

# Financial Statements, Internal Controls and How to Prepare for Your Audit

*Presented by Elizabeth Mauch, CPA*

# Objectives

- ▶ Understand basic nonprofit financial statements
- ▶ Learn the components of internal controls
- ▶ Review the risk assessment process including the risk of fraud
- ▶ Discuss entity level, activity level and IT controls and segregation of duties
- ▶ Prepare for a financial statement audit

# *My Financials say What?*



# *My Financials Say What?*

Nonprofit financial statements:

- ▶ Summarize the results of your organization's financial transactions over a designated period of time.
- ▶ Shows income, expenses, cash and debt balances amongst other things.

# *My Financials Say What?*

## Accounting Methods

### Cash-based accounting:

- Record transactions when payments are made or received (when cash exchanges hands not when event occurs)
- Typically, internally produced financial statements

### Accrual-based accounting:

- Record transactions when the event occurs, regardless of when payment has been made or received
- Payable and receivable accounts are used
- Typically, external produced financial statements

# *My Financials Say What?*

The basic financial statements consist of:

- ✓ Statement of Financial Position
- ✓ Statement of Activities
- ✓ Statement of Cash Flows
- ✓ Notes to the Financial Statements

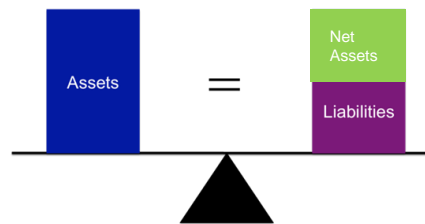
And sometimes

- ✓ Statement of Functional Expenses

# *My Financials Say What?*

## Statement of Financial Position (Balance Sheet)

- ▶ Shows a snapshot of your organization at a point in time (i.e. 6/30 or 12/31)
- ▶ Measures the cumulative result of your organizations efforts
- ▶ Always balances **ASSETS = LIABILITIES + NET ASSETS**



# *My Financials Say What?*

## Statement of Financial Position (Balance Sheet)

- ▶ Measures what you own and what you owe
  - What you own = Assets
  - What you owe = Liabilities
  - What you are worth = Net Assets



# *My Financials Say What?*

## Liabilities



Listed in order of nearness to maturity

- Accounts Payable: amount owed to business creditors on open accounts (i.e. utilities, supplies, rent, etc.)
- Accrued Expenses: estimates of liabilities not paid as of the statement date
- Notes Payable: more formal, longer-term debt owed to banks or other lenders
- Deferred Revenues: liabilities that have not been “used” for the purpose intended at that point in time

# *My Financials Say What?*

## **Net Assets**

- Difference between assets and liabilities (net worth)
- Net assets increase or decrease based on the operating results from the fiscal year
- Net assets can be:
  - ✓ Net assets without restriction (unrestricted)
  - ✓ Net assets with restriction (temporarily or permanently)

# *My Financial Say What?*

## **Reviewing Your Statement of Financial Position**

- ▶ **Cash** – Do you have enough liquid cash to meet your weekly, monthly, or yearly needs?
  - How much cash does the organization need to keep on hand?
  - Do you have sufficient reserves as a rainy-day fund?
- ▶ **Debt Management**
  - What are your debt obligations?
  - Can organization function without debt?
- ▶ **Age/State of Equipment or facilities**
  - Are there major replacements that are going to be needed?



# *My Financials Say What?*

## **Statement of Activities (Income Statement)**

- Shows the performance of your organization over a period of time
- Resets at the beginning of each new accounting period
- Summarizes all support and revenue generated by the organization by net asset class (net assets without restrictions and net assets with restrictions)
- Summarizes amounts incurred by the organization for various program activities and supporting services (management and general and fundraising)

# *My Financials Say What?*



## **Statement of Activities (Income Statement)**

- Total support and revenue – expenses calculates the change in net assets (net income/net loss)
- Tells you how well your organization is managed; Are you operating within the constraints of your financial resources?
- At the end of each year, net income is added to net assets on the statement of financial position (balance sheet) to calculate ending net assets (retained earnings)

# *My Financials Say What?*

## **Reviewing the Statement of Activities**

- ▶ How is your revenue trending?
- ▶ How are your expenses trending?
- ▶ What expenses are the highest?
- ▶ How do your expenses (as a % of income) compare to other nonprofit organizations?

# *My Financials Say What?*

## Statement of Cash Flows

- Shows funding activities and how cash is spent
- Cash Flows separated by activities



- Grants, fees & contributions
- Program expenses, supplies, payroll



- Sale of property, maturity of investments
- Purchase of property



- Short- or long-term loans
- Payment on debt, mortgage payments

# *My Financials Say What?*

## **Notes to the Financial Statements**

- Provides information about the nature of an Organization's work
- Summarizes significant accounting policies
- Provides explanations of amounts shown on the face of the financial statements
- Discuss concentrations of risk, commitments and contingencies, related party transactions, and other significant items



# *My Financials Say What?*

## Statement of Functional Expenses

- ▶ Expenses are categorized by natural category (i.e. salaries, rent, supplies)
- ▶ Expenses are further categorized by functional classification
  - Program Services – Organization's activities that fulfill the purpose or mission for which you exist.
  - Supporting Services – All activities other than program services
    - Management and General
    - Fundraising
    - Membership Development

# *My Financials Say What?*

## Statement of Functional Expenses

- ▶ *Management and General* – activities that are not identifiable with a single program, but are necessary to the conduct of why you exist (i.e. oversight, business management, accounting, producing an annual report)
- ▶ *Fundraising* – activities related to soliciting contributions (i.e. fundraising campaigns, special events, maintaining donor mailing lists)
- ▶ *Membership Development* – activities that result in significant benefits or duties connected with memberships

# *My Financials Say What?*

## **Analyzing Financial Statements**

Financial statement numbers should be compared against other numbers rather than looked at alone.

Compare them to:

- ▶ Your expectations and needs (budget to actual)
- ▶ Your competitors and industry norms (benchmarking)
- ▶ Historical performance (trending)
- ▶ Each other (ratios)

# *My Financials Say What?*

## Red Flags Relating to Financial Information

Inadequate explanations for numbers in financial statements	Unclear account titles	Significant audit adjustments	Infrequently produced financial statements
No prepared budget	No comparison of budget to actual results	Behind on required tax and informational filings	Limited or excess cash
Older property and equipment without a replacement plan	Major changes in liability categories	Poor liability-to-asset ratios	Declining revenues and increasing expenses

# *My Financials Say What?*

## Red Flags Relating to Financial Information



# *My Financials Say What?*

## Red Flags Relating to Non-Financial Information







# *Internal Control – Definition*

According to the COSO Report, internal control is “... a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives ....” in one of the following categories:

- ✓ Efficiency and effectiveness of *operations*.
- ✓ Reliability of *financial reporting*.
- ✓ *Compliance* with applicable laws and regulations.



# *Internal Control – Definition*



**Entity Level** – relates to the Organization as a whole



**Activity Level** – relates to operations and activities within the Organization

# *Overview of Internal Control Development Process*

- ▶ Step 1 – Understand your Organization
- ▶ Step 2 – Identify areas of potential risk
- ▶ Step 3 – Evaluate the design of controls
- ▶ Step 4 – Redesign the control if necessary

# *Internal Control – Understand your Organization*

- ▶ How is the economy in our area?
- ▶ Are there other organizations with a similar mission?
- ▶ Is the oversight of our Board effective?
- ▶ Have there been recent changes in management?
- ▶ Are there new regulations that we must comply with?

# *Internal Control – Identify Areas of Potential Risk at the Entity Level*

- ▶ Conduct a “brainstorming” session with management and the Board.
- ▶ Use the questions asked to understand your Organization and think of risks that could be associated with those questions.
  - For example: There is another organization that provides a similar service to us. Are we at risk for lower contributions this year? How do we respond?

# *Internal Control – Identify Areas of Potential Risk at the Activity Level*

- ▶ Contributions revenue –
  - How are contributions received? (cash, check, online)
  - How are these contributions recorded in the system and by whom?
  - Is there a reconciliation performed?
  - Is there a review of supporting documentation?
  - How are donor restrictions captured?

# *Internal Controls – Risk Assessment Process*

- ▶ Once the risks are identified, consider:
  - What can go wrong?
- ▶ Do we have controls in place to respond to the risk?

# *Internal Controls – Risk Assessment Process Example*

- ▶ **Understanding** – the Organization receives contributions that have third party restrictions
- ▶ **Risk** – the restrictions are not properly identified and recorded
- ▶ **What can go wrong** – The Organization does not use the money as directed by the donor which could result in negative publicity and loss of future contributions
- ▶ **Do we have controls** – Yes, management monitors compliance with donor restrictions and reports these restrictions to the Board

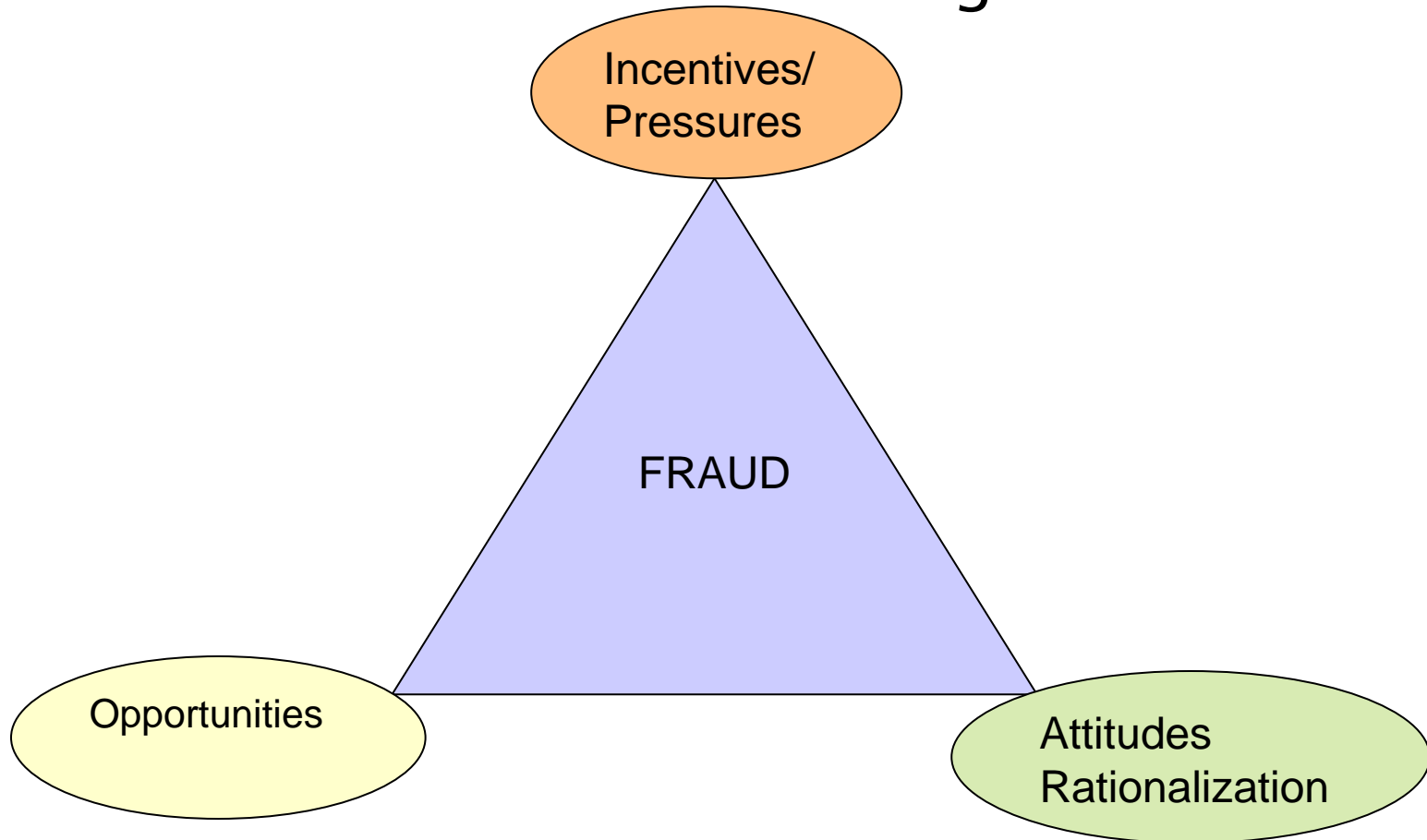
# *Internal Controls – Fraud Risk*

- ▶ Fraudulent financial reporting
- ▶ Misappropriation of assets



# *Internal Controls – Fraud Risk*

## The Fraud Triangle



# *Internal Controls – Fraud Risk Incentives/Pressures*

- ▶ Questions to consider:
  - Incentive to minimize reported fundraising and management and general expenses, and maximize reported program expenses, to make the not-for-profit entity (NFP) appear worthy of contributions?
  - Incentive to achieve certain fundraising goals, especially to meet terms of matching gifts
  - Incentive to "borrow" from restricted funds to cover a current unrestricted deficit

# *Internal Controls – Fraud Risk Opportunities*

- ▶ Questions to consider:
  - Limited number of staff involved in the accounting functions, if the result is inadequate internal control over assets that increases the susceptibility of misappropriation of those assets
  - Special events or fundraising methods result in large amounts of cash on hand or processed, for example, church plate collections, and door-to-door and other off-premises fundraising

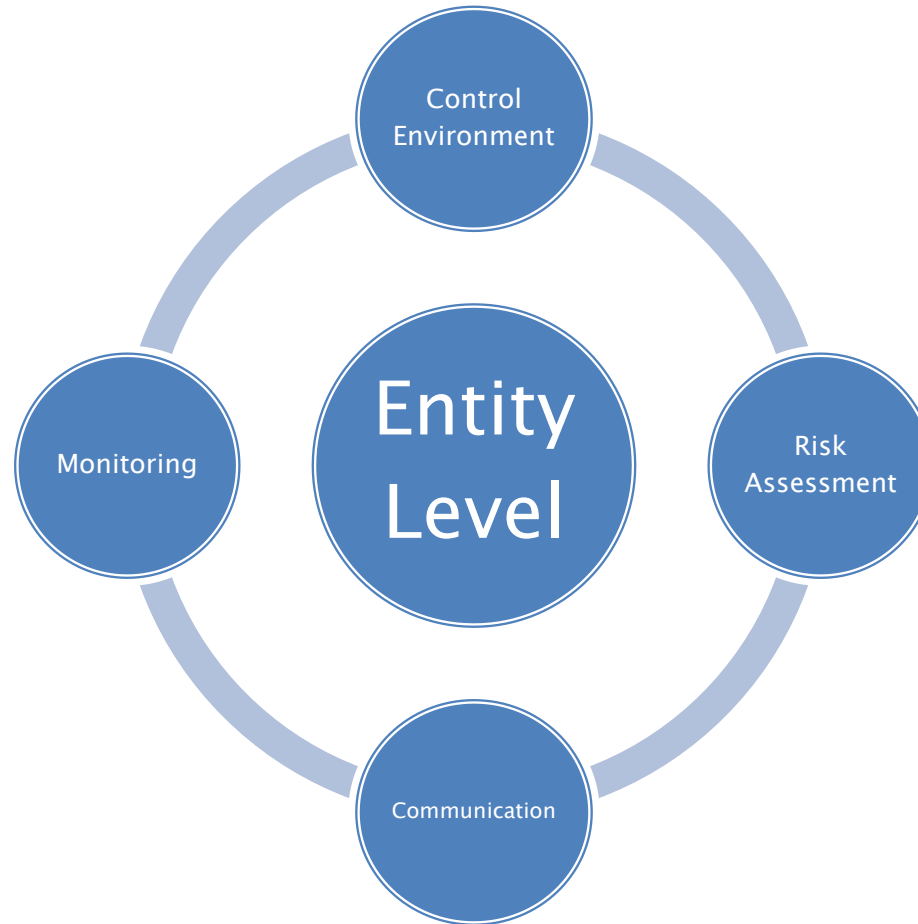
# *Internal Controls – Fraud Risk Attitude*

- ▶ Questions to consider:
  - An employee's attitude that because his or her compensation is lower than what the employee perceives could be earned in the for-profit sector, special perquisites are justified (such as rights to take donated noncash items for personal use)
  - An employee who has access to assets subject to misappropriation is dissatisfied, perhaps because of long work hours or inability to get resources assigned to the employee's projects

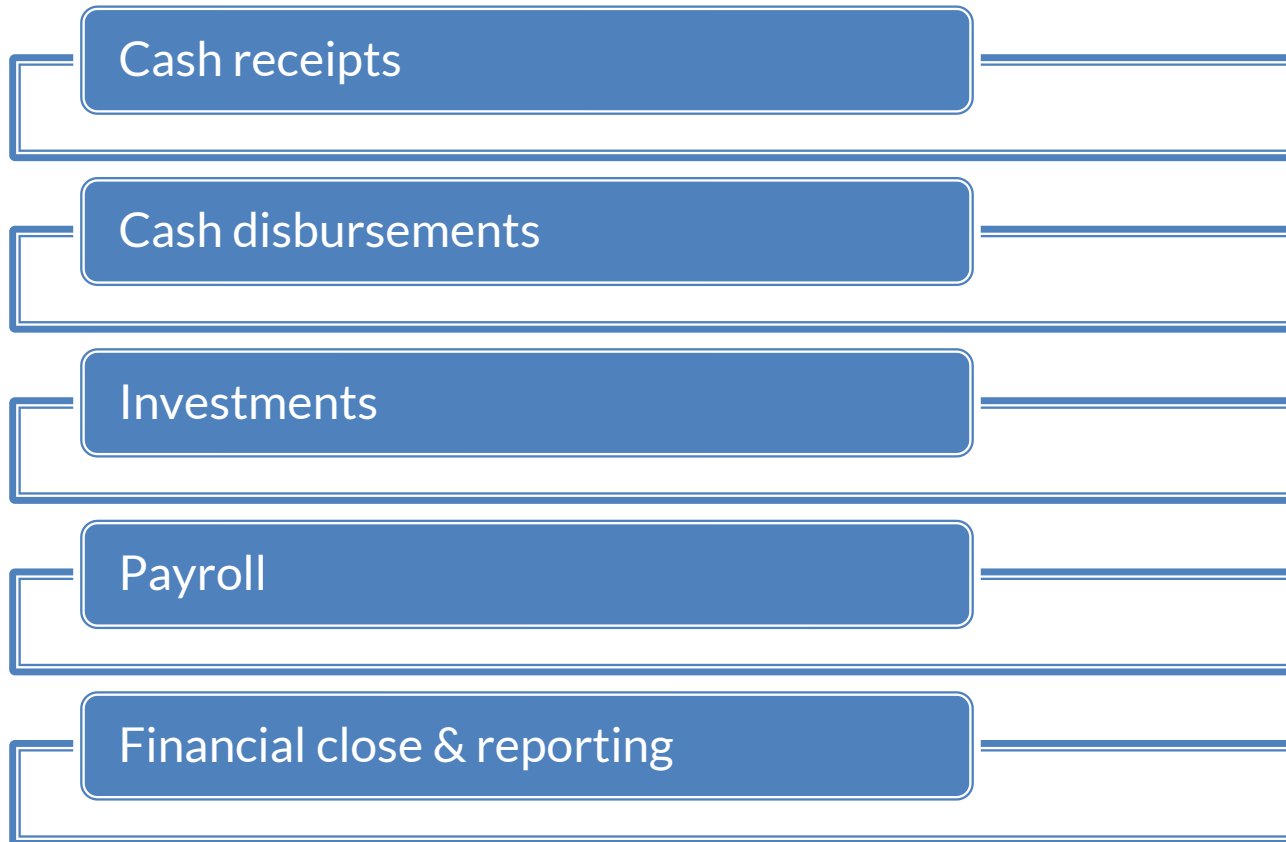
# *Internal Controls – Evaluate Controls*

- ▶ What is the objective of the control?
  - For example: The control objective is to capture third-party donor restrictions on contributions
  
- ▶ Evaluation of design includes consideration of:
  - the types of errors or fraud that could occur
  - the points in the processing stream where the errors or fraud could occur and
  - whether controls, as designed, address the potential errors and error points

# *Internal Controls – Entity Level Controls*



# *Internal Controls – Activity Level Controls*



# *Internal Controls – Cash Receipts*

## ▶ Suggested controls:

- Management periodically reviews the financial statements, including budget versus actual
- A daily listing of cash receipts/copies of check received is compared to the bank deposit by a person independent of the cash receipts function
- Use a lockbox
- Bank accounts are reconciled and reviewed timely

## ▶ Segregation of Duties:

- Open the mail
- Prepare deposits
- Record cash receipts in accounting system
- Reconcile bank accounts



# *Internal Controls – Cash Disbursements*

## ▶ Suggested Controls:

- Management and the check signer review supporting documentation before approving payment
- Checks are pre-numbered, the sequence is accounted for regularly, and blank checks are controlled and kept in a secure location
- Bank accounts are reconciled and reviewed timely

## ▶ Segregation of duties:

- Review, authorize or sign checks
- Initiate checks for expenditures
- Prepare checks
- Mail checks
- Reconcile bank accounts

# *Internal Controls – Investments*

## ▶ Suggested Controls:

- Third-party statements are reconciled to the general ledger
- Management approves investment transactions
- Bank accounts are reconciled and reviewed timely
- Accounting policies specify the correct treatment for valuing investments

## ▶ Segregation of Duties:

- Individuals who initiate investing transactions cannot:
  - ✓ Approve transactions
  - ✓ Record transactions
  - ✓ Reconcile transactions

# *Internal Controls – Payroll*

## ▶ Suggested Controls:

- Executive compensation is approved by the Board
- Access to data file is appropriately restricted
- Payroll register is reconciled to the general ledger
- Payroll changes are properly documented and approved

## ▶ Segregation of duties:

- Initiate payroll checks
- Prepare payroll checks
- Sign payroll checks
- Review & authorize electronic payroll disbursements
- Disburse payroll checks
- Resolve employee payroll inquiries
- Edit the payroll master file

# *Internal Controls – Financial Close & Reporting*

## ▶ Suggested Controls:

- Management establishes a well-defined process for financial reporting
- All journal entries have supporting documentation and are approved independently before posting
- Financial statements are reviewed and approved independent of the preparer

## ▶ Segregation of Duties:

- Review of financial statements independent of preparer
- Posting and approving of journal entries independent of the initiator

# *Internal Controls – Information Technology “IT” Controls*

- ▶ Consist of controls related to your accounting system (and integrated systems)
- ▶ Important to understand what “access rights” users have
- ▶ Passwords need to be changed frequently and not shared (or on a post it on your monitor)
- ▶ Prior periods need to be closed and locked to prevent errors
- ▶ Backup files to prevent data loss

# Internal Controls – Segregation of Duties



AICPA & CIMA

## Segregation of duties – Two people

### Accountant or other professional staff\*

- Mail checks
- Write checks
- Reconcile bank statement
- Record credit/debits
- Approve payroll
- Disburse petty cash
- Authorize purchase orders
- Authorize check requests
- Authorize invoices for payment



### Executive Director

- Receive and open bank statements
- Sign checks
- Make deposits
- Perform interbank transfers
- Distribute pay checks
- Review petty cash
- Review bank reconciliations
- Approve vendor invoices
- Perform analytical procedures
- Sign important contracts
- Make compensation adjustments
- Discuss matters with board or audit committee
- Review wire/ACH transactions
- Review account activity

*\*Non-accounting personnel such as a receptionist, administrative personnel, etc. can be trained to perform some of the less technical duties.*

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# Internal Controls – Segregation of Duties



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## Segregation of duties – Three people

### Accounting Staff

- Write checks
- Reconcile bank statement
- Record credit/debits
- Reconcile petty cash
- Distribute payroll



### Executive Director

- Sign important contracts
- Make compensation adjustments
- Sign checks
- Complete deposit slips
- Perform interbank transfers
- Perform analytical procedures
- Review bank reconciliation
- Review wire/ACH transaction
- Review account activity

### Accountant / other\*



- Approve payroll
- Process vendor invoices
- Mail checks
- Perform analytical procedures
- Approve invoices for payment
- Disburse petty cash
- Open mail and log cash
- Receive bank statements

*\*Non-accounting personnel such as a receptionist, administrative personnel, etc. can be trained to perform some of the less technical duties.*

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# *Preparing for an Audit*





# *Preparing for an Audit – Choosing Your Auditor*



- Working style & schedule suits your needs
- Open communication, responsive to questions
- Willing to meet with finance committee and board
- Provides a timely and quality product

# *Preparing for an Audit – Request for Proposal*



- Experience of the firm
- Level of staff assigned to the audit
- Credentials of key audit team members
- Client references
- Experience with Yellow Book and/or Uniform Guidance
- Copy of the audit firm's peer review report

# *Preparing for an Audit – Schedule the Audit*



- Determine reporting requirements
- Scheduling
- Avoid the organization's peak periods

# *Preparing for an Audit – Two Months Before the Audit*

- Schedule a meeting with the auditors
- Discuss engagement letter and identify your responsibilities
- Obtain and discuss client assistance package
- Review last year's audit
- Plan for year end inventory
- Make sure all policies and procedures are documented and updated
- How many copies of the audited financial statements will you need

# *Preparing for an Audit – Before the Auditor Arrives*

- Compare YTD financial statements to current year budget – any significant differences
- Schedule leave time accordingly – be available for auditor's questions
- Establish/reserve the auditor's workspace
- Communicate to your staff their responsibilities for the audit
- Double check your work papers
- Collect all invoices received after year end in a central location
- Keep copies of work papers given to auditors as starting point for next year's audit
- Be complete!

# *Preparing for an Audit – During the Audit*

- Don't be intimidated – Be open and candid
- Understand the purpose of the requests
- Ask when the auditor needs the request
- Discuss safety & security of information during the audit
- Ask for audit status updates



# *Preparing for an Audit – Concluding the Audit*

- Review draft financial statements
- Client representation letter
- AUC 270 letter (Management letter)
- AUC 260 letter (Communication with those charged with governance)

# *Top 10 Characteristics of a Perfect Client*





# *Top 10 Characteristics of a Perfect Client*

10. Prepares accurate and complete schedules for all significant accounts
9. Adheres to schedule and deadlines agreed at beginning of the audit
8. Has an organized file system
7. Posts all agreed upon journal entries
6. Does not post any entries to “net assets” during the year

# *Top 10 Characteristics of a Perfect Client*

5. Provides all information requested by the auditor in a timely fashion
4. Open and honest in answering questions
3. Maintains sufficient detail for all transactions
2. Receptive to recommendations and suggestions

# *Top 10 Characteristics of a Perfect Client*



1. Has prepared for the audit!

# Questions?

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