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Reviewing Financial Transactions:

Board and Staff Roles in Internal Controls and Audit Functions

A Risk Management Webinar
July 2, 2008

Generous funding for this webinar was provided by the Public Entity Risk Institute (www.riskinstitute.org).

Topics for Today's Program

- Overarching goals of financial management and financial *risk* management
  - ❖ What are they?
  - ❖ How are they different in the nonprofit sector?

Topics for Today's Program

- What is the Board's role?
- What are the barriers to the board discharging its duties?
- What can staff do to empower the board?

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Topics for Today's Program

- What is the staff's role?
- What can, should and *must* the staff do to discharge its duties to the organization?

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Topics for Today's Program

- What does the term "internal controls" mean?
- What is an independent audit?
- What is an audit committee?
  - ❖ Do we need one?
- What do we need to know about SAS 112?!

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Financial Management Goals

- Compliance and Accountability
  - ❖ Compliance = "The act of complying with a wish, request, or demand; acquiescence."
  - ❖ Accountability = The state of being accountable
    - ➢ Accountable: "subject to the obligation to report, explain, or justify something; responsible; answerable." (www.dictionary.com)
    - ➢ *Department of Defense Dictionary of Military and Associated Words: "The obligation … for keeping accurate* records of property, documents, or funds. The person having this obligation may or may not have actual possession of the property, documents, or funds. Accountability is concerned primarily with records, while responsibility is concerned primarily with custody, care, and safekeeping."
- Availability of resources for their highest possible use
- Accurate tracking of incoming and outgoing funds

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Financial Management Goals

- Goal: providing timely reports to key stakeholders on overall financial condition of nonprofit as well as specific results:
  - Overall financial condition:
    - Is the nonprofit viable? What are its prospects for mission fulfillment?
    - What is required to sustain the organization
  - Specific financial results:
    - What is the return on investment for specific programs?
    - What does it cost to deliver services? – per client, per program, per activity
    - How has the organization spent grant, contract and donated funds? Earned income?
  - Stakeholders: internal organizational leaders, funders/donors, staff/volunteers, regulators

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Goals of Financial Risk Management

- Identifying, measuring, and minimizing risk to financial assets while maximizing accountability to stakeholders, fiscal integrity and mission-fulfillment.
  - Protecting assets ($$, reputation) needed for...
  - Mission fulfillment
    - use of resources for mission-critical activities

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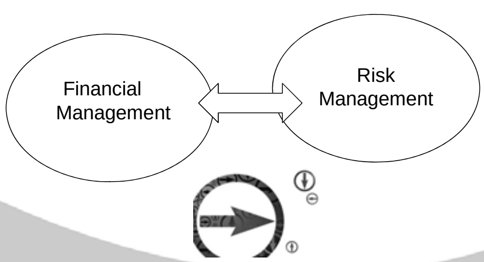
Two Disciplines Intersect



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Nonprofit Distinctions

- What's the same? What's different?
  - ❖SAME: accurate reporting, potential criminal penalties, stakeholder reliance on information
  - ❖DIFFERENT: intense scrutiny of nonprofits; resource and regulatory constraints; lack of basic financial literacy on many boards

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Financial Risk Management is most effective when...

- It becomes embedded in the nonprofit's culture
  - ❖ intuitive
- It doesn't rest squarely on the CFO's shoulders… instead, it's a shared responsibility
  - ❖ employees
  - ❖ management
  - ❖ board of directors
  - ❖ professional advisors

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Why Quality Reporting Matters

Public Confidence in Charitable Organizations, New York University's Organizational Performance Initiative, March 2008

- Survey of 1001 respondents conducted on behalf of the *Organizational Performance Initiative* at New York University's Robert F. Wagner Graduate School of Public Service shows **four patterns** that should worry charitable organizations and sector leaders.
- *Source for analysis and commentary*:
  Paul C. Light, The Brookings Institution

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Pattern #1

- **Charitable confidence has not risen significantly since it hit bottom in 2003**. As of September 2002, 37 percent of Americans reported having "not too much" confidence in charitable organizations or "none at all." As of March 2008, 34 percent gave the same rating, a figure that is well within the ±3 percent margin of error in both surveys.

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Pattern #2

- **Americans remain skeptical of charitable performance**. Only 10 percent of the Americans interviewed in March 2003 said charitable organizations did a "very good job" spending money wisely; 17 percent gave the same rating to running programs and services, and being fair in decisions; and 25 percent gave the same rating to helping people. In other words, a vast majority of Americans rated charitable performance on these four tasks as either "somewhat," "not too good," or "not good at all."

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Pattern #3

- **The considerable drop in the ratings of helping people poses a serious challenge to the sector's distinctiveness as a destination for giving and volunteering**. As of October 2003, 34 percent of Americans said charitable organizations did "very good" in helping people; in March 2008, only 25 percent gave that same rating. This statistically significant drop is the most troubling finding in the survey.

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Pattern #4

- **Estimates of charitable waste remain disturbingly high**. As of March 2008, 70 percent of Americans said that charitable organizations waste “a great deal” or “fair amount” of money. ***This figure has risen 10 percentage points since October 2003***. Although Americans estimate that big business and government waste <u>even more money</u>, charitable organizations seem bound and determined to catch up.

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Risks to our Sector?

- Falling confidence:
  - ❖Fewer donations, grants and contracts
  - ❖Fewer service and leadership volunteers and fewer eager applicants for paid positions
- Increasing regulation at the federal and state levels
  - ❖ AGs, IRS, Senate Finance Committee, state legislatures… and more!

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How Should We Respond?

- “I’m just the CFO!” (don’t shoot the messenger)
- Timely, accurate reporting
- Engagement of leaders
  - ❖ Board must be schooled in reviewing financial transactions/presentations *and* empowered to do so
- Commitment to disclose the “bad news”

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Red Flags

- Leaders don't know how much organization owes and don't know how to find out.
- Nonprofit consistently spends more than it receives.
- It takes a great deal of time and effort to generate regular financial reports.

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Red Flags

- Critical income sources are declining and no plans are in place to replace these sources of funding or curtail expenses accordingly.
- Board *won't* or *can't* participate in resource development efforts of the organization.
- Nonprofit dips into restricted or deferred funds for current expenses.
- Receivables are mounting.

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Rules for "Good" Financial Management

Alan Strand, California Association of Nonprofits

- Don't squeeze expenses into categories where they do not belong.
- Do track and report fundraising costs.
- Do establish an audit committee even if not required to do so.
- Do account for restricted grants properly.
- Do use footnotes on financial statements and tax returns, especially to address red flags and out-of-the-norm ratios.

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More Rules for "Good" Financial Management

- Do present financial statements to the board or finance committee MONTHLY.
- Do think about outcome measurement, not just cost-based information and devise ways to measure the effectiveness of programs (ROI).
- BE CONSISTENT in your reporting.
- Do INSIST on the board's involvement in financial management policies:
  - Accounting Policy and Procedures Manual updated annually
  - Employee Handbook reviewed periodically by an attorney licensed in your state
  - Regular performance reviews
  - Conflict of interest statements executed by board and staff and kept up to date
  - Board approval of executive compensation; documented!
  - Board training on reviewing nonprofit financial statements

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What is the Board's Role?

- Oversight of financial management policies, procedures, and transactions
- Related to discharging the duty of care

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What are the barriers?

- Lack of time
- Lack of interest?
- Lack of knowledge?
- What else?

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What's Required to Discharge the Duty of Care with regard to the Nonprofit's Finances?

The board MUST:

- Have a keen interest in the fiscal affairs of the nonprofit, including its overall, current financial position; the reliability of the reports the board receives; and the effectiveness of the nonprofit's management of incoming and outgoing funds.
- Require regular, timely and complete financial reports.
- Be in position (and have sufficient opportunity) to ask critical questions about the financial reports the board receives, including budgets, periodic financial statements, the annual Form 990 and annual, audited financial statements.

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What can the staff do to empower the board?

- Design and arrange for appropriate training
- Add questions/interactive components to the board's deliberations
- Obtain outside help/guidance

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What are the consequences of failing to provide appropriate oversight?

- "The finances of a national teacher-recruitment program have come under scrutiny by the federal government, reports *The New York Times.*
- According to the inspector general at DOE, Teach for America did not provide adequate documentation as to how it spent federal grant money it received from 2003 to 2005. The group received about $6-million in grants, and of that amount, auditors examined $1.5-million. Teach for America couldn't account for $775,000 of the figure auditors looked at." (Reported in *Chronicle of Philanthropy* on June 9)

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What is the staff's role?

- Managing day to day financial activities
- Keeping the board up to speed on key developments
- Presenting policy options and seeking the board's approval as and when needed

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What can, should and must the staff do to discharge its duties?

- Apply expertise and training
- Identify resource and training needs
- Keep leaders informed; support decision-making
  - ❖Communicating difficult news!
- Empower the board
  - ❖Recognize reluctance to admit lack of understanding

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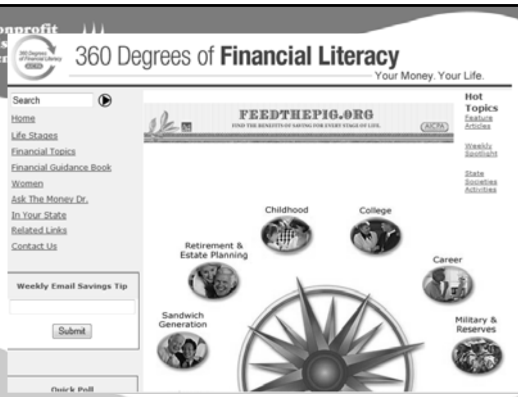

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What are "Internal Controls"?

- Source: **www.nonprofitsassistancefund.org**
  - ❖**Internal controls:** The system of practices, procedures and policies intended to safeguard the assets of the organization from fraud or error and ensure accurate recordkeeping.
- Designing internal controls at your nonprofit: focused, feasible, and followed
- Where is your organization with regard to maturity and resources? What is the appropriate role of the board?

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What is an independent audit?

- **Audit:** A financial report that has been tested and verified for accuracy and prepared in accordance with Generally Accepted Accounting Principles. An essential component of the audit is the Opinion Letter.
- **Independent**

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What is an audit committee?

- Do we need one?
- Why? Why not?
  - ❖What's the difference between an audit committee and a finance committee?
    - ➢See supplementary handout…

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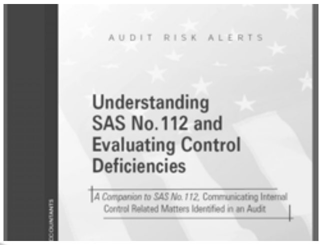
What do we need to know about SAS 112?

- Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit*



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What is SAS 112?

- Attempt to guide auditors in their efforts to *identify* and *evaluate* control deficiencies during an audit, and then communicate with management and governing bodies decisions that are *significant* or *material weaknesses*.

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Unconditional Requirements of SAS No. 112

- Auditor must:
  - ❖Evaluate control deficiencies and determine if they are significant or material weaknesses
  - ❖Communicate, in writing, significant deficiencies or material weaknesses previously identified but not remedied issues to management and governance

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Did you know?!

- Auditors are NOT required to perform procedures to IDENTIFY control deficiencies…
- They are required to notify management/governance if they become aware of deficiencies in the design or operation of internal controls.

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Did you know?! Change from SAS No. 60 to SAS No. 112

- The term “reportable condition” has been retired…
- “Significant deficiency” and “material weakness” are the new terms
  - ❖ **Significant deficiency:** “control deficiency… that adversely affects the entity’s ability to initiate, authorize, record, process, or report financial data reliable… such that there is more than a remote likelihood that a misstatement of the entity’s financial statements that is more than inconsequential will not be prevented or detected.”
  - ❖ **Material weakness:** “significant deficiency… that results in more than a remove likelihood that a material misstatement of the financial statements will not be prevented or detected.”

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Risk Management in Auditing!

- Auditors consider the following measures from the discipline of risk management:
  - ❖Likelihood (how likely, how often)
  - ❖Magnitude (how significant, how costly)

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According to AICPA:

- Most common misunderstanding about SAS No. 112 is:
  - "belief that the auditor's drafting of the client's financial statements automatically results in a material weakness. Asking the auditor to draft the financial statements does not cause a control deficiency; however, it may be the result of a control deficiency. A control deficiency exists if the client does not have controls over the preparation of the financial statements, including the footnote disclosures, which would prevent or detect a misstatement in the financial statements."

Key Underlying Concepts – SAS 112

- The auditor cannot be part of a client's internal control. Becoming part of a client's internal control impairs the auditor's independence.
- What the auditor does is independent of the client's internal control over financial reporting. Therefore, the auditor cannot be a compensating control for the client.
- The client's designation of an individual who possesses suitable skill, knowledge, and/or experience to oversee a service performed by the CPA (Ethics Interpretation 101-3 *Performance of Nonattest Services*) is not a control. Therefore, having such a designated person does not mean that the client does not have a control deficiency.

Key Underlying Concepts – SAS 112

- SAS No. 112 does not require the auditor to search for control deficiencies, but rather to evaluate them if they have been identified.
- A system of internal control over financial reporting does not stop at the general ledger; rather it includes controls over the preparation of the financial statements.
- To properly apply SAS No. 112 the auditor has to have a working knowledge of the COSO framework. COSO's *Internal Control-Integrated Framework* describes the elements of internal control over financial reporting. SAS No. 112 directs the auditor to evaluate control deficiencies when identified, and communicate certain deficiencies to management and those charged with governance.

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Experience as a Risk Management Tool

- "Our experience is the only thing about which we may be completely sure. Everything else we think we know is merely inference."
  - ❖ *Rene Decartes*
- "Once we have an experience, we are thereafter unable to see the world as we did before."
  - ❖ *Daniel Gilbert – "Stumbling on Happiness"*

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Resources

- **www.CAnonprofits.org**
  - ❖ **Click on "Programs," then follow links to "Reporting" or "Financial Services"**
  - ❖ Warning customers about duplicate purchases
- **http://canbootcamp.blogspot.com**
  - ❖ **There you will find:**
    - ➢ **IRS Publication Links & Downloads**
    - ➢ **Articles**
    - ➢ **A place to ask and respond to questions**
    - ➢ **Other resources!**

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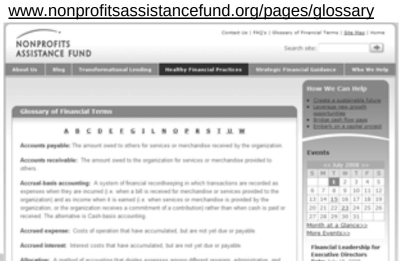
Glossary of Financial Terms

www.nonprofitsassistancefund.org/pages/glossary



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Reach out for Help!

- Nonprofit Risk Management Center
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  - Melanie@nonprofitrisk.org

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