration of the quality of the audit work. AUP13 "Control of the Quality of Audit Work" deals with the use of audit assistants and time spent on audits. To address these issues, a comparison of total hours spent on the audit by staffing levels used is undertaken. In particular the amount of time spent by partners, managers, seniors and graduates is analysed. Data is also collected on fees charged since a large proportion of nonprofit organisations are performed in an honorary capacity and an analysis of the correlation between fees charged and the other attributes will produce useful information for future consideration. The time spent on various aspects of the audit is a function of the auditor's assessment of internal control risk, inherent risk, level of materiality, results of prior years audit and personal judgement. It is not possible to compare the time spent on individual audits to specific benchmark. This paper is addressing a group of non profits relative to a group of profit organisations and making general statements with regard to the processes used. It is not placing value judgements on the appropriateness of the processes. The results of prior hypotheses will impact on the expected direction of any difference in the mean time spent or staff levels used. The purpose here will be to determine if there are any differences.

HYPOTHESIS 7

Audit Cost

H0: $u_{ACNP-ACP} = 0$

H1: $u_{ACNP-ACP} \neq 0$

Where:

ACNP = the total audit cost for the nonprofit organisation.

ACP = the total audit cost for the audit of the matched profit organisation.

HYPOTHESIS 8

Staff levels

H0: $u_{SLNP} - u_{SLP} = 0$

H1: $u_{SLNP} - u_{SLP} \neq 0$

Where:

SLNP = for each staff level the time spent on the audit of the nonprofit organisation.

SLP = for each staff level the time spent on the audit of the matched profit organisation.

SECTION 3: METHODOLOGY

The population to be used in the analysis will be the 1218 Charities registered with the Justice Department (Queensland) under the Collections Act 1966. This population is chosen because it represents a discrete set of nonprofit organisations which have been structured under a variety of legal structures such as companies limited by guarantee and incorporated associations. This data is being made available by the Justice Department in recognition of their support for an investigation of this nature.

A sample of 45 was chosen using charities in the Brisbane metropolitan area. A questionnaire was sent to the auditor of each nonprofit organisation requesting it be matched with a profit organisation signed by the same auditor. The matching to be on the basis of total revenue. Charities with revenue of >$100000 were chosen as it was unlikely that profit organisations wit total revenue (not profit) would be unlikely to be audited. Even with this stratification over half of the nonprofit auditors were unable to match with a profit organisation. Matching was undertaken to control for the extraneous factor most likely to contaminate the study ie size. Twenty-one useable responses were received with ten auditors able to provide a matched profit organisation. The other eleven, either did not perform any other audits or did not have audits of a similar size based on revenue.

Each auditor was requested to complete a questionnaire addressing the attributes outlined in the hypotheses for the nonprofit organisation and the profit organisation. A comparison the matched and unmatched nonprofit organisations was conducted to ensure the matched ten were representative of the twenty-one replies received.

SECTION 4: RESULTS

Table 1 provides a summary of the means for each variable for profit and nonprofit organisations. A number of variables indicate large differences in their means. In particular the level of materiality, the levels of risk and staff levels. Table 2 provides a summary of Wilcoxon Matched-pairs Signed-ranks tests for each variable. This test is the nonparametric equivalent to the correlated *t* test. The test is appropriate for establishing whether the two groups are different. The Wilcoxon test accounts for the magnitude and direction of differences. A number of the variables are significantly different at the <.1 level of significance when comparing nonprofit organisations with matched profit organisations.

A Mann-Whitney U-Wilcoxon Rank Sum W Test was undertaken for the nonprofit organisations for which the auditor was unable to provide a matched profit organisation against the nonprofit organisations for which a matched pair was provided. The results are shown in the last column of Table 2. For the majority of variables there is no significant difference between the two groups indicating that these findings will be relevant to the broader group of nonprofit organisations. There are three variables which are significantly different for the unmatched and matched nonprofit organisations. These are the use of management representation letters, accounts receivable internal controls and the use of graduates. Each of these is discussed within the results discussion for the relevant hypotheses.

HYPOTHESIS 1

The mean value of engagement letters issued indicates that there is no significant difference (p=.8551) in the issue of engagement letters by the auditor's of nonprofit and profit organisations. It was expected that due to the number of changes in the management committee of nonprofit organisations that the number of engagement letters issued by the auditors of nonprofits would be higher. An examination of the frequency of changes in the management committee shows that nonprofits do change more frequently than profit organisations (mean nonprofit u(np)=1.9; mean profit u(p)=.6; p=.1763). There is not a corresponding increase in engagement letters. It is possible that this is due to auditors of profit organisations issuing increased engagement letters for other purposes, for example, a change in the clients business or revising the terms of the engagement. However this is not the case since 80% of profit organisations have issued 0 or 1 engagement in the last five years. In summary, while the nonprofits do change management committee more frequently than profit organisations there is not a corresponding increase in the issue of engagement letters.

HYPOTHESIS 2

A comparison of the mean values and ranking for the use of management representation letters (u(np)=2.2; u(p)=1.4; p=.3454) would indicate that nonprofits auditor's use management representation letters more frequently however the difference is not significant at p=.1 level. An increased usage would be in line with the purpose of a management representation letter. However, comparison with other nonprofits (Table 2; p=.0207) indicates that this may not hold for other nonprofits since the mean for the unmatched nonprofit group is 1.36 compared to u(np)=2.2. This would result in less difference between profits and nonprofits. There is no significant difference in the use of management representation letters by nonprofits where a difference was predicted.

HYPOTHESIS 3

Materiality levels for the Profit and Loss Account have different means (u(np)=\$15411; u(p)=\$18430) however they are not statistically different (p=.1731).The lack of significance is possibly due to the large range of values in the groups and the resultant high standard deviations. It is noted that for 80% of the pairs the profit and loss materiality levels for nonprofits were less than the levels set for profit organisations. Since the groups were matched on total revenue the absolute values can be compared.

Materiality levels for the Balance Sheet are significantly different (p=.0077; u(np)=\$18320; u(p)=\$40957). Materiality levels are lower for nonprofits than for profit organisations in absolute terms. This is due to the large difference in the asset base of the nonprofit and profit organisations u(np)=$3,741,950; u(p)=$9,169,272. When a comparison is made in percentage terms the u(np)=.48% and u(p)=.45% which are not significantly different. In summary, the mean materiality levels for the balance sheet and profit and loss account are lower for nonprofits they are not significantly different to the profit organisations.

HYPOTHESIS 4

The Inherent Risk of nonprofit organisations was ranked less than or equal to profit organisations in 90% of pairs (u(np)=2.7; u(p)=3.3; p=.0759). The inherent risk was expected to be higher for nonprofits due to the factors previously outlined. This lower assessment may indicate that for these nonprofit organisations the management did not fit the profile established by McDonald (1992). The study by McDonald used a broad range of Charities whilst this study is limited to Charities with revenue greater than $100000. It is possible that for charities of this size the management has greater expertise and participation. In fact this is partially supported by the results of this study which asked the auditors to rank the level of knowledge of the preparer of the financial statements. Whilst 50% of the staff of nonprofits ranked lower than profit organisations, the difference was not significant (p=.6241). Further studies of smaller nonprofit organisations are needed to determine changes in auditors perceptions of inherent risk. It may be that the auditors perceptions of management knowledge and involvement may be different to management perceptions of their own levels of knowledge.

HYPOTHESIS 5

Control risk with means of u(np)=3.0 and u(p)=2.9 are not assessed as being significantly different (p=.7150) between groups. The level of control risk was further analysed by consideration of classes of transactions. There were no significant differences; cash receipts (p=.2489), payments (p=.9165), receivables (p=.8551), assets (p=.8658), payroll (p=.4185) and payables (p=.7874). It was expected that internal control risk for nonprofits would be higher than for profit organisations. This may be due to the size of the organisations used in this study. As nonprofit organisations increase in size they install control procedures similar to those of profit organisations.

HYPOTHESIS 6

Given no difference in the assessment of control risk it would be expected that there would be no difference in the proportion of time spent on compliance testing. There is a large difference in the mean values for compliance and substantive testing undertaken by auditors. Compliance testing u(p)=46.1: u(np)=16.79 and Substantive testing u(p)=71.35; u(np)=40.49. This indicates that auditors of profit organisations spend more time on both forms of testing for these organisations than they do for nonprofit organisations. The differences however are not significantly different (compliance testing p=.2626; substantive testing p=.5536).

Compliance testing as percentage of total testing is also not significant (p=.7672). The reason for lack of significance is the wide range of hours spent by auditors and the large standard deviations for both groups. This level of significance would improve if the groups were stratified to allow for adequate discrimination, however a theoretically sound basis for stratification could not be established. In summary the mean values are very different but not statistically different. This is part due to the limited size of the sample and this is discussed further in the conclusion to the paper. Given that the control risks and materiality are not significantly different and that inherent risk is lower for nonprofits, large differences in the amount of testing would not be expected.

HYPOTHESIS 7

The audit cost similarly has large differences in the means (u(p)p=$9827; u(np)=$4970), but are not statistically different (p=.2026). It is noted that 70% of nonprofits were charged less fees than profit organisations. Audits of nonprofits are often undertaken on a reduced or honorary fee basis. The difference in hours worked may be a reflection of this.

HYPOTHESIS 8

The staff levels undertaking the audit are significantly different at the manager (p=.1) and senior level (p=.027). All of the nonprofit audits were conducted using less or equal senior time and 90% used less or equal manager time. There was no significant difference at partner level or graduate level. This indicates that nonprofit audits are completed by graduates and partners rather than as part of an audit team. This would also lead to cost savings. The use of lower level staff would require increased supervision and review, however there is no significant difference in the hours spent by partners. The total time spent by partner manager and senior level staff is significantly different between groups ($p=.0972$) with more time spent by graduates.

Validity

Attention is given to the generalisability of Queensland Charities to all nonprofit organisations in Australia. This is justified on the following grounds:

- Auditors in Queensland are strongly affiliated with auditors in other States, often in partnerships;
- All auditors in Australia are subject to the same professional guidelines;
- Whilst the Legislation governing charities is marginally different between States these differences are unlikely to affect the results;
- Charities can have any legal structure and therefore enables a cross-section of structures to be investigated.

The internal validity may be questioned given that the organisations were not randomly assigned. Control of extraneous variables has been established by the use of matched pairs of organisations. This has allowed control of organisation size, the variable most likely to bias the results. It is not anticipated that any other extraneous variables with significantly bias the results.

The construct validity has been established by the use of the AUP's which are professionally recognised measures of the audit process.

Further Study

To improve the external validity of the study replication in other States and for smaller nonprofit organisations would be useful. The results in this study in some instances are not as hypothesised. It is possible that the use of organisations with revenue >$100000 have different characteristics than organisations with revenue< $100000 and are more likely to fit the profile of a nonprofit organisation established by other researchers. Extension of the study to other countries would be extremely interesting, in particular to USA and England where an audit is not legislatively required.

There are a number of other AUP's which are less significant. Given the prediction of significant results, these could be pursued to further guide legislators and the profession on areas in need of attention.

The content of management representation letters could be pursued to determine whether there are specific differences within the letters.

Auditors could be surveyed on their opinions of the audit of nonprofit organisations in a qualitative sense rather than the quantitative objective approach used in this paper. It would be interesting to determine if their perceptions of how they audit nonprofits correlates with the objective measures.

SECTION 5: CONCLUSION

The audits of nonprofit and profit organisations do exhibit significant differences in some of the areas addressed and do not exhibit a difference in others where a difference was expected. Nonprofit auditors issue the same number of engagement letters and use the same number of management representation letters when greater numbers of both were expected. The inherent risk of nonprofits is lower with equal levels of control risk and materiality levels. The time spent on internal control assessment and substantive testing does not provide statistically significant results however the means do indicate a trend towards lower levels of time spent by the auditors of nonprofits. The audit costs are lower for nonprofits and the audits tend to be conducted using graduates rather than manager and partner level staff. This paper has not attempted to assess the adequacy or otherwise of the audit of nonprofit organisations, rather is attempts to isolate the differences with the aim of providing information for policy makers and users. The paper provides insights to the impact of risk assessment of auditor's decision making and could be extended to the audit judgement research domain.

TABLE 1
Means for each Variable
Profit and Nonprofit Organisations

	Variable	Profit Mean Value	Nonprofit Mean Value
H1	Engagement letter	1.1	1.2
	Change in Management Committee	.6	1.9
H2	Management Represent Letters	1.4	2.2
H3	Materiality Limits - Profit and Loss	18430	15411
	Balance Sheet	40957	18320
H4	Inherent Risk	3.3	2.7
H5	Control Risk	2.9	3.0
	- Receipts	3.4	4.0
	- Payments	3.3	3.2
	- Accounts Receivable	3.1	3.2
	- Non Current Assets	3.0	2.9
	- Payroll	2.6	2.9
H6	Time Spent - Compliance Testing	46.1	16.79
	- Substantive Testing	71.35	40.49
H7	Audit Cost	9827	4970
H8	Time spent - Partner	11.4	11.03
	- Manager	24.65	16.9
	- Senior	48.65	11.46
	- Graduate	50.18	42.96

TABLE 2
Wilcoxon Matched- Pairs Signed-Ranks Test Results
Nonprofit with Matched Profit Organisations

	Variable	Nonprofit < Profit	Nonprofit > Profit	Nonprofit = Profit	P value Nonprofit - Profit	P value Matched / Unmatched Nonprofit
H1	Engagement letter	2	2	6	.8551	.4502
	Change in Management Committee	2	5	3	.1763	1.00
H2	Management Represent Letters	2	4	4	.3454	.0207
H3	Materiality Limits - Profit and Loss	7	2	1	.1731	.7738
	Balance Sheet	9	0	1	.0077	.7418
H4	Inherent Risk	6	1	3	.0759	.5561
H5	Control Risk	2	2	6	.7150	.6138
	- Receipts	2	4	4	.2489	.2025
	- Payments	4	2	4	.9165	.2601
	- Accounts Receivable	2	2	6	.8551	.0920
	- Non Current Assets	4	3	3	.8658	.1202
	- Payroll	1	4	5	.4185	.1160
H6	Time Spent -Compliance Testing	5	3	2	.2626	.3657
	- Substantive	5	4	1	.5536	.6234
	-I/C %	5	4	1	.7672	.7875
H7	Audit Cost	7	3	0	.2026	.1413
H8	Time spent - Partner	3	4	3	1.0	.2879
	- Manager	6	1	3	.128	.2350
	- Senior	6	0	4	.027	.3773
	- Graduate	4	4	2	.5754	.0682

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