Common Mistakes in Financial Statements

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WIPFLI

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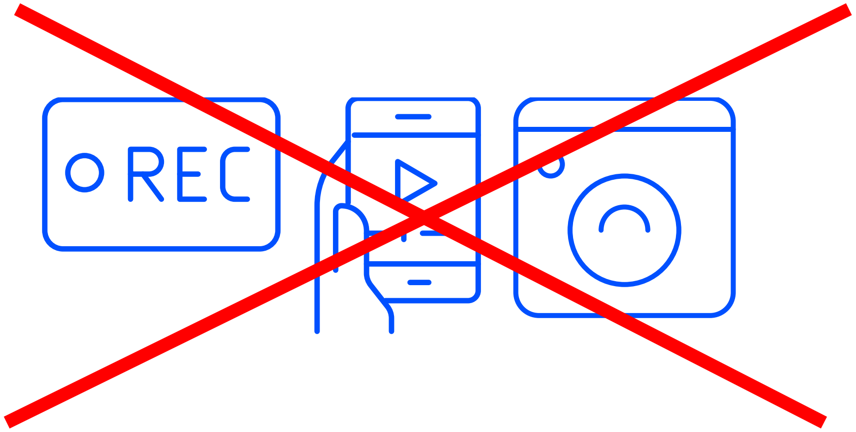

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Agenda

- Identify and review common errors that auditors find during annual audits and how to avoid them or prepare a response to them
- Explore the difference between a significant deficiency and a material weakness
- Discuss how to respond to audit findings

Audit Findings

- Financial statement audit
  - Not required to perform procedures around internal control to:
    - Identify deficiencies in internal control
    - Express an opinion of the effectiveness
  - Obtain an understanding
    - May become aware of deficiencies
    - Influenced by the nature, timing, and extent of audit procedures performed, as well as other factors

What is an Internal Control Deficiency?

Control Deficiency	Significant Deficiency	Material Weakness
Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.	Deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.	Deficiency, or combination of deficiencies, in internal control such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected and corrected on a timely basis.

A reasonable possibility exists when the likelihood of the event is either **reasonably possible** or **probable**.

Deficiencies in Internal Control – What are they?

- A deficiency in **design** exists when:
  - A control necessary to meet the control objective is missing; or
  - An existing control is not properly designed so that, even if it operates as designed, the control objective is not always met.

- A deficiency in **operation** exists when:
  - A properly designed control does not operate as designed; or
  - When the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

Common Financial Statement Errors

Common Financial Statement Errors

- Financial Statements Errors
  - Financial statement amounts are not supported by general ledger amounts
  - Statement of Financial Position

Improperly classifying assets and liabilities	Net assets not agreeing between statements	Statement not balancing	Footing and cross-footing the totals
Missing necessary information	Debt issuance costs not shown net of debt	Net asset classification	

Common Financial Statement Errors

- Financial Statements Errors (cont.)

Statement of Activities	Functional Expenses

• Improper presentation
  • No functional expense breakdown
  • Failure to show activity based on net asset restrictions
  • Failure to recognize releases from restriction
• Improper classification of expenses
	• Improper presentation in the financial statements
	• Improper classification of expenses
	  • Management and General
	  • Program
	  • Fundraising
	• Totals not agreeing to other financial statements

Common Financial Statement Errors

- Financial Statements Errors (cont.)
  - Statement of Cash Flows

Improper classifications

Amounts presented do not match the rest of the report

Missing supplemental disclosures

Common Financial Statement Errors

- Financial Statements Errors (cont.)

Statement of Cash Flows	Footnote Errors
• Improper classifications • Amounts presented do not match the rest of the report • Missing supplemental disclosures	• Do not agree with financial statements • Missing/applicable footnotes and/or information • Outdated footnotes

Common Financial Statement Errors

- Supplemental Information Errors
  - Schedule of Expenditures of Federal Awards (SEFA)

Expenditure amounts do not agree to underlying records or audited balances

Incorrect program name and CFDA Number

Missing necessary information

Failure to identify clusters

Missing or incorrect information in the notes to the SEFA

Common Financial Statement Errors

- Supplemental Information Errors (cont.)
  - Supplemental Schedules (varies by entity)
    - Balances do not agree with financial statements, footnotes etc.

OIG Findings

OIG Report Findings

Ineffective controls and accountability over its assets

- Assets not adequately safeguarded – inventory issues
- Bank reconciliations not timely and duties not properly segregated
- Grant drawdowns not always supported
- Employees did not obtain approval for credit card purchases

Questionable methods used to allocate shared costs

- Some shared costs may have been incorrectly allocated – couldn't explain method
- Vacation, holiday and sick pay incorrectly allocated – didn't follow salary allocations, used predetermined percentages
- No method for allocating shared equipment costs – did not address method

OIG Report Findings

Ineffective controls and accountability over funds	Procurement	Assets not adequately safeguarded
• Payroll – timesheets not signed • Bank reconciliations - not timely, several months late, not signed off by preparer and reviewer	• Related requirements were not always met • Failure to obtain competitive bids or perform cost or price analysis	• Failure to follow property management standards – equipment records incomplete

OIG Report Findings

Unallowable costs claimed/ Costs did not benefit the program

- Costs did not directly benefit the program
- Equipment did not benefit the program; sat idle for over a year
- Unallowable salaries and wages – wages for other programs charged to the HS program
- Unnecessary storage costs – storing obsolete and useless items and old files
- Costs not allocated in proportion to benefits received

OIG Report Findings

Non-federal share was not always supported

- Non-federal share was not supported by documentation, therefore disallowed and subsequently did not have enough
- Non-federal share claimed was partially paid for by Federal funds
- Home activities were not specific, only said "home task" etc.
- Facility costs not supported
- Signatures missing

Accounting records were not always supported by source documentation

- Invoices missing
- Valid approval signatures missing
- Proof of payment missing
- Incorrect account classification
- Incorrect invoice amounts were paid

OIG Report Findings

- First agency's questioned costs $4,700+
- Second agency's questioned costs $550,000+

Questioned Costs

Wipfli Findings

Sample Findings

- MATERIAL ADJUSTMENTS
  - During our audit, Wipfli LLP proposed multiple adjusting journal entries which we deem to be material in relation to the financial statements. These entries were subsequently recorded by management. Since The NPO’s internal controls did not detect and correct these adjustments prior to the audit, a material weakness exists in The NPO's controls over year-end close and financial statement preparation.

Preventable? How?

Sample Findings

- INTERNAL CONTROLS
  - While significant changes were made during the year to correct internal control deficiencies identified in previous audits, Wipfli LLP identified the following two internal control matters which constitute a significant deficiency in internal controls:
    - We selected a sample of 10 adjusting journal entries for testing. In our sample, it was noted that two of the journal entries were not supported by adequate documentation to substantiate the adjustment. In addition, two of the entries did not contain approval for the entries.

Preventable? How?

Sample Findings

- INTERNAL CONTROLS (cont.)
  - While significant changes were made during the year to correct internal control deficiencies … (cont.):
    - At September 30, 20xx, a number of invoices totaling approximately $400,000, were not recorded in accounts payable. Management was aware of the issue at the time of the audit, and significant reconciliation was required and performed on vendor account balances in order to determine the ultimate liability. Subsequently, management made an adjustment to accounts payable during the current audit year to properly reflect the actual liability.

Preventable? How?

Sample Findings

- INTERNAL CONTROLS (cont.)
  - During the audit of The NPO, the following internal control matters were identified which constitute a material weakness in internal controls:
    - We noted the Finance Director is the administrator for the general ledger accounting software, is an authorized check signer, receives the bank statements unopened, and reviews the bank reconciliation. As a result, there is not proper segregation of duties surrounding cash as the Finance Director has custody and control of cash.

Preventable? How?

Sample Findings

- INTERNAL CONTROLS (cont.)
  - During the audit of The NPO, … material weakness… (cont.):
    - We noted a check with a November date that was issued to pay an invoice dated in December for approximately $3,500.
    - We selected a sample of 10 adjusting journal entries. In our sample, it was noted that five of the journal entries were not supported by adequate documentation to support the adjustment. In addition, four of the entries contained only the approval of the Finance Director. We were unable to determine who the preparer of the entries was. This is a repeat finding.

Preventable? How?

Sample Findings

- INTERNAL CONTROLS (cont.)
  - During the audit of The NPO, ... material weakness... (cont.):
    - At the time of audit fieldwork, significant accounts were not reconciled and adjusted. Grants receivable, accounts payable, and grant funds received in advance were eventually reconciled by management after fieldwork but prior to issuing the audit report. This is a repeat finding.

Preventable? How?

Sample Findings

- PHYSICAL INVENTORY OF GRANT-FUNDED EQUIPMENT
  - During our audit, Wipfli LLP noted inadequate evidence to indicate The NPO performed a physical inventory of grant-funded equipment in the last two years, with an appropriate reconciliation to the general ledger.

Preventable? How?

Sample Findings

- ALLOWABLE COSTS/ COST PRINCIPLES
  - During our audit, Wipfli LLP noted that The NPO was incorrectly allocating shared costs intended as contract and service costs for one federal program to multiple other programs. This resulted in overcharging federal, state, and local program funds for approximately $76,000, of which $23,000 applied to the major program under audit. Because The NPO's internal controls failed to detect and correct this error, there is a significant deficiency in internal control that resulted in a noncompliance.

Preventable? How?

Sample Findings

- EXPENSE ACCRUALS
  - During our audit, Wipfli discovered The NPO does not accrue expenses to the appropriate fiscal period; items are expensed when paid. The financial statements are materially correct as adjusting journal entries were posted to remedy the deficiency. The finding did not affect any completed grants during the year; however, the lack of expense accrual affected the monthly grant reporting process at year-end.

Preventable? How?

Sample Findings

- GRANT REPORTING AND CASH MANAGEMENT
  - The final Financial Status Report filed with DHHS for the Head Start grant ending July 31, 20xx, was obtained to determine if the total reported federal expenses were supported by the general ledger. Upon examination of The NPO's Head Start expenses recorded for the above grant, it was noted that $4,300,000 in federal expenses were recorded in the general ledger, while The NPO reported, and received reimbursement for, total federal expenses of $4,375,000.

Preventable? How?

Sample Findings

- FINANCIAL ACCOUNTING AND REPORTING
  - The preparation of annual GAAP financial statements requires an accounting standards expertise. In order to prepare GAAP basis financial statements, The NPO requested Wipfli LLP to assist in preparing the GAAP basis financial statements as part of our professional services for the year ended September 30, 20xx. Our assistance in the preparation of The NPO's financial statements represents a significant deficiency in internal control over financial reporting.

Preventable? How?

Sample Findings

- ACCOUNT BALANCE ADJUSTMENTS AND FINANCIAL STATEMENT PREPARATION

  - During the audit, Wipfli LLP proposed several adjusting journal entries for grant revenue, grant expense, grants receivable, and property and equipment which we deem to be material in relation to the financial statements. An organization's internal control over financial reporting does not end at the general ledger but extends to the preparation of the financial statements and notes.

  - As part of our professional services for the year ended December 31, 20xx, Wipfli LLP made significant adjustments to the financial statements and related footnotes. Since The NPO's internal controls did not discover the adjustments prior to our audit, and management relies on Wipfli LLP to provide the necessary understanding of current accounting and disclosure principles in the preparation of the financial statements, a material weakness exists in The NPO's internal controls over these areas.

Preventable? How?

Sample Findings

- DATA COLLECTION FORM FILING
  - It was determined that the Data Collection Form (DCF) for the year ended September 30, 20xx, was not submitted to the Federal clearinghouse within the earlier of 30 days after receipt of the auditor’s reports or nine months after the end of the audit period.

Preventable? How?

Case Study

Case Study

- Segregation of Duties
  - The organization has a single accountant handling the day to day operations. This individual handles collections, billings, and general ledger maintenance.
  - How would you report this?

Management Comment

Significant Deficiency

Material Weakness

Case Study

- Lack of Segregation of Duties could be reported as:

Management comment	Significant Deficiency	Material Weakness
• The auditor has discussed this with management. • The effects of this finding are not material to the financial statements; there are compensating controls.	• The auditor has disclosed this in the Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on Audit of Financial Statements Performed in Accordance With Government Auditing Standards and on the Schedule of Findings and Questioned Costs. • The auditor has discussed with management and management and the auditor have agreed that the compensating controls in place do not mitigate the risk to an acceptable level.	• The auditor has disclosed this in the Independent Auditor's Report on Internal Control Over Financial Reporting and on Compliance and Other Matters Based on Audit of Financial Statements Performed in Accordance With Government Auditing Standards and on the Schedule of Findings and Questioned Costs. • The auditor has discussed with management and management and the auditor have agreed that there are no compensating controls and the financial statements are at risk to be materially misstated.

Case Study

- How will we respond to the auditor?
  - Why the lack of segregation of duties?
    - Cost benefit of hiring additional staff
    - Compensating controls

Preparing your Response and Corrective Action Plan

- Preparing responses to auditor findings
  - Discuss with the auditor what their findings are and make sure you have a clear understanding.
  - Determine if there are compensating controls or other means that mitigate their finding.
  - Draft a response to the finding and the corrective action plan (Single Audit Entities).

Corrective Action Plan

- Preparing Corrective Action Plan under Uniform Guidance
  - Reference the finding number from the auditor's schedule of findings and questioned costs.
  - The corrective action to be taken.
  - Identify the specific individuals to implement the plan.
  - Identify the anticipated date for the action to be completed.

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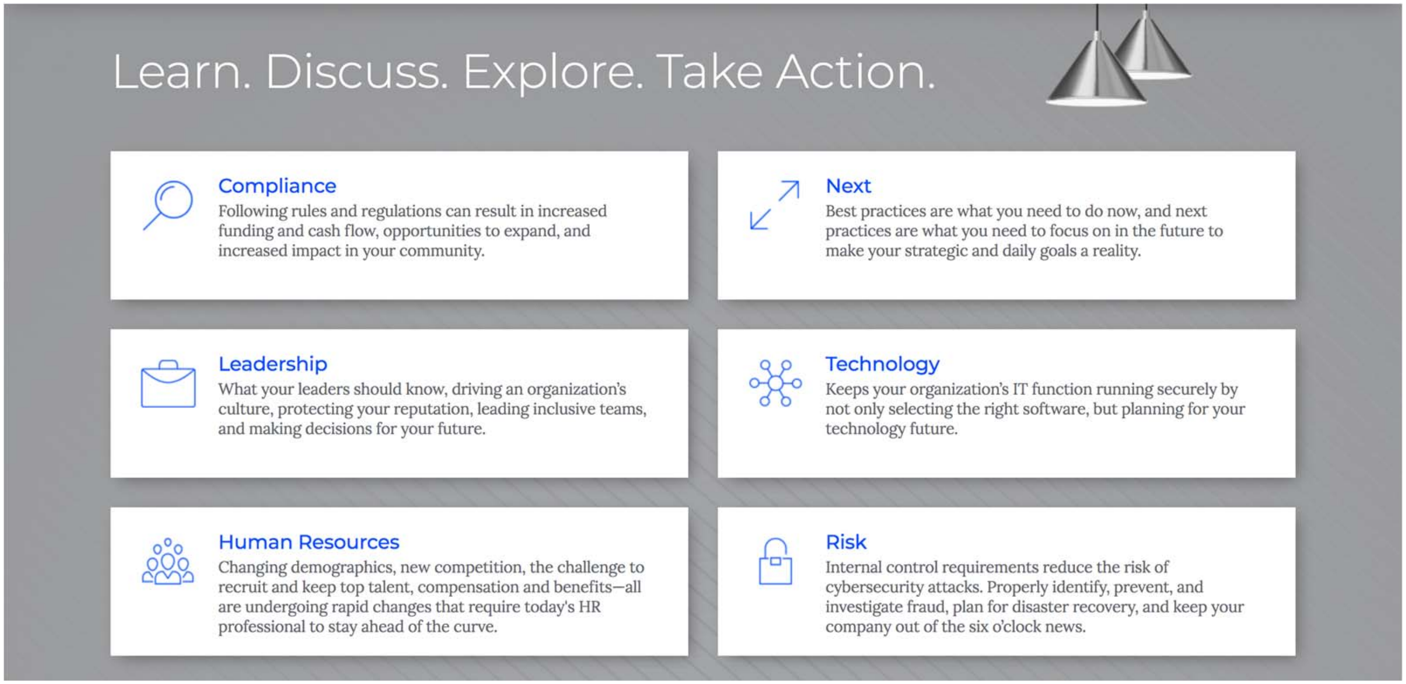

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How did we do?

Please take a moment to fill out your evaluation.

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Thank You

Thank you for your participation.

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