LINDLEY AUDIT GUIDE

LINDLEY AND COMPANY LLC

CERTIFIED PUBLIC ACCOUNTANTS

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Table of Contents

PART 1. DECIDING TO HAVE AN AUDIT

1.0 Audit Alternatives

1.01 The Compilation

COMPILATION - PREPARING FINANCIAL STATEMENTS AND FOOTNOTES FROM INFORMATION PROVIDED BY THE ORGANIZATION'S MANAGEMENT. THIS IS USUALLY FROM ORIGINAL DOCUMENTATION, SUCH AS A CHECK REGISTER OR BANK STATEMENT. THIS IS THE LOWEST LEVEL OF ATTESTATION (MEANING TO RENDER A PROFESSIONAL OPINION) A CPA PROVIDES. THIS IS USUALLY PROVIDED WHEN THERE IS NO PERSON FAMILIAR WITH BOOKKEEPING OR ACCOUNTING.

The CPA may prepare monthly, quarterly, or annual financial statements. During a compilation, the data is simply arranged into conventional financial statement form. No probing is conducted beneath the surface unless the CPA becomes aware that the data provided is in error or is incomplete.

In conjunction with the compilation, the CPA usually provides accounting services by recording entries to adjust the books to generally accepted accounting principles.

Compilation procedures: The CPA becomes familiar with the accounting principles and practices common to the client's industry, and acquires a general understanding of the client's transactions and how they are recorded.

After compiling the financial statements, the CPA is obliged to read them and consider whether they are appropriate in form and free from obvious material errors. The CPA then issues a standard report that says, in effect, that the financial statements were compiled, but because they were not audited or reviewed, no opinion is expressed. In addition, a CPA does not have to be an independent third party to issue a compilation.

Compilation standards permit an accountant to compile financial statements that omit footnote disclosures required by generally accepted accounting principles or another comprehensive basis of accounting (cash or income tax). This is allowable as long as the omission is clearly indicated in the report and there is no intent to mislead users. However, when footnote disclosures have been left out, the CPA adds a paragraph to the compilation report stating that management has elected to omit disclosures. This paragraph lets the user know that if the financial statements contained this information, it might affect the user's conclusions.

If a nonprofit needs to provide some degree of assurance that its financial statements are reliable, it may be necessary to engage a CPA to perform a review or an audit.

1.02 THE REVIEW

REVIEW - INQUIRY AND ANALYTICAL PROCEDURES APPLIED TO FINANCIAL STATEMENTS AND FOOTNOTES OF A NONPROFIT ORGANIZATION.

In performing a review, the CPA performs analytical procedures and asks management a number of questions, "inquiry". The CPA obtains an understanding of the accounting principles and practices in use, the procedures used for recording transactions, and the procedures for accumulating the financial statement information. Analytical procedures include financial comparisons, such as current financial results with prior years' results and with budgeted or anticipated amounts. The purpose of these "analytical review" procedures is to identify relationships or individual items that appear to be unusual. The object is to determine if the nonprofits' financial statements to see if they comply with accepted standards.

The independent accountant's opinion briefly describes the nature and extent of the procedures it performed. The report also states that it is not aware of any material modifications which are needed for the financial statements to meet professional standards of acceptability. However, since most of the steps required in an audit – such as independent verification with banks, customers and vendors; observation of physical assets; tests of the accounting records; examination of detailed support; and the study and evaluation of internal accounting procedures and controls are NOT performed – the report also states that the CPA firm did not perform an audit and that it cannot express a professional opinion.

A review provides limited assurance that material changes to the financial statements are not necessary. With respect to reliability and assurance, a review falls between a compilation, which provides no assurance, and an audit, which provides assurance that the statements are materially correct.

Inquiry of management includes how transactions are recorded and basic procedures of accounting personnel. Analytical procedures identify accounts which have significant changes, which are followed by inquiring of nonprofit personnel as to the reason for changes. If any internal control issues come to the CPAs attention, they will be brought to management's attention.

The CPA must be independent of the client. Procedures performed are under the on Standards for Accounting and Review Services of the AICPA. In Washington, the CPA is subject to Peer Review standards.

REVIEW PROCEDURES: The CPA obtains a working knowledge of the industry in which the organization operates and acquires information on key aspects of the organization, including revenue sources, accounting procedures, services, and material transactions with related parties.

The CPA will make inquiries concerning such financial statement-related matters as accounting principles and practices, recordkeeping practices, accounting policies, actions of the board of directors, and changes in business activities. The CPA will apply analytical procedures designed to identify unusual items or trends in the financial statements that may need explanation. Essentially, a review is designed to see whether the financial statements "make sense" without applying audit-type tests.

The CPA does not confirm balances with banks or creditors, observe inventory counting, or test selected transactions by examining supporting documents. A review is performed in the CPAs office, not the client's office.

Evaluation of internal control is not a review procedure.

1.03 THE AUDIT

AUDIT - INCLUDES SUCH PROCEDURES AS CONFIRMATION WITH OUTSIDE PARTIES, OBSERVATION OF INVENTORIES, AND TESTING SELECTED TRANSACTIONS BY EXAMINING SUPPORTING DOCUMENTS.

A nonprofit may engage a CPA to audit its financial statements and to issue a report that provides the highest level of assurance that the financial statements are presented fairly in conformity with generally accepted accounting principles.

In an audit, as in a review, the CPA must be independent of the client and the financial statements must contain all required footnotes.

AUDIT PROCEDURES: The audit objective is to gather evidence that the financial statements are materially correct. The CPA generally confirms balances with banks or creditors, observes inventory counts, and traces selected material transactions by examining supporting documents. The auditor may (but is not required to) perform "tests of transactions" to determine if the internal control procedures are in place and operating per the intent of management. Evidence will be obtained from three levels: outside parties, prepared by the auditor, and schedules prepared by the nonprofit. The auditor then issues a report stating that the financial statements are presented fairly, in all material respects, in conformity with generally accepted accounting principles.

An audit is planned and performed with an attitude of professional skepticism; that is, the auditor designs the audit to provide "reasonable assurance" that material errors or fraud are detected. An audit is not "insurance" that no fraud has occurred. Fraud concealed through forgery or collusion may not be found because the auditor is not trained to catch forgeries, nor will customary audit procedures detect all conspiracies.

The auditor is required to "document their understanding of internal control". Testing internal control is not required.

An audit provides a reasonable level of assurance that the financial statements are free of material errors. An audit does not, however, provide a guarantee of absolute assurance.

1.04 AGREED UPON PROCEDURES

An agreed-upon procedures engagement is one in which a CPA is engaged by a nonprofit to issue a report of findings based on specific procedures performed on subject matter. The client engages the practitioner to assist specified parties in evaluating subject matter or an assertion as a result of a need or needs of the specified parties. This engagement is usually crafted by the nonprofit and the CPA outlining goals and objectives and who they can be met.

PART 2. ENGAGING A QUALIFIED AUDITOR

2.0 WHEN DO YOU NEED AN AUDIT?

BOARD Many times Boards would like an outside independent CPA perform an audit. This may due to a long time board member, who has been the bookkeeper, or the internal bookkeeper is leaving and they want some assurance that the remaining board members will not be left with problems, known or unknown.

At times, board members are scattered throughout the United States and want more assurances that an organization they have a fiduciary responsibility for has accurate financial statements.

Sometimes the board understands that in a competitive donor market, they want to put their best foot forward in a competitive setting by providing audited financial statements with grant applications and to interested donors.

Some boards request an audit to fulfill their fiduciary obligations to the organization.

STATE LAW There are currently seventeen states which have imposed some regulation on nonprofits. Washington adopted such regulation in early 2009 after two years of debate. State law is:

WAC 434-120-107 AUDITED FINANCIAL REPORT--TIERED REPORTING REQUIREMENTS (EFFECTIVE JANUARY 1, 2010).

(1) Charitable organizations submitting an initial registration, shall meet the financial reporting requirements, specified in RCW 19.09.075 or WAC 434-120-105. If an organization does not file a federal form (990, 990PF, 990EZ, 990T), the organization must complete the solicitation report contained in the form prescribed by the secretary.

(2) Charitable organizations that have more than <u>one million dollars</u> in annual gross <u>revenue</u> averaged over the last three fiscal years, shall have the federal financial reporting form (<u>990, 990EZ, 990PF or 990T</u>) prepared or reviewed by a certified public accountant or other professional, independent third-party who normally prepares or reviews the federal returns in the ordinary course of their business.

(3) Charitable organizations that have more than <u>three million dollars</u> in annual gross revenue averaged over the last three fiscal years, shall submit an <u>audited financial statement</u> prepared by an independent certified public accountant for the year immediately following the year in which the organization achieved a three year average of more than three million dollars.

(4) The secretary may waive the requirement to file audited financial statements prepared by an independent certified public accountant when the organization can demonstrate that they have reached a three year average of more than three million dollars in gross revenue through unusual or nonrecurring revenue received in a single year without which they would have not met the three year annual gross average threshold.

FEDERAL LAW requires that any organization, government for-profit or nonprofit, have a "Single Audit" if they receive over $500,000 in federal funding (directly or indirectly) during the year of the organization. This is a specific type of audit, has specific guidance, and requires an auditor that meets the continuing education and peer review requirements.

2.1 How To Find And Select An Auditor – The Request for Proposal Process

All CPA firms do not perform audits, and of those firms that do, not all specialize in nonprofits or government funding. Time will be well spent to locate an auditor with specific industry experience. You do not need an auditor familiar with "schools" to audit your school, but you do need one experienced nonprofit accounting. Generally accepted accounting principles are broad in nature, not specific.

We recommend you select three to six firms. You may find eligible firms by inquiry, form the Washington Society of CPA's website (www.wscpa.org) or web search for specialized firms.

2.2 What To Look For When Selecting An Audit Firm

- EXPERIENCE AND AN ONGOING COMMITMENT TO AUDITING NONPROFIT ORGANIZATIONS;
- KEEPS UP-TO-DATE THROUGH CONTINUING PROFESSIONAL EDUCATION (CPE);
- PERFORMS WORK EFFICIENTLY, USING YOUR STAFF WHENEVER POSSIBLE;
- CHARGES FEES WHICH ARE REASONABLE FOR SERVICES PROVIDED;
- COMPLETES THE AUDIT IN A TIMELY MANNER;
- IS INDEPENDENT OF YOUR ORGANIZATION.

2.3 Length Of Contract

Single year audit proposals fees may be higher than multi-year proposals. First year start-up costs for both the organization and the auditor are unavoidable. The use of widely used audit software, which groups accounts for the financial statement and tax return, is time intensive to set up in the first year.

2.4 Accepting Proposals

CPA firms which are considering responding to a proposal will perform inquiry before submitting a response regarding the condition of your records and your internal control procedure. This information is used in making a fee estimate. For larger organizations, a site visit may be requested to become familiar with the organization, the operations and to look at the books and records.

After receiving proposals, you may wish to conduct oral interviews with the firms of interest. High level staff and possibly a representative of the audit committee should be present. This interview provides the best opportunity for a clear understanding of the responsibilities of each party to the engagement, and allows both parties to determine if they will be able to work together effectively.

Remember, the auditor is also evaluating you as you evaluate them. Organizations with chronic unaddressed issues, who have a high turnover of auditors, or other issues are not a good fit for a firm, either. Unpaid bills from former CPAs is a red flag to pass on a proposal.

2.5 The Predecessor Auditor

Prospective auditors are required by professional standards to attempt to communicate with the predecessor auditor. Before the prospective auditor accepts an engagement, he or she will want to know about disagreements between the auditor and management about accounting principles and auditing procedures, the integrity of management, reasons for changing auditors and if there are any outstanding fees.

2.6 The Engagement Letter

The board should use an evaluation process to determine the acceptance of a firm. For Single Audits, this is even more important to document a competitive and fair process. The selection process should be documented in the board minutes. Upon notification of the audit award, the auditor will send an engagement letter which should be signed by management and a board member. An engagement letter is a personal service contract and should be treated as such.

IMPORTANT CLAUSES IN THE ENGAGEMENT LETTER INCLUDE:

A. THE SERVICES TO BE PERFORMED AND FOR WHAT PERIOD

B WHAT ARE THE ORGANIZATION'S RESPONSIBILITIES AND WHAT ARE THE AUDIT FIRM'S RESPONSIBILITIES;

C. FEES CHARGED FOR THE AUDIT AND RELATED WORK;

D. WHAT HAPPENS WHEN THE AUDIT CANNOT BE COMPLETED

2.7 Fees

The engagement letter should present the fee arrangements and terms for payment of fees. While some auditors may present a fixed fee or a "not to exceed" fee, frequently there is a range based on the estimated number of hours it will take to complete the audit. CPAs are prohibited from discussing their fee proposals with other CPAs under the WA Uniform Commercial Code, so price fixing is prohibited.

2.8 Controlling Costs

1. A major consideration in audit services, after qualifications, is price. The pricing of audit services is subjective. Many not for profit audits are bid at a fixed dollar amount, so it is important to know the separate cost components that establish the price of your audit. The four blocks of audit time (and therefore the basis of cost) are 1) time spent prior to fieldwork, 2) fieldwork, 3) after fieldwork including the resolutions of problems and 4) subsequent service.

The estimates of this time are based on auditor experience and the hours spent. There are usually three levels of staff classification in an audit. Staff accountants (associates) have one to three years of experience. They are usually the people doing the audit at your site. The supervisor/manager has four to eight years of experience and is at the audit site for approximately one fourth of the audit time to supervise the staff accountant. The Partner may visit the audit site for meetings with management. If the audit fee is approximately $5,000, the breakdown is approximately 20 staff accountant hours, five manager hours and 2 – 3 partner hours. The audit cost would also include administrative fees such as word-processing time, postage, and report binding and delivery changes. Since the staff accountant and the manager both have to perform additional work before and after the audit, the above hours translate to the staff accountant at your site for three days and the manager for one day.

From this information, you should be able to estimate the cost. Large variance is price come from the hourly rate. In a large firm, the partner’s hourly rate could be as much as $350 hour, but in a smaller firm, $200 per hour. The organization must determine what is most important to them in selecting a firm and the people who perform the audit.

At times the auditor will revise the fee estimate because the organization did not adequately prepare for the audit or unexpected situations arose that were unknown prior to the beginning of the audit.

2) The greatest cost saver to the audit is to be fully prepared for the audit fieldwork. If you do not have the trial balance completed, need to be out the office, or have not completed the requested information, you have decreased the time the auditor has to spend actually doing the audit. If you are not ready, postpone and reschedule.

2.9 Economies Of An Audit

What are the costs of an audit - what can you control, what can't you control?

Emails We estimate the cost to receive and respond to a short email is $17. Think of accounting firms like a law firm – lawyers charge for phone calls, emails, time to prepare an invoice. How can you reduce costs? A good rule of thumb would be, if it is not so important that a phone call is not necessary, then probably an email is not necessary either. Do not include the auditor in the chain email for meetings to be scheduled. Do not send four emails when one well planned email would be appropriate and cost efficient.

Drafts of financial reports Preparation of drafts is time consuming (i.e. expensive). Multiple revisions are costly as each page must be corrected and reviewed again. Like emails, one well planned draft with corrections is most cost efficient.

Meetings NFPs have a congenial atmosphere of camaraderie. Auditors would like to – but we do not have the luxury. Remember, like attorneys, we have billable time to consider. To have two auditors sit in on a half hour meeting runs in the hundreds of dollars. It might be wise to ask the auditor what meetings they consider most effective.

Hours NFPs often have flexible working hours. Auditors schedule audits based on nine hour days – when we are asked to begin at 9 am or everyone leaves at 3 pm, the inefficiencies add up.

No accounting personnel available Auditors have questions and need sufficient access to the appropriate personnel. When key personnel work part-time on certain days, are not available during the audit, or have scheduled appointments outside of the office during fieldwork– inefficiencies mount up.

Critical accounts not reconciled If pledges are recorded in another department but no one told them to prepare for the audit and there are 50 more confirmations that need to be done; the audit has just slowed down.

New activities for the year the auditor did not know about
Capital campaigns, new constructions, pledge drives, investment issues – these all take time to plan audit procedures appropriately. Bring these issues up before the audit begins and provide the requested financial information well before the audit so the auditor can be prepared.

FAILURE TO POSTPONE THE AUDIT WHEN INFORMATION IS NOT READY Sometimes followed by "and the grantors need the audit right away"- we are just auditors, we can't fix everything.

CHANGES TO THE GENERAL LEDGER In conjunction with not being prepared for the audit, the auditor receives the "preliminary" trial balance, invests 4 – 8 hours in planning and setting up workpapers, only to find out the first day of the audit that the numbers have changed.

EXPECTING BASIC BOOKKEEPING ADVICE FROM THE AUDITOR Auditing standards have changed – the client is responsible for preparing and understanding the financial statements. If you ask the auditor basic bookkeeping questions, it calls into question if the client understands their financial statements.

PART 3 THE AUDITOR'S JOB

3.0 DESCRIPTION OF A FINANCIAL AUDIT

A nonprofit organization's needs to contract with licensed certified public accountant to perform an audit of the organization's financial statements. In Washington, firms performing audits are also required to have a "peer review" every three years so that a regulatory agency, the Washington State Board of Accountancy, can determine if the work performed by the firm meets American Institute of Certified Public Accountants (AICPA) standards. CPAs, as an individual, are certified by the AICPA after meeting education requirements and passing a national exam. States license individual CPAs and CPA firms and monitor their procedures under state law.

An audit is a process for verifying the accuracy and completeness of information presented in an organization's financial statements from third party information – confirmations, agreements, contracts, cash receipts and cash disbursements. An audit is also based on 'materiality" – a predetermined amount of what is "important" enough to misstate the financial statements if incorrect. Following an audit, the CPA issues an opinion on if agency's financial statements <u>fairly represent</u>, in all <u>material respects</u>, its financial position and whether they comply with generally accepted accounting principles (GAAP). GAAP is determined by the American Institute of Certified Public Accountants.

The auditor will request information from individuals and institutions to confirm bank balances, contribution amounts, conditions and restrictions, contractual obligations, and monies owed to and by your organization. The auditor will review physical assets, journals and ledgers, and board minutes to ensure that all activity with significant financial implications is adequately disclosed in the financial statements. In addition, the auditor will select a sample of financial transactions to determine whether proper documentation exists and whether the transaction was posted correctly into the books. In addition, the auditor will interview key personnel and read the procedures manual, if one exists, to determine whether the organization's internal accounting control system is adequate. The auditor usually spends several days at the organization's office looking over records.

Auditors do not guarantee that 100 percent of the transactions are recorded correctly. They are only required to express an opinion as to whether the financial statements, taken as a whole, give a fair representation of the organization's financial picture. In addition, audits are not intended to discover embezzlements or other illegal acts. Therefore, a "clean" or unqualified opinion should not be interpreted as an assurance that such problems do not exist. An audit is not an insurance policy.

The audit usually covers a twelve month period, either a calendar (ending 12/31) or any other 12 month period, called a fiscal year, and represents twelve months of activity up to and including the last day of a fiscal year). At the conclusion of the work, the auditor will render an opinion on the financial statements.

As part of the audit, the auditor may prepare a management letter recommending improvements to the organization's internal control and financial system. This report cites areas in the organization's internal accounting control system which the auditor evaluates have significant deficiencies and material weakness.

3.1 Understanding Your Organization

To form a professional opinion, an auditor in most cases should (a) understand and document the nature of the organizations, (b) review, evaluate and document their understanding of the organization's internal control procedures, (c) confirm major transactions and balances (for example, cash and accounts receivable), (d) and test underlying accounting records (for example, trace amounts from the general ledger to invoices).

At the end of the audit, management will be asked to attest to the information in the audit was complete and accurate by signing a management representation letter.

3.2 What An Audit Is

An audit is to provide reasonable assurance that the financial statements are fairly stated in all material respects according to generally accepted accounting principles.

WHAT AN AUDIT IS NOT

- IT IS NOT A VERIFICATION OF EVERY TRANSACTION
- IT DOES NOT PROVIDE ABSOLUTE CONFIDENCE THAT YOUR ORGANIZATION IS IN "GOOD" FINANCIAL HEALTH
- IT DOES NOT EVALUATE PERFORMANCE MEASURES
- IT IS NOT AN INTERNAL CONTROL EVALUATION OTHER THAN TO DETERMINE IF THEY CAN BE RELIED UPON TO PRODUCE ACCURATE FINANCIAL STATEMENTS
- IT IS NOT A GUARANTEE TO DISCOVER THEFT OR EMBEZZLEMENT
- IT IS NOT A GUARANTEE THAT THE ORGANIZATION IS DOING "EVERYTHING" CORRECTLY

3.3 Audit Issues

There are several methods of communicating audit issues:

Oral comments These are low level comments, such as improving document filing (alphabetical is preferred to date order for fraud reasons), which are managerial in nature.

Written in a stand-alone letter Called the "management letter", this is used for two levels, "significant deficiencies" and "material weaknesses" in internal control. This is used when an issue is noted that if not corrected, fraud could occur. Some audit committees and board members erroneously believe that if they do not receive such a letter that the auditor "did not do their job". There are standards of what is to be reported to whom, in what manner, and when. There is auditor judgment, of course, but we do not issue such letters just to appear to be doing our job. Many clients believe an audit is not "complete" unless they receive a management letter. However, this is a misplaced expectation and undermines the auditor's judgment as to the correct circumstances under which to issue such a letter.

PART 4 THE CLIENT'S JOB

4.0 Assignment Of Tasks

It is important to identify which tasks you expect the auditor to perform and which ones can be carried out by your organization's staff, remembering that even if the auditor assists the client with some accounting functions, the financial statements are still the responsibility of management. If the auditor performs clerical tasks such as finding invoices, cancelled checks, and other documents, costs can soar. The organization's staff should expect to (a) locate and sort invoices and bank checks; (b) assemble documents such as contracts, bills, minutes of board meetings and by-laws; (c) copy documents; (d) prepare confirmation forms and letters; (e) other clerical tasks.

WHAT ARE OTHER DELAYS THAT SIGNIFICANTLY AFFECT AUDIT COSTS?

- People are on vacation or in meetings for long periods of time
- Requested information is not gathered in advance
- Failure to provide requested information in a timely manner during fieldwork
- Persons in authority to approve reports etc, are not brought in until very late in the process
- Hostile, aggressive, or "it's not my job" attitude towards the auditor
- Failure for anyone at the Organization to take responsibility for the audit

- NOT PREPARING AN "AUDIT BOOK" – THE REQUESTED INFORMATION NEATLY GATHERED, COPIED, AND AVAILABLE AT THE BEGINNING OF THE AUDIT

Larger organizations may request a pre-audit or entrance conference to outline the timing of the audit procedures. An exit conference may also be requested. Such conferences are usually standard in government audits, but less frequent in smaller audits. The audit committee should consider contacting, if only by phone, the auditor before and after the audit.

4.1 AUDIT COMMITTEE RESPONSIBILITIES

If there is an audit committee, a committee representative should talk with the auditor before, during and after the audit. Attending the presentation of the financial statements should not be the first time any dialogue has occurred.

An evaluation of the audit process should be discussed with management and the auditor. The board should be sensitive that auditors are trained specialists performing complicated procedures in a time effective and efficient method. While management can evaluate several areas, such as friendliness and timeliness, they are not in a position to determine the quality of the audit process.

Part 5 THE AUDIT APPROACH

ALL AUDITS ARE NOT THE SAME, AS NONPROFITS ARE NOT IDENTICAL TO EACH OTHER. THE AUDITOR IS REQUIRED TO PERFORM AUDIT PROCEDURES CRAFTED FOR EACH ENTITY.

LET'S DISCUSS THE AUDIT PROCESS, KEEPING IN MIND THAT EACH AUDIT IS UNIQUE.

1) THE BOARD APPROVES AN AUDIT TO BE PERFORMED.
2) MANAGEMENT PERFORMS A DUE DILIGENCE TO MAKE A LISTING OF QUALIFIED AUDIT ORGANIZATIONS.
3) MANAGEMENT CONTACTS THE AUDIT ORGANIZATIONS (USUALLY BY LETTER).
4) THE BOARD EVALUATES THE FIRMS AND SELECTS ONE BASED ON SELECTION CRITERIA (OR MORE THAN ONE AND CONDUCTS ORAL PRESENTATIONS).
5) THE CPA FIRM ISSUES AN ENGAGEMENT LETTER, WHICH FOR MOST INTENTS, IS A CONTRACT BETWEEN THE NFP AND THE CPA FIRM FOR SERVICES. THIS IS AN IMPORTANT DOCUMENT WRITTEN BY ATTORNEYS – IT IS AN IMPORTANT DOCUMENT.
6) AFTER RECEIVING THE SIGNED ENGAGEMENT LETTER, THE AUDIT FORMALLY BEGINS.

5.0 Preliminary Planning Process - Understanding Audit Objectives

(THIS IS DONE PRIOR TO FIELDWORK)

This stage establishes the foundation for the audit and/or other procedures. This increases effectiveness, thus decreasing costs. The CPA firm will send a listing of electronic files needed and documentation to be assembled for fieldwork.

Our planning objectives will include:

Determine if the NFP has financial statements that are ready to be audited by uploading electronic files to audit software.

Perform planning procedures of inquiry (how is this year different from the prior year, etc.) and analytical procedures (changes highlighted by material changes in account balances).

Coordinate audit timing and CPA staffing requirements based on the NFP's needs.

Discuss the audit's broad objectives with management and perhaps conducting an entrance conference.

Document in writing the CPAs understanding of NFPs history, goals and objectives.

5.1 Preliminary Process - Audit Design

(THIS IS DONE PRIOR TO FIELDWORK)

This stage is to determine the overall procedures to perform the services requested. This is specifically based on the information provided in the planning phase and inquiry of management. This is instrumental in developing cost effective methods of meeting the audit objectives. At this time the client should be collecting the requested information, and coordinating with their staff. Our audit design objectives include:

Concluding the planning and preparation of audit procedures (called audit programs) tailored to the NFP.

Define high-risk areas that may require additional audit procedures, such as market investments, capital campaign, pledges, areas affected by poor internal control.

Develop and document in writing audit objectives.

Determine specific audit steps and tests to be performed.

5.2 Perform And Document Audit Procedures

(This is the on-site portion of the audit)

During this phase, we review documents and evaluate the information requested in the preliminary planning phase. We perform audit procedures as indicated to determine if account balances are fairly stated in all material respects, in accordance with generally accepted accounting principles (i.e. is the balance of the account supported by other documentation of transactions, such as bank statements, vouchers, etc).. We will send letters of confirmation for cash, accounts receivable and other accounts as deemed necessary. We will document our understanding in writing, and may perform tests of, internal control. Our objectives in this phase include:

Perform audit procedures that comply with applicable standards and compliance regulations.

Document in writing internal control policies and procedures. This may be done by inquiry and memos, client prepare questionnaires, flowcharts, etc.

Perform tests of internal controls, if necessary, and develop recommendations for strengthening such controls. Testing internal control is NOT required.

If there is an audit committee, and they are "active", this is the point that they should contact the auditor.

5.3 Concluding the Audit

(this is done in the CPA office after fieldwork)

During this phase, we close the workpapers, verifying that all supporting documentation has been reviewed and we have documented our audit procedures by completing the audit programs. At this time we prepare draft financial statements and footnotes. At this time, we prepare the draft management letter, the letter of recommendations to strengthen internal control.

Discuss proposed adjusting journal entities, if any, with management.

Document audit outcomes in independent auditor's report.

Provide a draft to the NFP for any factual changes and to discuss wording.

Send copy of the management representation letter (this is a different letter than the management letter).

In this phase, the final procedures are conducted between the CPA and the NFP. The CPA receives the signed management letter (which includes the approval of the adjusting journal entries) and obtains approval to issue the final financial statements.

Prepare presentation to the board of the financial statements. This is NOT the time to bring up audit issues for the first time. The board should have been informed of all issues prior to the meeting. (We recommend that board approval is required to issue the final financial statements and that they have read and understand any management letter).

If discussion other that the financial statements is required by the board, this should be scheduled with the auditor.

For “active” audit committees, they should contact the auditor prior to the final meeting. They should inquire as to what the auditor would like to discuss. (Audit committees that develop their own agendas are well meaning but somewhat misguided.)

Audit reports cannot be issued if there are unpaid fees as this is an independence conflict.

5.4 Single Audits And Other Regulatory Audits

Review federal and state compliance regulations required to be documented and tested if material to the financial statements. Document applicable compliance criteria and develop and perform tests of compliance. After meeting with NFP personnel, gather information relevant to internal control and documenting preliminary assessment, we will develop specific audit procedures (and document in written audit programs) to determine compliance with such regulations. Our objectives are to:

Document and perform tests of compliance deemed material to the financial statements.

Understand and document specific areas of compliance of interest to regulatory agencies, if material to the financial statements.

Develop written audit procedures and perform tests of compliance.

Document compliance or noncompliance to develop management letter or findings.

Note: a management letter is only issued if required under the reporting requirements of OMB Circular a-133 and governmental auditing standards, which requires a management letter be issued for nonmaterial instances of noncompliance with program requirements.

TOOLS AND TEMPLATES

ENGAGEMENT LETTER

The following is a sample engagement letter which outlines the auditor's responsibilities, your responsibilities, scope of work, fees and other issues. This is a contract, not an informational letter. It should be signed by a board member and a representative a management who has the authority to sign contracts on behalf of the organizations.

This letter is provided by the AICPA to assist auditors from claims regarding the audit and of fees. It is usually modified to suit the terms a particular firm has implemented.

SAMPLE ENGAGEMENT LETTER

October 7, 2013

Client Name and address

Dear Client:

We are pleased to confirm our understanding of the services we are to provide for the Organization for the years ended December 31, 2007 through 2009.

We will audit the statement of financial position of the Organization as of December 31, 2007 (and through 2009) for the year then ended and the statement of activities, functional expenses and cash flows , for the year then ended in accordance with applicable auditing standards generally accepted in the United States of America. Under these professional standards, the accuracy of the Organization's financial statements is the responsibility of the Organization's management, not our firm.

This letter confirms the services you have asked our firm to perform and the terms under which we have agreed to do that work. Please read this letter carefully because it is important to both our firm and you that you understand what you can and cannot expect from our work. In other words, we want you to know the limitations of the services you have asked us to perform. If you are confused at all by this letter or believe we have misunderstood what you need, please call to discuss this letter before you sign it.

Our audit will be made in accordance with generally accepted auditing standards and will include tests of the accounting records of the Organization and other procedures we consider necessary to enable us to express an unqualified opinion that the financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. If our opinion is other than unqualified, we will fully discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit, we will not issue a report as a result of this engagement.

Our procedures will include tests of documentary evidence that support the transactions recorded in the accounts and direct confirmation of cash, investments, and certain other assets and liabilities by correspondence with creditors and financial institutions. We will request written representations from your attorneys as part of the engagement, and they may bill you for responding to that inquiry. At the conclusion of our audit, we will also request certain written representations from you about the financial statements and related matters.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; therefore, our audit will involve judgment about the number of transactions to be examined and the areas to be tested. Our audit is designed to provide reasonable assurance of detecting misstatements that, in our judgment, could have a material effect on the financial statements taken as a whole. Consequently, our audit will not necessarily detect misstatements less than this materiality level that might exist due to error, fraudulent financial reporting, or misappropriation of assets. The Organization's management is responsible for establishing and maintaining a sound system of internal control, which is the best means of preventing or detecting errors, fraudulent financial reporting, and misappropriation of assets. Our responsibility as auditors are limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

The applicable professional standards for this audit require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audit will include examining, on a test basis, evidence supporting the amounts stated and disclosures made in the financial statements. Our audit will also include an assessment of the accounting principles utilized by the Organization and the significant estimates included by management in the financial statements, as well as an evaluation of the overall financial statement presentation. While we will advise the Organization about appropriate accounting principles and their application and will assist in the preparation of the financial statements, the responsibility for the financial statements remains with the Organization's management. This responsibility includes the maintenance of adequate records and related internal controls, the selection and application of accounting principles, the determination and use of estimates, and the safeguarding of assets. The Organization's management is also responsible for adjusting the financial statements to correct material misstatements and for confirming to us in the management representation letter that the effects of any uncorrected misstatements aggregated by us in the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

We expect our audit to be based primarily on tests of accounting records and related supporting data and it will not involve testing of more than a sample of representative transactions. For example, our audit procedures will include tests of certain documentary evidence to support the transactions recorded in the accounts. We also may confirm account receivable and accounts payable as well as certain other assets and liabilities, including leased assets, though contact with selected customers, grantors, donors and funders, financial institutions, creditors and your legal counsel. Since we do not perform in a audit a detailed examination of all transactions or information involved in the preparation of financial statements, our audit is subject to the inherent risk that we will not discover material errors, irregularities, or illegal acts, including but not limited to fraud or defalcations affecting the accuracy of the financial statements.

In other words, as auditors, we are not insurers or guarantors of the accuracy of financial statements and we cannot, as a result of our audit, tell you we are certain there are no material misstatements, illegal acts, defalcations or other irregularities affecting the financial statements. As such, although our audit will be designed to provide reasonable assurance of detecting errors and fraud that are material to the financial statements, it is not designed and should not be relied on to disclose all fraud, defalcation, or other irregularities affecting the financial statements. However, we will inform you of any material errors, and all illegal acts or irregularities, unless they are clearly inconsequential, that come to our attention. The Organization agrees that our firm's responsibility is limited to that described in this letter and that the Organization will indemnify, defend and hold our firm and its employees, harmless for all actions against us arising out of illegal acts perpetrated by the Organization's management or its employees.

Our audit is not specifically designed and cannot be relied on to disclose significant deficiencies in the design or operation of the internal control. However, during the audit, if we become aware of such significant deficiencies in internal control or ways that we believe management practices can be improved, we will communicate them to you in a separate letter. We will also inform you of any no reportable conditions or other matters involving internal control that come to our attention.

In the event we encounter circumstances that lead us to believe we cannot continue to perform our services consistent with the requirements of the applicable professional standards, including but not limited to ethics rules, we will inform you of our concerns and, if those concerns cannot be addressed to our satisfaction, we may be compelled to withdraw from the engagement. Further, you agree the Organization will pay for all services rendered even if a report cannot be issued.

Our audit opinion on these financial statements is prepared for use by management only in connection with its internal evaluation of the Organization's performance and is not prepared for or intended for use or reliance by third parties. Before using or disclosing any portion of our report to third parties outside management, the Organization agrees to contact our firm for consent of disclosure except for the following persons or entities, which you informed us, will receive copies of our report: Board of Directors, management, specific legislative or regulatory bodies, federal awarding agencies and pass-through entities, if applicable.

You agree that the Organization will provide us with the basic information required for our audit on a timely basis and that you are responsible for the accuracy and completeness of that information. You agree that delay in our originally scheduled start date or providing inaccurate or incomplete information may require us to charge additional professional fees and/or reschedule your engagement for our next available time. Should your engagement need to be rescheduled, your specific time deadlines, including tax and government filings, may go unmet.

You agree that ______________________, your representative, will serve as our contact person for your management responses to our audit inquiries, and that we may rely on such responses as being those of the Organization.

Our fees for these services will be based on the actual time spent at our standard hourly rates, plus travel and other out-of-pocket costs, such as report production, typing, and postage. Our standard hourly rates vary according to the degree of responsibility involved and the experience level of the personnel assigned to your audit. Our invoices for these fees are billed on the 30th of each month as work progresses and are payable upon receipt. Amounts not paid by month-end will accrue finance charges of 1.5% per month on the past due balance. Work will be suspended if your account becomes 30 days or more overdue, or for any other reason, and work will not be resumed until your account is paid in full.

Based on our preliminary estimates, the fee should approximate $xxxxxx each year for the audit for a three year contract (for the years ended December 31, 2007 through 2009). That estimate is based on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during the audit. If significant additional time is necessary; we will discuss it with you and arrive at a new fee estimate before we incur the additional costs. If appropriate, we will submit a change order for your review and approval reflecting the additional services and related costs. Items that may result in a change order include but are not limited to time delays, incomplete audit requested schedules, identification of fraud risk factors, incomplete account reconciliations, unavailability of your accounting personnel, and difficult or unusual accounting issues.

In cases in which we can estimate our fees, our estimate is based on our experience as accountants and on certain assumptions about the amount and character of the work entailed and our involvement in the project. An estimate is not a fixed fee quote but it is our best estimate based on our discussions and review of the prior audit report and/or other financial information. It does not constitute a commitment, guaranty, or promise by us to perform the accounting services for that amount. Each situation is unique, and the actual fees may be more or less than estimated. The actual work required may vary from the assumptions due to complexities or other factors that we cannot foresee or additional services subsequently requested by you. As a result of additional complexities, unknown factors, additional or different facts of which we are not presently aware, changes which you may desire, or other circumstances, if the required accounting work has changed, the fees billed will be adjusted to reflect that change. Any changes will be discussed fully with you to reach mutual agreement. Any additional fees will be discussed prior to incurring any such charges. We do not anticipate that such discussion will be required.

We will retain our own workpapers for this engagement so that we may be better able to assist you with your professional needs and, in some cases, to comply with legal or professional requirements. We will also retain some information electronically and sometimes access that information over the Internet. You authorize us to transmit, update and store information electronically and to transmit your information over the Internet. Under our firm's documentation retention policy, we will keep our audit workpapers for a period of seven years after the engagement. The Organization agrees we are free to destroy such records at our sole discretion after that seven year period without notice to the Organization.

In the event we receive a subpoena or summons requesting documents or other evidence relating to this engagement, we may be compelled to comply. We will notify you before responding to any request. You may, within the time permitted for our firm to respond to any such request, take such action, as you deem appropriate to protect information from discovery. If you take no action within the time permitted for us to respond, or if your action does not result in a judicial order protecting us from supplying requested information, we may construe your inaction or failure as consent to comply with the request. You agree to indemnify, defend, and hold our firm harmless from all costs, legal fees, expenses and reasonable professional fees on our part that are incurred in connection with responding to any subpoena or summons arising out a request by a third party for any information relating to this engagement.

We appreciate the opportunity to be of service to the Organization and believe this letter accurately summarizes the significant terms of our engagement. If you have any questions, please let us know. If you agree with the terms of our engagement as described in this letter, please sign the enclosed copy and return it to us.

Very truly yours,

Lindley and Company LLC

Approval:

______________________________________ ________________________

Board Member Signature Date

____

Board Member Name Printed

____ __________________________

Management Representative Signature Date

____

Manage

Compilation Report

A Illustrative compilation report:

Accountants' Compilation Report

Martha Foundation

Board of Directors

We have compiled the accompanying statement of financial position of the Martha Foundation as of December 31, 2010, and the related statements of activities, functional expenses and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.

A compilation is limited to presenting in the form of financial statements information that is the representation of management (owners). We have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or any other form of assurance on them.

Lindley and Company LLC

May 5, 2011

Review Report

B Illustrative review report:

Accountants' Review Report

Martha Foundation

Board of Directors

We have reviewed the accompanying statement of financial position of the Martha Foundation as of December 31, 2010, and the related statements of activities, functional expenses, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of the Martha Foundation.

A review consists principally of inquiries of company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

Lindley and Company LLC

May 10, 2011

AUDITOR'S REPORT

C Illustrative audit report:

Independent Auditors' Report

Martha Foundation

Board of Directors

We have audited the accompanying statement of financial position of the Martha Foundation as of December 31, 2010, and the related statements of activities, functional expenses, and cash flows for the year then ended. These financial statements are the responsibility of the Martha Foundation's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Martha Foundation as of December 31, 2011, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Lindley and Company LLC

May 10, 2011

EXAMPLE CLOSING YEAR END

This list may not be comprehensive as other cash to accrual and GAAP adjustments may need to be made.

GENERAL

1. Any adjusting journal entries made to the year ended December 31, 2009, after your accountant prepared the trial balance.
2. Post prior year AJE's (2008) and tie out net asset accounts to ending 2008 balance.
3. Prepare and post cash to accrual adjusting journal entries.
4. Reconcile accounts to third party documentation – payroll, pension, etc.

ASSETS

1. Bank statements and bank reconciliations for all bank accounts for the entire year (twelve months).
2. Schedule of equipment bought and sold during the year, if applicable.
3. Perpetual inventory records at December 31, 2009
4. Agree receivables to billings.
5. Reverse prior year receivables.
6. Adjust prepaid insurance account to actual.

LIABILITIES AND NET ASSETS

1. Schedule of any contributions received with very specific restrictions (for example, to spend for the programs in general are not a specific restriction; to spend for a new printer is a specific restriction).
2. Post accounts payable at December 31, 2009.
3. Reverse prior year payables.
4. Record accrued vacation payable.

REVENUE

1. List of in-kind donations: use of facility, equipment, professional service hours – and record to the general ledger.
2. Copies of any amendment/contractual changes.

EXPENSES

1. Form W-2 and Forms 941(for each quarter) as filed for the year, which agree to the general ledger.

2. Agree retirement payments to third party documentation.
3. Post payroll adjustments to agree 941 to payroll expenses, health payments to health expense, and retirement payments to retirement expense.

OTHER

1. Copy of all agreements for the audit period (this may include government, private funding, etc).
2. Copy of all contracts (from a vendor or the government) for the audit period (this does not included contracts reviewed in the prior audit).
3. Copy of minutes from January 1, 2008 to the date of fieldwork.
4. Copy of insurance policy(s) in-force during the audit period.
5. Copy of lease agreement for the space rented, if applicable.
6. Prepare statement of functional expenses.

Audit Proposal Evaluation Checklist

All audit proposals will be evaluated based on the following factors listed in order of importance. The audit committee should evaluate each factor and assign points in accordance with the scale presented below:

Technical expertise	up to 40 points
Qualifications	up to 30 points
Organization and control	up to 20 points
References	up to 10 points
Total	100 points

Rate each proposer in the following categories.

1. Technical Expertise — *Maximum points 40*

The proposal must clearly indicate that the offeror understands the requirements of the audit. The offeror's proposal must also contain an adequate plan for conducting the audit.

- Firm should have extensive experience with not-for-profit audits.
- Key personnel should be active members of professional organizations and committees.

2. Qualifications — *Maximum points 30*

The proposal must demonstrate the adequacy of professional qualifications, background and relevant work experience of the firm and of proposed personnel.

- Firm should have a minimum of three years of experience conducting audits of nonprofit entities.
- Proposed key personnel (manager, supervisor, and senior auditor) should have experience planning and conducting audits of not-for-profit entities.
- Continuing Professional Education of manager involved should include specific nonprofit courses.

3. Organization and Control *Maximum points 20*

The proposal must demonstrate that the offeror has adequate supervisory controls and quality assurance. The offeror's management plan must show that the firm is organized to efficiently complete the tasks in a timely and effective manner.

- Firm should make available their most recent peer review report, which shows that they have adequately met all standards.
- Key personnel should have experience managing audits.

4. References *Maximum points 10*

GLOSSARY

ACCOUNTING PRINCIPLES GENERALLY ACCEPTED IN THE USA (GAAP) THE conventions, rules and procedures necessary to define accepted accounting practice at a particular time. GAAP includes not only broad guidelines of general application but also detailed practices and procedures, and provides a standard by which to measure financial presentations.

ACCRUAL THE accounting basis whereby revenues and expenses are indentified with specific periods of time, such as a month or year, and are recorded during the period in which they occur, without regard to the date of receipt or payment of cash; distinguished from cash basis.

ASSETS An owned physical object (tangible) or right (intangible) having economic value.

AUDIT an independent examination of accounting records and procedures for the purpose of forming an opinion about an organization's financial statements.

AUDIT EVIDENCE documentation which supports transactions; this is third party, auditor prepared, and/or client prepared.

BALANCE SHEET See statement of financial position

CASH BASIS a method of accounting whereby revenues and expenses are recorded when received (in the case of "cash in") or when paid out, without regard to the time period in which the event to which they apply occurred.

CONFIRMATION LETTER

FIELD WORK the auditor's tests of transactions and account balances, much of which is done on site

FINANCIAL STATEMENTS a complete set of financial statements for not-for-profit organizations consists of the statements of financial position as of the end of the financial period (formerly, balance sheet); statement of activity (formerly, statement of support, revenue, expenses and changes in fund balance) for the reporting period; statement of cash flows for the reporting period; statement of functional expenses (only required for voluntary health and welfare organizations); and notes to financial statements.

FISCAL YEAR an accounting period of 12 consecutive months which is established by an organization according to a variety of management and reporting considerations

FUND BALANCE See net assets

Internal control those elements of accounting procedures designed to give management reasonable assurance that assets are safeguarded from unauthorized use or disposition and that financial records are sufficient for the preparation of reliable financial statements.

Liability amount owing by one entity to another; in accrual based accounting, a debt recorded when it occurred, but not yet paid.

Management letter a letter from an auditor to a client which communicates the auditor's observations and recommendations regarding improvements in accounting practices, internal control and operation procedures. Content is outlined under Statements of Auditing Standards, 115 (SAS).

Management representation letter a statement from client management to the auditor in which management acknowledges that the financial statements are its responsibility, and that important matters stated to the auditor during the course of the audit engagement are true to the best knowledge and belief of management. This statement is required on every audit under generally accepted auditing standards.

Materiality the relative importance of any item which may be included or omitted from the financial statements; any procedure or change in procedure which might affect the financial statements. Calculated before audit begins – roughly 5-10% of the smaller of revenue or assets.

Net assets the excess assets of an entity over its liabilities. There are three different categories of net assets: unrestricted, temporarily restricted, and permanently restricted net assets. Refer to *Statement of Financial Accounting Standards No. 117* for a definition of each category of net assets.

Reconciliation bringing the balances of two or more related accounts into agreement; a statement detailing the differences between two or more accounts

Revenue contract income and grants from governmental agencies; also program service fees, sales of books or materials, investment income, gains (or losses) on sales of assets.

SAS Statements of Auditing Standards which establish the format of the auditors work

Source document evidence of an event or decision which caused an accounting transaction to occur, e.g. purchase order, payroll time-card, check request voucher.

SFAS No. 117 this pronouncement of the Financial Accounting Standards Board, effective for fiscal years beginning after December 15, 1994, sets standards for the display of financial statements for not-for-profit organizations, particularly reporting restricted and unrestricted assets.

Single audit federal audit requirements for federal funds.

Statement of financial position a statement disclosing the assets (cash, equipment, etc.) liabilities (loans, accounts payable, etc.) and the net assets of a not-for-profit organization as of a point in time.

Support income over which a 501(c)(3) organization has no control, that is, which is voluntarily given (e.g. contributions).

Surety bond an agreement under which a person or corporation such as an insurance company becomes surety to pay, within stated limits, for financial loss caused to another by the act or default of a third person or by some contingency over which the principal may have no control.

Trial balance a list of account balances used to determine that debited and credited amounts have been posted equally (in double entry bookkeeping), and used to establish a basic summary of account balances for financial statements.

Variance the difference between corresponding items in a budget supporting a grant application or service contract and the actual expenditures.

Yellow Book the name commonly used to refer to governmental auditing standards published by the U.S. General Accounting Office.

Sample Internal Control Activities

Cash Receipts

Segregation of duties in the handling of cash is one of the most effective ways to gain control over this asset. No individual is to have complete control in the handling of cash. Specifically, no one individual's duties should include the actual handling of money, recording receipt of money, and the reconciliation of bank accounts or with the state treasurer. Employees handling cash are to be assigned duties that are complementary to or checked by another employee.

Incoming cash must be made a matter of record as soon as possible.

Two persons should open the mail when they expect cash or checks in the mail. Remittances by mail are listed in duplicate at the time the mail is opened. A person other than the one opening the mail prepares the listing. One copy of the listing is forwarded to the cashier with the receipts. The other copy forms the basis for accounting controls through ledger posting. A third person periodically compares the listing with the deposit.

Amounts of currency contained in each item of mail are verified. Documents enclosed with the currency received are machine date stamped or dated and initialed by the employee opening the mail.

A secure area is needed for the safeguarding and processing of cash received. Access to the secured area is restricted to authorized personnel only. The secured area is locked when not occupied.

Cash is protected by the use of registers, safes, or locks, and kept in areas of limited access.

Collections made over the counter or in the field are documented by the issuance of sequentially pre-numbered official receipts or through cash registers or automated cashiering systems. All such receipts are to be strictly accounted for and the reason for any missing documents determined and documented. Blank form receipts are not used. Receipts indicate mode of payment, such as cash, check, etc. The total dollar amount recorded on cash receipt forms, by mode of payment, is balanced daily to total cash, checks, etc. collected.

The cash receiving function of an agency is centralized to the extent possible.

When cash is received in branch offices, it is to be transmitted to the central office through the banking system. Branch office personnel are restricted to making cash deposits and central office personnel make any cash withdrawals and reconcile bank accounts.

A balance and summary of all cash receipts is prepared daily. Any shortages or overages are carefully investigated and, to the extent possible, corrected.

Receipts are deposited intact on a daily basis. In the handling of cash and making of deposits, security procedures that will best safeguard the cash asset are to be followed.

Authenticated, duplicate deposit slips are retained and compared with amounts recorded in cash receipts records.

A person other than the cashier or receivable bookkeeper makes the bank deposit.

Moneys are picked up or delivered to appropriate authorities on a scheduled basis.

Adequate records are maintained to assure the correct handling and final disposition of items held in suspense. Suspense accounting is eliminated whenever possible by the direct deposit of the item to the correct fund and account. However, deposits are not to be delayed because the account distribution cannot be immediately determined.

Cash receipts retained on the premises overnight are minimized and locked up in a secure place, such as a safe.

Cashiers are prohibited from cashing personal checks or notes of personal indebtedness.

Written procedures on all cashiering and cash control procedures are maintained by each agency.

Petty Cash

Petty cash accounts, other than change accounts, are to be established and maintained as bank checking accounts whenever possible. Only minimal amounts of petty cash are kept on hand.

Petty cash accounts are on an imprest basis.

Responsibility for a petty cash account is vested in only one person.

Original (no photocopies) receipts or vouchers bearing the signature of the payee support all disbursements from petty cash accounts.

Petty cash checking accounts are reconciled monthly by a person other than the custodian.

Surprise counts of petty cash are made periodically by a person other than the custodian.

If a postage meter is used:

- The postage meter book is properly completed and maintained.
- Purchases of postage are made only by check.
- Purchases of postage credited to a meter are regularly confirmed with the Post Office.
- Purchases of postage are compared periodically with usage.

If a postage meter is not used, proper control is to be exercised over postage stamps.

Disbursements - General

The responsibility for disbursement procedures is clearly documented and assigned to specific personnel of the agency.

Disbursements are handled in such a manner as to ensure that the proper funds and accounts are charged; that the disbursement is used only for authorized purposes; and that laws, rules, and regulations governing the disbursement are followed.

Controls are established to assure that all payments are made on a timely basis and in accordance with all purchase orders and contracts.

Controls are established to ensure that duplicate payments are not made.

Original invoices (or authorized facsimiles) totaling the amount of the disbursement are to be attached to each voucher before payment.

Employee duties in the handling of disbursements are separated to the extent possible with regard to:

- The initiation of purchase requisitions and field orders.
- The approval of vouchers, invoices, and warrant registers.
- The preparation of warrants/checks.
- The mailing of warrants/checks.
- The recording of disbursements.
- Each cash disbursement is properly vouched and approved by the proper authorities of the agency before the actual disbursement occurs. This will ensure the proper and regular review of all disbursements.

To the extent possible, employee duties in this area are to be complementary to or checked by another employee.

Disbursements are to be made by warrant/check or journal voucher. Where payments are made by check, counter signatures provide an additional control.

Blank warrants/checks are to be kept in locked storage under the control of a designated, responsible employee. Access to blank warrants/checks is limited to this employee and a designated alternate. When blank warrants/checks are received; the date, quantity, and inclusive serial numbers are recorded and added to the total balance on hand.

When warrants/checks are required from the locked storage, the individual requesting the warrants/checks completes a requisition form. The custodian of the warrants/checks records the date, quantity issued, inclusive serial numbers, and the new balance on hand on the control form.

A separate record is maintained for each warrant/check series issued or voided. The record for voided warrants is to include the date voided, inclusive serial numbers (if more than one warrant in a series is voided), quantity voided, reason for voiding, and initials of individual taking action.

The custodian and a responsible supervisor take a physical inventory of the entire stock of blank warrants/checks on a monthly basis. The quantity and inclusive serial numbers of all warrants/checks on hand at the beginning of the period, and receipts, issues, voids, and warrants/checks on hand at the end of the period are recorded on an appropriate form. Separate forms are completed for each warrant/check series, and furnished to a designated supervisor by the warrant custodian. If the physical inventory agrees with the book inventory, certification of this fact, signed by the custodian and supervisor who assisted in the taking of the physical inventory, will accompany the forms. Any variance between the book or computed quantity of blank warrants/checks and the actual quantity determined by the physical inventory is to be reported to the designated supervisor immediately.

Disbursements - Travel

Formally adopted, written internal policies and procedures, are established to control the utilization of meals, coffee, and light refreshments at meetings and formal training sessions.

Authorization of travel is exercised through use of a Travel Authorization Form, or other equally effective means.

Travel Expense Vouchers are signed by the employee and approved by the agency head or authorized designee.

Travel Expense Vouchers of agency heads are to be signed by the chief financial officer certifying that the reimbursement complies with state travel regulations.

The Agency Fiscal Officer reviews travel Expense Vouchers and supporting documentation of agency heads reporting to the governor.

The Executive Director does not approve his or her own expenses.

Reimbursement for air transportation in greater than tourist class or its equivalent are approved in writing in advance by the agency head or authorized designee.

Prior written approval for travel outside the continental USA, or British Columbia, Canada, by employees of agencies is obtained.

Prior to payment, the agency copy of the Transportation Request is matched to the transportation provider's copy, or the customer copy of the credit card receipt (attached to the Travel Expense Voucher) is matched to the monthly statement from the credit card company, whichever is applicable.

Unused credit cards and blank stock of Transportation Request forms are inventoried and kept under lock.

Persons who authorize commercial transportation are not to receive tickets or use the transportation.

The employee responsible for the choice of locations and facilities is to submit justification in writing to the agency head or authorized designee when a convention, conference, or meeting is held at a non approved facility.

The agency head or designee must approve in writing prior to an individual authorizing any direct billing and direct payment of travel allowances.

Disbursements - Local Checking Accounts

Bank checks are pre-numbered.

Bank checks are completely filled out before being presented for signature.

Someone maintains physical control of checks other than persons originating disbursement requests.

Spoiled or voided checks are retained and the signature blocks on the checks are removed.

If a check-signing machine is used, the signature plate and use of the check-signing machine is kept under control of the official whose name appears on the signature plate or an authorized designee.

Dual signatures are required on all checks or checks over a certain dollar amount.

Bills or vouchers are presented with checks for signature.

Bills or vouchers are marked "Paid" only at the time checks are signed.

Someone mails checks other than the person preparing the checks.

Someone approves bills for payment other than the persons who sign checks.

Bank statements are reconciled at least monthly by an employee not involved in cash receipt or disbursement procedures.

The bank statement and band reconciliation are initialed and dated by the approving person.

PURCHASES

Pre-numbered purchase and field order forms are used and strictly accounted for by number.

Invoices are matched with purchase orders and receiving reports before approval for payment.

Invoice computations and pricing are verified before approval for payment.

Invoices are paid in a timely manner so that discounts may be taken.

Monthly statements are compared with accounts payable balances.

Purchases should be made by competitive solicitation, when applicable.

Payable Subsidiary Ledgers are reconciled to the control accounts monthly.

Copies of the order forms are distributed to receiving and accounting departments.

Claims are filed promptly for goods damaged in shipment.

Investments and Securities

The authority to purchase, exchange, or sell investments and securities is to be clearly defined.

The custody of securities is the responsibility of a person not authorized to purchase, exchange, or sell securities. The securities are kept in a safe deposit box or vault. Access to the securities is to be strictly controlled. No single person is to have complete control of vault combinations or keys. Access to the securities is to require the presence of at least two designated officers.

The accounting department maintains a detailed record of each investment and security. The custodian also maintains a record of securities deposited or withdrawn.

Employees handling and having access to securities are closely supervised or reviewed by other employees.

Periodic checks are made to verify that all income due has been received.

Periodic evaluations of the performance of investment portfolios are to be performed by authorized personnel independent of investment portfolio management activities.

Receivables

There is a segregation of duties with regard to billing, collection, cash receiving, receivables accounting, and the maintenance of general ledger control accounts.

Receivables are made a matter of record promptly upon the completion of the acts which entitle the agency to collect the amounts owed it. Separate accounts are to be maintained for each major category of receivables in order to ensure the clear and full disclosure of the agency's resources in its financial reports. Controls are established so that receivables are reported in the proper funds and accounts.

Records of receivables are strictly guarded. Limited access to these records as well as the physical protection of them is required.

Control accounts are balanced with the detailed ledgers at least monthly.

Officials not involved in the collection activity approve credit adjustments to receivable balances. The use of pre-numbered credit memorandum forms is desirable.

Receivable accounts are reviewed periodically for credit balances.

There is an independent verification of quantities, prices, and clerical accuracy of billing invoices.

Billings are prompt and statements are sent to all customers on a regular basis.

Receivable accounts are aged at least monthly and reviewed by authorized personnel.

Controls are established to ensure the prompt follow-up of past due receivables.

Authorized individuals are responsible for receiving and issuing the supplies and merchandise for an agency. These individuals are to be responsible for inspecting all goods received to verify that they conform to specifications. In addition, these persons are responsible for the enforcement of all policies necessary for the internal control of these assets.

Specific central points for receiving and issuing supplies or merchandise are determined. All loading and unloading operations are closely supervised.

Receiving reports and issue reports are prepared for all receipts and issues.

Quantities received are compared to the bill of lading and receiving report.

Effective control procedures are established to ensure that state supplies are used properly and for authorized purposes.

Supplies and merchandise not currently in use are stored in areas where access is limited to authorized personnel only. Storerooms or warehouses where such property is kept are locked when not occupied and during other than normal working hours. Special protective measures are taken for items having a high pilferage rate or a high value.

An actual physical inventory count of all state supplies and merchandise is made periodically. Causes for differences between quantities determined by physical inspection and those shown on accounting records are investigated and, to the extent possible, improvements in procedures are made to prevent future error or losses. The responsible official brings accounting records into agreement with the physical inventories after authorization.

Physical inventories are taken and certified by personnel acting under written instructions.

Inventories are taken by personnel other than those normally responsible for inventories.

A perpetual or periodic inventory record is maintained to reflect dollar value and quantities of merchandise for resale and significant supplies inventories.

Supplies and merchandise are arranged so that the earliest received or produced will be issued first.

Damaged and obsolete goods are physically segregated.

Supplies and merchandise are kept neat.

Payroll

Responsibilities for supervision and time keeping, personnel, payroll processing, disbursements, and general ledger functions should be assigned to provide segregation of duties.

A person other than the employee's immediate supervisor distributes payroll warrants.

Personnel other than employees connected with preparation of payroll distribute forms W-2.

Detailed records of hours worked are maintained and approved, as appropriate.

Payroll charges should be reviewed before disbursements are made.

Payroll charges, including fringe benefits, should be recorded and distributed accurately and promptly.

Written procedures are required for authorization, recording, and controlling sick leave, vacations, holidays, overtime, compensatory time, and stand-by time.

Procedures are established to ensure that all attendance reports and payroll reports are verified by supervisory personnel.

Payroll records and reports should be adequately safeguarded.

Approved reports should be initialed and dated when reviewed and approved.

Automated Data or Information Processing

The Information Services (IS) department is independent of the accounting and operating departments for which it processes data.

An appropriate segregation of duties is maintained within the data processing function for system development (design and programming), technical support (maintenance of systems software), and operations.

Controls are established and followed for the preparation and approval of input transactions outside the IS department. These controls prohibit the IS department from initiating and processing transactions without the approval of affected users.

Controls are established over completeness and accuracy of input, processing and output.

Controls are established for error correction of rejected transactions.

Controls are established over entry of data in on-line systems to restrict access to terminals and data entry to authorized employees. Password security should be established on an individualized basis.

User controls include user reconciliation of output totals to input totals for all data submitted, internal reconciliation of file balances, and the review of outputs for reasonableness.

Controls are established over the use and retention of tape and disk files, including provisions for retention of adequate records to provide backup capabilities.

Controls are exercised over changes to system software.

Controls are in place which safeguard and limit access to data processing equipment, tapes, disks, files, system documentation, and application program documentation to authorized employees.

Written documentation of procedures are established and followed by computer operators.

A written and tested contingency plan is in place providing for continued processing of critical applications in the event of a disaster to the computer facility.

Controls are established for the use and contents of personal computers.

General

Accounting records are neat and in proper order.

Accounting records are kept current.

Employees take periodic vacations and other employees then perform their work.

Internal audits are performed.

Authorized personnel approve journal entries.

A current organizational chart is maintained and followed.

Appropriate documentation of procedures exists for all agency systems and functions such that the organization could continue to operate if key employees leave.

The accounting department is headed by a financial executive with the appropriate background, skills and training.

Reviewed reports are initialed and dated upon review.

INTERNAL CONTROL CHECKLIST

An effective internal control system enables you to manage significant risks and monitor the reliability and integrity of financial and operating information. It also ensures that the audit committee acts as a powerful and proactive agent for corporate self-regulation. The Committee of Sponsoring Organizations of the Treadway Commission developed the following questions to help senior executives and directors gain a better understanding of their organizations control systems.

ETHICAL ENVIRONMENT

Do board members and senior executives set a day-in, day-out example of high integrity and ethical behavior?

Is there a written code of conduct for employees? Is it reinforced by training, top-down communications and periodic written statements of compliance from key employees?

Are performance and incentive compensation targets reasonable and realistic, or do they create undue pressure for short-term results?

Is it clear that fraudulent financial reporting at any level and in any form will not be tolerated?

Are ethics woven into criteria used to evaluate individual and business unit performance?

Does management react appropriately when receiving bad news from subordinates and business units?

Are business risks identified and candidly discussed with the board of directors?

RISK ASSESSMENT AND CONTROL ACTIVITIES

Is relevant, reliable internal and external information timely identified, compiled and communicated to those positioned to act?

Are risks identified and analyzed and actions taken to mitigate them?

Are controls in place to ensure management decisions are properly carried out?

Does management routinely monitor controls in the process of running the organizations operations?

Are periodic, systematic evaluations of control systems conducted and documented?

AUDIT COMMITTEE EFFECTIVENESS

Are audit committee members functioning independently of management?

Do committee members possess an appropriate mix of operating and financial control expertise?

Does the committee understand and monitor the broad organizational control environment?

Does the committee oversee appropriateness, relevance and reliability of operational and financial reporting to the board, as well as to investors and other external users?

Does the committee oversee existence of and compliance with ethical standards?

Does the committee or full board have a meaningful but challenging relationship with independent and internal auditors, senior financial control executives and key corporate and business unit operating executives?

INTERNAL AUDITING FUNCTION EFFECTIVENESS

Does internal auditing have the support of top management, the audit committee and the board of directors?

Does internal auditing have and use open lines of communication and private access to all senior officers and the audit committee?

Is there an internal audit plan (reviewed by the audit committee) describing internal audit responsibility?

Source: Internal Control — Integrated Framework by the Committee of Sponsoring Organizations of the Treadway Commission, 1993.

SAMPLE FINANCIAL STATEMENTS