

“The Real Deal”

Best Practices in

Internal Controls, Financial Statements, Management Tools

(with a Twist of Risk Assessment)

Presented by:

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Ethan Kahn is an audit manager and member of ERE's Not-for-Profit Group. He has dedicated his services to the nonprofit sector for nearly a decade. As a manager, Ethan is been responsible for overseeing financial statement facilities—including those requiring audits pursuant to *OMB Circular A-133*—and pension audits of not-for-profits, engaging in strategic planning for clients looking to expand or having to deal with significant future occurrences, and assessing whether clients have maximized on their reimbursement rates from funding sources. Ethan's audit findings and recommendations have consistently been well accepted and have significantly improved his clients' operations.

Prior to joining the firm, Ethan served as an assistant controller for a large nonprofit organization and managed the government grants to assure the accuracy and adherence to contractual requirements, and administered the voucher and budget process.

He has conducted audits for a broad range of nonprofit organizations, some of which were previously served by national and international firms. Clients served include schools, fundraising and membership organizations, research foundations, public advocacy organizations, and "rehabilitation".

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Today's Goals

- Introduction to internal controls
 - Risk assessment
 - Deficiencies
- Internal controls
- Financial statements
- Management tools

Internal Controls—Risk Assessment

Understanding “Risk Assessment”

- Why do we need it?
- What is it?
- How to assess risk
- Response(s)

Internal Controls—Risk Assessment

- Why do we need risk assessment?
 - Identify risks so you can manage them
 - Roadmap to internal controls
 - Platform for accurate reporting
 - Informed decisions
 - Running smooth operation

Internal Controls

Importance of internal controls:

- NPOs collectively accountable for \$2 trillion+ in assets; fast growing industry (annually, approximately 67,000 organizations approved for tax exemption)
- Risk management
- Accountability
- Governance
- Ethics

Internal Controls—Risk Assessment

■ What is risk assessment?

- Identifying vulnerable areas in an organization that are prone to error or fraud
 - Fiscal
 - Program
 - Development
 - Information technology
 - Identify risk areas in **your** organization

Internal Controls—Risk Assessment

What is risk assessment?

- Assessing the risk of
 - Misappropriation of assets
 - Erroneous or fraudulent financial reporting
- Noncompliance with contractual agreements
 - Government contracts
 - Operational contracts

Internal Controls—Risk Assessment

How to assess risk—the thought process

- Understand the organization
- Identify areas where error/fraud can occur
- Quantitative and qualitative factors
- Consider where “organization” is at risk
 - Monetary damage
 - Reputation damage

Internal Controls—Risk Assessment

Response to risk assessment:

- Determine risk direction
- Develop internal controls to address issues
- Risk assessment policy
 - Implementation: policy acknowledgment form

Internal Controls—Deficiencies

■ Control Deficiency

- Control does not allow management or employees in the normal course of business to prevent or detect misstatements on a timely basis.

■ Significant Deficiency

- Control deficiency adversely affects the entity's ability to authorize, process, or report financial data reliably in accordance with GAAP—more than remote likelihood that misstatement that is more than inconsequential will not be prevented or detected.

■ Material Weakness

- When a significant deficiency exists that results in more than a remote likelihood that a material misstatement will not be prevented or detected.

Internal Controls—Deficiencies

- Establish mitigating controls
- Deficiencies are not reported in the normal GAAP financial statements, however they are reported in the A-133 financial statement reports
- Some governmental entities will request the letter of deficiencies and corrective actions

Internal Controls—Deficiencies

- The significance of a deficiency depends on the potential for a misstatement, not on whether a misstatement has actually occurred.
- Conversely, the absence of identified misstatement does not provide evidence that a control deficiency is not a significant deficiency or material weakness.

Internal Controls—Deficiencies

■ Examples of deficiencies commonly found:

1. Significant accounting services
2. Inadequate segregation of duties
3. Not safeguarding assets
4. Lack of timely reconciliations
5. Insufficient monitoring of internal controls
6. Inability to prepare financial statements
7. Employee fraud

Internal Controls

Understanding “Internal Controls”

- What are internal controls
- Importance of internal controls
- How to create effective internal controls
- First step in moving forward

Internal Controls

What are internal controls?

- Processes and procedures used (tools) to run a proficient and prudent operation
 - Operations consist of transactions
 - Processing
 - Recording
 - Reporting
- Mitigating controls
 - Address the inevitable weaknesses

Internal Controls

Consider internal controls for:

- Adhering to mission
- Good governance
- Compliance
- Efficiency

Internal Controls

- Provide clarity of responsibilities and roles
- Reduce risk of loss
- Promote sound fiscal management
- Meet expectations of external monitoring agents
- Serve as reference point during litigation, non-compliance, staff transition

Internal Controls

Importance of internal controls:

- Checks and balances
- Building blocks for staying focused on mission and compliance
- Accurate reporting; diminishes risk
- Clarity of transactions
- Oversight agencies
- Litigation protection
- Applicability: all levels including board of directors

Internal Controls

How to create effective internal controls:

■ Processes and procedures analysis

- Minimize vulnerability to perpetrate fraud
 - Segregation of duties
 - Board Members
- Manager understanding all tasks performed
 - Rotation of duties
 - Avoids fraudulent activity
 - Adds new perspective
 - Future of an organization remains within its processes
 - » Employees carry out process – mission and passion

Internal Controls

General controls to look out for:

- Catch input errors (\$1,000.00 to \$100,000)
- Service provided but not invoiced/vouchered
- Double entry of information (invoice, payment)
- Entry to wrong account
- Allocations
- Year-end transactions

Internal Controls

Common controls to look out for:

- Cash received

- Recorded on general ledger
- Timely deposited to organization's bank account
- Board approves new and closing accounts
- Timely reconciliations
- Wire transfers

- Revenue – recognized when earned

Internal Controls

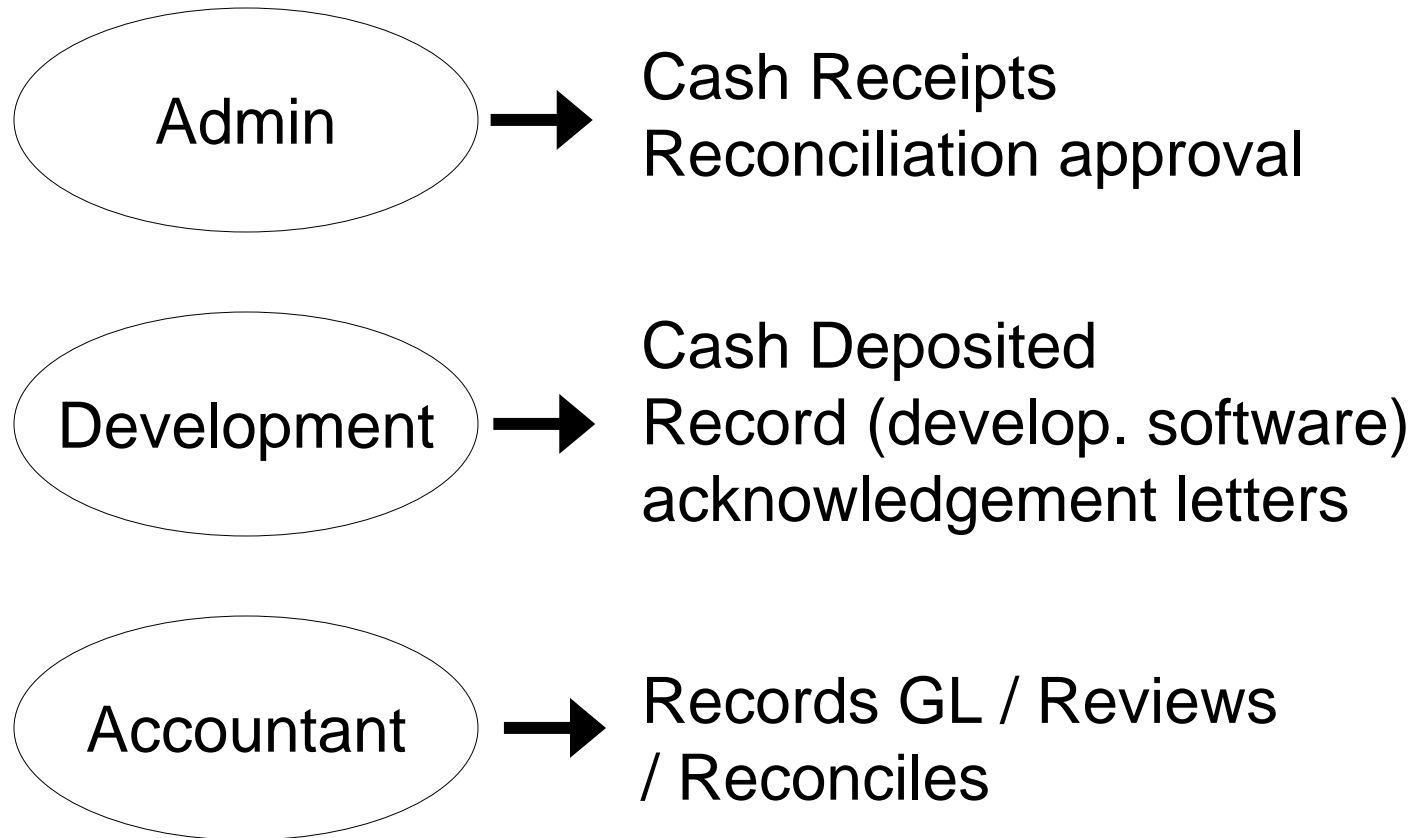
- Expenses – recognized when incurred
 - Purchases authorized
 - Purchase orders
 - Reconcile amounts ordered, received, paid for, recorded on general ledger
 - Proper approval
 - Bidding

Internal Controls

- Expenses – recognized when incurred
 - Unused checks stored securely
 - Payroll
 - Background check
 - Required licenses and certifications
 - Increases have proper authorization
 - Time sheets

Internal Control:

Sample Segregation of Duties



Internal Controls

How to create effective internal controls:

- 3 Examples ... (Fact and Appearance)

- Cash/Revenue
- A/P Expenses
- Payroll

Internal Controls

How to create effective internal controls:

- Design / documentation of analysis: the “Policies & Procedures Manual”
 - Financial information
 - Preparer
 - Reviewer/approval (document)
 - Reconciliation
 - Policies: board-approved

Internal Controls

How to create effective internal controls:

- Implementation – “Buy-in”

- Board
- Management
- Employees
- Consultants

- Monitoring

- Monthly
- Quarterly
- Annual reviews (internal audit)

Internal Controls

First steps forward:

- Objective evaluation
- Develop flow charts or other visual assistants
- Speak to independent auditor
 - Corrective action plan
 - Deficiencies
 - Develop internal audit function

Questions?

Financial Statements

■ Meeting the requirements of:

- New York State Charities Bureau
- Board of directors
- Lending institutions
- Granting agencies
 - Federal government (OMB A-133)
 - SED – Consolidated Fiscal Report (CFR)
 - Foundations

Financial Statements

■ The statements:

- Opinion Letter
- Statement of Financial Position
- Statement of Activities
- Statement of Changes in Net Assets
- Statement of Functional Expenses
- Statement of Cash Flows
- Notes to Financial Statements

Financial Statements

■ Opinion letter:

- Auditors' vs. organization's documents
- Managements responsibility
- GAAP – Accrual
- Unqualified opinion
- US GAAP vs. IFRS
- Economic meltdown: going concern assessment

Audit Opinions

"Unqualified"	<ul style="list-style-type: none">➤ Considered a "clean opinion"➤ States that financial statements are "presented fairly"
"Qualified"	<ul style="list-style-type: none">➤ Financial statements have one or more material problems➤ Raises awareness of issues in the opinion letter
"Adverse"	<ul style="list-style-type: none">➤ Financial statements do not conform to GAAP➤ Readers are provided "no assurance" on the figures
"Disclaimer of Opinion"	<ul style="list-style-type: none">➤ "No opinion" on financial statements➤ Auditors were unable to apply auditing standards

Financial Statements

Opinion letter:

■ Going concern assessment

- Substantial doubt about ability to continue for reasonable period of time
- Matters that jeopardize an entity's ability to operate
- Additional paragraph in auditors' opinion letter
- Financial statement note disclosure
- Consider merger or acquisition

Financial Statements

Statement of Financial Position:

- “As of” year end, not for the “year ended”
- Assets, Liabilities, and Net Assets
 - Sequenced by order of liquidity
 - Current vs. noncurrent
 - Disclosure in notes about liquidity
- Cash Balance
 - Should be positive
 - Safeguarding of assets
 - High cash balance may be questioned by funders

Financial Statements

Statement of Financial Position:

- Receivables
- Investments
- Unearned revenue
- Maintain roll forward schedules
- The multiple year end confusion
- Temporary restricted net assets and Board designated funds

Financial Statements

Statement of Financial Position:

■ Investments

1. Policy
2. Relationship with the advisor
3. Committee
4. Ask the questions
5. Signs of issues

Financial Statements

Statement of Activities:

- For the period ended
- Income, expenses, and net assets
- Special events
- Net income vs. net deficit
 - Analyze several years side by side

Financial Statements

Statement of Activities:

■ Net asset classifications

- Unrestricted
 - Internally restricted
- Temporarily restricted (by donor)
- Permanently restricted (endowment)
- Releases of restrictions

Financial Statements

Statement of Changes in Net Assets:

- How net assets increased and decreased throughout the audit period
- Combined in statement of activities vs. separate statement

Financial Statements

Statement of Functional Expenses:

- Required by voluntary health and welfare organizations
- Expenses presented based on functional and natural classifications in a matrix format
- Overall analysis

Classifying Expenses

Statement of Functional Expenses:

■ Personnel Services

➤ Salaries

- Vacation and compensated absences

➤ Fringe Benefits

- Payroll taxes, insurance, and pension

■ Other Than Personnel Services (OTPS)

Financial Statements

Statement of Functional Expenses:

- Program and supporting services
 - Program services – expenses by program
 - Supporting services – expenses allocated to management and general and fundraising
- Appropriate allocations
 - Salaries and fringes
 - Depreciation
 - Telephone
 - Others

Financial Statements

Statement of Functional Expenses:

- Expense line items
 - Unusual titles
 - Suspense account
 - Unallocated funds
 - Exchange accounts
- Useful tool for internal use – snapshot of entire year by program
 - Compare expenses in each program
 - See which line items seem out of character
 - Consider chart of accounts agreeing to these line items

Financial Statements

How does the organization allocate its resources?

The percentage of funds spent by the organization in each functional area (non-authoritative)

<u>Program Expense</u> Total Expense	<u>Mgmt. & General Expense</u> Total Expense	<u>Fundraising Expense</u> Total Expense
Benchmark: 65% – 70%	Benchmark: 20% – 25%	Benchmark: 10% – 15%

Financial Statements

Why might the program ratio be less than 65%?

- Organization is new
- Expenses are being misallocated
- Organization is in the midst of unusual transaction – acquiring capital or building administrative capacity
- Spending on programs is too low

Financial Statements

Statement of Cash Flows:

- Examines the changes in the balance of cash
- Begins with change in net assets and ends in year end cash balance
- Divides sources and uses of cash among the following activities:
 - Operating
 - Investing
 - Financing

Financial Statements

Statement of Cash Flows:

■ Operating

- Reconciliation
- Increases and decreases

■ Investing

- Purchased asset (fixed assets)
- Investments (purchases, sales)

■ Financing

- Principal payments on mortgage, loans etc.
- Proceeds from notes payable (increase in)

Financial Statements

Notes to Financial Statements:

- Tie to statements
 - Accounts receivable
 - Investments
 - Fixed assets
 - Other
- Verify mission and programs
- Be clear on what your auditor is putting into notes – these are **your** financial statements

Management Tools:

Common Functions & Time Budgeting

Marketing/
Client Relations

Development/
Donor Relations

Purchasing

Office Management &
Admin Services

Grant & Contract
Compliance

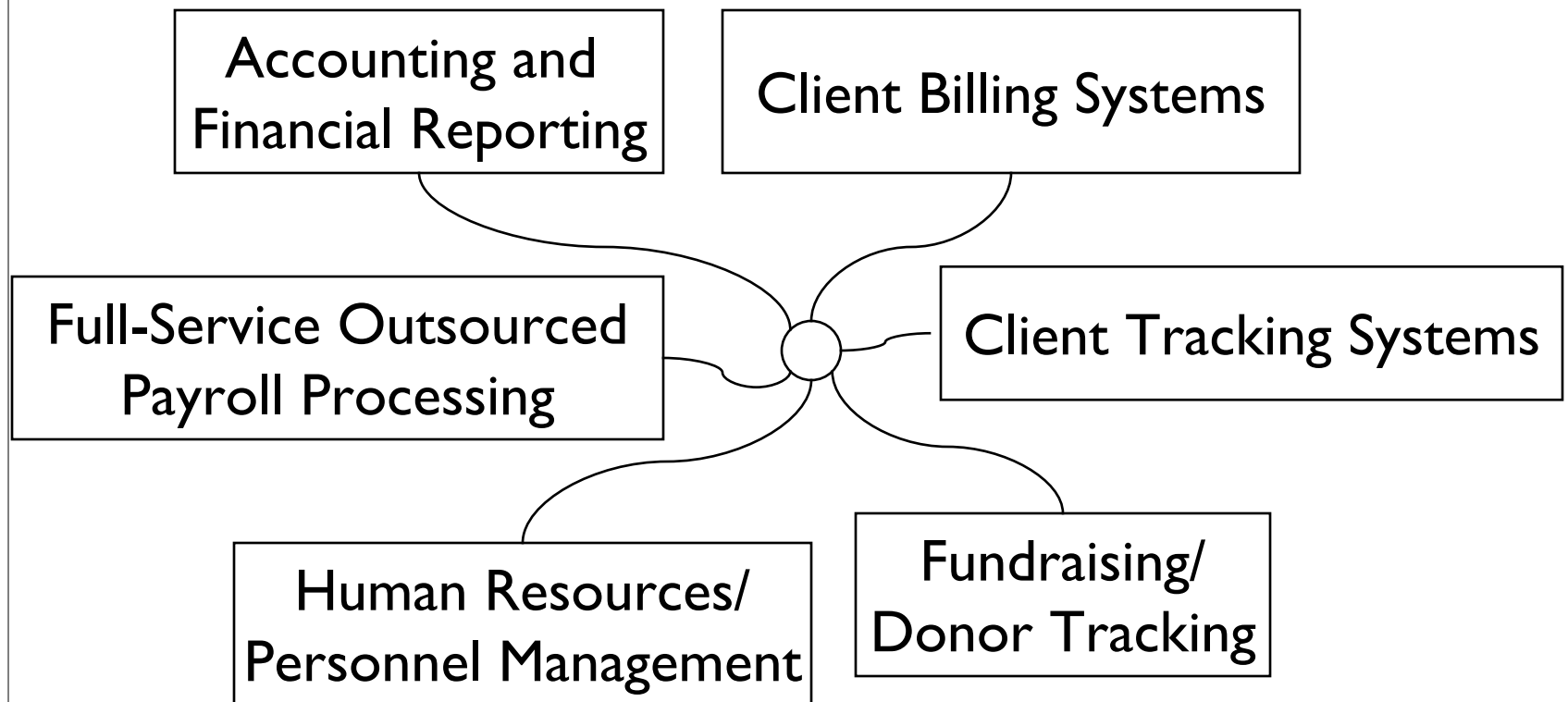
Technology and
MIS support

Risk
Management

Human
Resources

Management Tools: Common Information Systems

Critical Systems



Management Tools

Executive level financial data:

- White papers – “less is more”

- 3-column schedule

- A/R white paper
 - A/P white paper
 - Government grants white paper
 - Professional fees white paper

- Analyze with financial statements

Management Tools

5-Tier model for supporting schedules:

1. Financial statements – summary of trial balance accounts
2. Trial balance – multiple G/L accounts grouped together
3. Trial balance account detail – detail generated by the G/L software
4. Summary schedule (“white paper”) describes what specific accounts are comprised of limited just relevant information.
5. Transaction detail – detail of all entries made during the year (each invoice and transaction from the whole year)

Management Tools

Best Practices:

- Finance Committee and Audit Committee
- Chart of accounts – management's opportunity to track according to reporting expectations
- Budgeting
 - Budget-to-actual
 - Budget assumptions
 - Program and administrative budgets
 - Communicate the budget
 - May involve projections
 - Bring all related departments into the analysis

Management Tools

Best Practices:

- Maintain a permanent records file
 - Corporate documents, contracts, agreements, board's minutes, employee benefit plan documents, policies, reports
- Form 990 – view from funding entity's perspective
 - Allocations – donors
 - Governance
 - Narratives
- Federal vs. non-federal funds

Management Tools

Best Practices:

- Financial ratios – at times need the industry standard
 - % Admin to Program
 - % Admin to total
 - % Fundraising to total
 - Other ratios

Management Tools

Best Practices:

■ Delegation Do's

- Understand your staff member's potential
- Understand the task before you delegate
- Reward performance

■ Delegation Don't's

- Control freak
- Assume delegation = expedited job

Questions?

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