



Council Financial Audits A Workshop

Purpose: To present and discuss the need for audits of council financial records and to introduce a process for performing audits with council resources.

Learning Objectives:

1. To understand the importance of sound financial accounting and reporting in your council.
2. To identify the options available for completing financial audits.
3. To present a process for completing financial audits using council resources (Financial review).
4. To develop an action plan for completing a financial audit for your council.

- Agenda:**
1. Discuss the responsibility of Council Board of Directors for financial oversight.
 2. Discuss the benefits to the council of maintaining sound financial records and reporting.
 3. Identify methods for completing a council financial audit.
 4. Present a financial review process for council use.
 5. Finalize action plans.

Limit: 1 Hour

Overview

The Council Board of Directors is accountable for governance of the council in order to protect the public interest. One program that is used for financial oversight is the **council financial audit**. Let's start with your ideas. **First**, what are some reasons why councils might audit their financial records? List them below as "Supports Audits" and rank them. **Next**, think of reasons why councils do not audit their financial records. List them below as "Deters Audits" and rank them. Complete the list working by yourself, then we will share our results and discuss how to overcome resistance.

<u>Supports Audits</u>	<u>Ranking</u>	<u>Deters Audits</u>	<u>Ranking</u>

Generally, councils do not perform audits due to *resource constraints* (time, money, expertise) or *to avoid conflict*. In this workshop we will present strategies to address each of these issues.

Importance of Financial Audits

A business must perform financial audits in order to attract investors, protect investor interests, borrow money, or satisfy state and federal regulations. A Council Board of Directors usually wants to conduct financial audits to encourage continuing financial support of council activities and programs. Additional reasons cited are to protect against lawsuits and to maintain the council's tax-exempt status. The goal of a financial audit is to insure, insofar as is feasible, that all financial records are **accurate and complete** and appropriately included in the council's financial reports for the year.

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Every council should have their financial records audited periodically - at least every two years or any time a new Treasurer is elected. Some boards neglect this important accountability, believing "an audit is an accusation" of suspected malfeasance! Nothing could be further from the truth. The incoming and outgoing Treasurer should both want to know that everything is in order when accountability shifts - for their own protection! Potential donors may ask to see audited financial records before making contributions to council programs. The donor wants to know that their money is being used for the purpose of the donation. The Council Board of Directors wants to properly represent the interests of the council and provide protection against lawsuits. Whatever the reason, financial audits are a good practice and are not threatening *when performed regularly*.

Audit or Review?

A certified financial audit must by law be conducted by Certified Public Accountants (CPAs) or Public Accountants (PAs) in most states. A CPA or PA can give an opinion on the accuracy of financial statements and the adequacy on internal controls to protect the public interest. The CPA or PA can also *make recommendations* for procedures to improve controls, such as requiring two signatures on checks over a certain dollar value. The CPA or PA may also address the adequacy of the council's accounting and bookkeeping practices, as well as funds management (e.g. timely processing of checks or other funds received). The board, by acting upon these recommendations and documenting their decisions in board minutes, is demonstrating their accountability for governance **and may insulate themselves from lawsuits**. So what can a council board do to get a certified financial audit?

The first option is to pay for the audit. Councils with adequate financial resources and major corporate donors to protect may chose this option. However, for most councils, the practical option may be to get the audit performed *pro bono*. A council may have an accountant on their board who is a CPA or PA and is willing to lead an audit team of council volunteers. The board may decide to recruit an accounting firm as a Community Affiliate member and place a partner on their board to provide this expertise. Another option is to ask a local Corporate or Community Affiliate member to influence their firms accountants to do the audit *pro bono*. One last option is to seek a barter arrangement for the audit with a customer of your council.

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If the audit cannot be completed by a professional accounting firm, the Board should appoint an Audit Committee to complete a *financial review*. The term review is used because the procedures recommended in this workshop are similar to those employed by a CPA or PA in conducting an audit, but *lack the professional opinion of a CPA or PA*.

Audit Committee Considerations

Committee Members. The audit committee should consist of no less than three persons, appointed by the board to conduct the audit. Membership does not have to be restricted to Navy Leaguers if outside talent is available (e.g. a Supply Officer from a Sea Services unit or the Comptroller from a local organization). Members should have experience in evaluating financial records, in accounting procedures, or in auditing (financial or non-financial). Audit committee members should have no involvement in managing council finances (handling of financial or accounting functions) during the period being reviewed, nor should they related to anyone who manages council finances.

Audit Procedures. The audit procedures described in this workshop are the minimum that should be carried out by the audit committee. Additional procedures, suggested by committee members, that are helpful and appropriate in light of specific circumstances encountered by the committee, can be adopted. Adoption of additional procedures or increasing the scope of the audit should be driven by circumstances. The Council Board of Directors should authorize the review procedures and empower the committee to act in the best interest of the council as the situation demands.

Scope. Council Financial Audits should include all funds that the council manages, including council operational funds, scholarship funds, restricted funds and Sea Cadet funds. The audit team must be told which period to audit - i.e. the annual financial statement, or the period since the last audit if more than a year. The audit team should also be authorized to increase the scope of the audit if significant discrepancies are found.

Review Procedure

Gather records. The council treasurer, bookkeeper and secretary should collect the following records and make them available to the audit committee:

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- All bank records for the year (or for the period being audited), including bank statements, cancelled check stubs, deposit slip copies, savings account statements and documentation related to savings certificates, certificates of deposit, brokerage accounts or other financial investments of the council. The records for every account of the council or other related organizations (for example, Sea Cadets) must be obtained.
- Any records of cash receipts and disbursements must be presented.
- Periodic financial reports provided to the Council Board of Directors. These records typically include budgets, monthly financial reports, the annual financial report and any special reports or statements (for example, financial records from fundraisers or special events).
- Minutes of the Board of Directors meetings for the period covered.
- The Council Annual Report, if completed.
- Quarterly membership totals, separated into the membership categories listed on page 23 of the Navy League Operations Manual. Separate the records into new members and renewals for each membership category. Include Community Affiliate Members.
- Any other financial books, ledgers and records regularly maintained, including software report printouts.

The council's system of accounts (classifications and definitions) should also be collected to assist the audit team in the review.

Review receipts. Receipts for most councils include member rebates received, money received from fundraisers and special events, net revenue from regular meetings, and net revenue from sales. Perform the following steps to review receipts:

1. Rebates. Compare rebates received with membership records for each classification (page 23, NLUS Operations Manual) to confirm receipt of all rebate revenue. Explain any significant difference. Verify that all rebates have been posted to revenue appropriately (in the correct account for rebate revenue).
2. Council dues. If the council collects local dues. select a random sample (10% of members suggested) of council members and verify that council dues were received and posted correctly.
3. Fundraising. Select a random sample of donations (suggest 10% of all donation checks received) and verify that each check was posted to revenue appropriately (in the correct account for the donation). Include "50-50" funds raised at meetings.

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4. Meetings. Select a sample from meetings (typically 2-3) and verify that all receipts were documented, expenses deducted, and net revenue posted to the correct account. Net revenue should be used to account for meetings to avoid exceeding the \$25,000 annual revenue hurdle, which requires filing a Form 990 with the IRS.
5. Other revenue. Other revenue typically comes from sales of Navy League products to members or the public. Special accounts may have been set up for large events to track receipts and expenses for net revenue. Select a sample from these other revenue accounts and verify all receipts and net revenue from events have been posted appropriately. Miscellaneous income, such as interest on savings accounts, should be posted to the source of the revenue. Reconcile any significant differences.
6. Miscellaneous. Review the Board meeting minutes and the Council Annual Report to verify that all special events, donations and revenue sources identified therein have been correctly posted to the appropriate account.

Review disbursements. Disbursements should be reviewed to verify their accuracy and that proper approval was obtained for the disbursement.

1. Expense approval. Determine the procedures followed for the approval of expenses. Normally, some type of invoice or document (receipt) approval system is in effect, supported by explicit or implicit authority to approve payment at various levels. Review a sample of paid bills (10% recommended) to evaluate compliance with the approval procedure.
2. Budget performance. Compare major account totals with the budget and the previous year(s) expenses and obtain explanations for any significant differences (perhaps 5% budget variation).
3. Reconciliation. For one month picked at random (recommend January, April, July, or October, when rebate checks are posted) and for the month of December, perform a reconciliation of all monthly bank statements. This procedure provides assurance about the appropriateness of bank reconciliation and receipts for the months reviewed, but its' most critical purpose is to insure that all checks written are recorded in the council records.
4. Operational expenses. Identify major items (suggest over \$100) charged to each operating account to determine that expenses have been properly classified. Locate supporting documents for the sampled items and evaluate adequacy of the document and proper approval for payment. Unsupported or unapproved disbursements should be investigated further.

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5. Endorsements. Review endorsements on a sample of cancelled checks for agreement with payee. Verify that the council's check signing policy was followed (for example, if all checks over \$500 require two signatures, were they present). Investigate any discrepancies.
6. Special accounts. Review disbursements from special accounts (e.g. scholarship funds or adopted unit funds) to determine that such funds were used or paid out as designated.
7. Salaries. If salaries covered by Social Security were paid during the year, review the quarterly reports (Form 941) to the IRS. Determine 1) that the earnings shown in these payroll reports agree with the salaries in the financial statements, 2) that the employer's share of Social Security remittances per the reports agree with the payroll tax expense in the financial statements, and 3) that checks remitting payroll taxes to the IRS agree with dates and amounts reported on Form 941. Investigate any discrepancies. Note that "contractor fees" in excess of the "Nanny Tax" level (\$1300 in 2003), if paid to any single individual in the year, may also be subject to Social Security taxes. Validate the determination as to whether to pay Social Security taxes or not.
8. Tax reporting. If salaries have been paid during the year, year-end reporting to employees and the IRS is generally required on Form W-2. Contract labor and other non-salary payments for personal services generally require reporting on Form 1099 if more than \$600 was paid to any individual. Review records to insure that reporting requirements have been met and compare amounts reported with related expense totals in the financial statements.
9. Investments. Handling procedures for any financial assets not reflected in the bank accounts (e.g. stocks, bonds, notes, CDs, etc) should be reviewed. Their existence should be verified by physical examination unless held in a "street name" account. Verify the currency of any income due from these assets and verify proper posting of this income. Evaluate the security of their custody and safekeeping.
10. Insurance. The audit committee may review insurance expense and insurance coverage, although responsibility for determining the adequacy of insurance coverage belongs to the Council Board of Directors.
11. Taxes. If property is owned which is subject to ad valorem taxes, utility district taxes or assessments, etc., review files of renditions, assessments, tax bills and paid receipts. Verify that any such payments are correctly reported in financial statements and that there are no delinquent obligations.

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12. Debt. Any year-end statements or other documentation related to indebtedness should be reviewed to determine that interest and principal paid during the period examined and the debt balance at the end of the period agrees with the same items found in financial reports. Any interest expense not identifiable as related to indebtedness, but reflected in the financial statements, should be investigated. If a year-end statement or other documentation is not available from the creditor, mortgage or bond indebtedness may be confirmed by direct communication with the lender.

Reporting. The final duty of the Audit Committee is to prepare a report to the Council Board of Directors that documents their findings. The report should contain three elements:

1. A cover letter addressed to the Board of Directors and signed by all members of the Audit Committee. The *opinion* of the committee should be stated as follows:
"We believe the _____ Council financial records accurately and completely present the financial condition of the council." In the negative case, insert the words "do not" after "...financial records"
2. A copy of the year-end financial statements, as reviewed, including both a balance sheet and an income or cash flow statement.
3. A list of concerns identified by committee members about discrepancies discovered, adequacy of the system of accounts (too few, inappropriate classification or too many) and adequacy of financial controls. Each concern identified generally has the committee's recommendation for improvement.

The Council Board of Directors should review the Audit Committee Report and accept or reject each recommendation forwarded. Decisions should be documented in Board Meeting Minutes.

Exercise

Purpose: *To prepare your council for a review and list action items to initiate the review. This exercise should be completed by the Council Board of Directors.*

- Action:**
1. *Discuss need for completing an audit or review. If a certified audit is desired, select an option to complete the audit from the workshop options presented and complete the action plan below.*
 2. *For a review, prepare a list of candidates for Audit Committee membership. Committee members should not be authorized to approve or sign checks for the*

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council, should not be responsible for preparing financial records and should not consist of Board members only. Members with accounting and bookkeeping experience or experienced auditors (non-financial) are particularly desired for this committee. Financial experience is also valuable.

3. *Review the Audit Review Procedure presented in this workshop and modify to suit your council's needs.*
4. *Prepare an action plan to recruit an audit team, and set a schedule for completion.*

<i>What action is needed?</i>	<i>Who will complete this action?</i>	<i>Is Board approval required?</i>	<i>When will action be completed?</i>	<i>Remarks</i>

5. *Schedule a follow-up meeting to review progress until the review is completed.*

Limit: *This exercise should take 30 minutes.*

The End!