



“So then, each of us will
be accountable to God.”

“We are taking pains
to do what is right, not
only in the eyes of the
Lord, but also in the
eyes of the Church.”

“Who then is the wise
and faithful steward?”

“Turn in the account
of your stewardship.”

THE LOCAL CHURCH AUDIT GUIDE

For
United Methodist Congregations

This booklet is given to you as a service of the Internal Audit Department and the Committee on Audit and Review of the General Council on Finance and Administration of The United Methodist Church. We hope you will find it useful. If you have suggestions for making it better, please telephone, write, fax or e-mail the Director of the Department, who can be reached at these numbers and addresses:

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The Committee on Audit and Review
by Stan Sutton, Chair
Nashville. November, 2001.

The Legal Department tells us we should start with a disclaimer. It is a good lesson to begin this booklet with since all organizations within the Church should be attentive to professional advice given to them.

DISCLAIMER

The General Council on Finance and Administration and the Internal Audit Department are not responsible for the conduct of local church audits, nor do they provide legal or financial advice to local churches through this booklet. Local churches should seek assistance and advice from their local advisors when specific issues arise. This booklet is provided to you as a service; it should be used to increase knowledge of auditing principles within your local church, including the understanding of why audits should be conducted and the uses to which they can be applied by local church officials.

LOCAL CHURCH AUDIT GUIDE *Second Edition*

We will use a question and answer format in presenting the information provided in the following pages. The questions and answers come from the experience of those who have prepared this booklet, who are individuals who serve or have served on local church finance committees and who have been there, done that. Some are professionals in the field of church finance. The questions that follow are questions we ourselves have asked or have been asked by others.

So let's start by learning a little terminology—some definitions. You remember what the Music Man said about being good at selling musical instruments in that musical show named after him: "You gotta know the territory!" Well, let's learn the territory. It's not difficult to explore, and who knows, you might even have some fun getting to know your job better.

Speaking of definitions, just what is an audit?

The *Book of Discipline* does not define what a local church audit is. It does not, for example, say that an audit must be performed by a professional, or that it must conform to generally accepted auditing standards, or that it must be prefaced by the usual representations and caveats that auditing firms incorporate into their audits.

For that reason, we have gone to the *Book of Discipline*, where we found no definition of the term "audit." We then turned to definitions used by professionals and have tempered them by the application of common sense made necessary by the fact that local churches vary so much in their resources and in their budgets. We conclude that an "audit", as the term is used in the Discipline, is meant to be a process that provides reasonable assurance that good stewardship is being used in handling and accounting for the funds and other assets of the local church. To a professional auditor or accountant, how we define an audit may be closer in professional jargon to a "review." However, the Discipline does not call for a "review," and that is why the definition we have chosen and the steps we outline in this booklet may fall somewhere in the middle between a full-blown "audit" and the simpler "review."

Here is our practical, working definition of an audit for the local church:

A local church audit is an independent evaluation of the financial reports and records and the internal controls of the local church by a qualified person or persons for the purpose of reasonably verifying the reliability of financial reporting, determining whether assets are being safeguarded, and whether the law, the Discipline and policies and procedures are being complied with.

Why in the world would a local church want an audit?

This is a commonly asked question. Believe it or not, there's one set of answers that fits all. And yes, we know that local churches come in all sizes from a handful of members to thousands, with every gradation in between. We know, too, that your locations vary from the heart of the inner city to way out in the countryside. And yes, we've heard all kinds of related questions asked about why a local church should have an audit, including—

why a small church with a tiny budget?

and why a big church with lots of controls in place and with a full staff of professional administrators?

and then there's this one—why waste the time or the money, or both, when everybody knows the church treasurer is as honest as the day is long?

Well, here's the number one reason why (sing to the tune of "Jesus Loves Me"):

"For the Discipline tells me so."

Section 258.4 *c*) of the 2000 *Book of Discipline* makes it *mandatory* that every local church finance committee "shall make provision for an annual audit of the records of the financial officers of the local church and all its organizations and shall report to the charge conference."

But there are more reasons than that for annual audits. Here are a few:

An annual audit is the best way we (and the General Conference) know of

- to protect the persons the local church elects to offices of financial responsibility from unwarranted charges of careless or improper handling of funds;
- to build the trust and confidence of the financial supporters of the church in the way their money is being accounted for (trust and confidence lead to improved patterns of financial support);
- to set habits of fiscal responsibility to assure that when there is turnover in personnel there will be continuity in accountability and nothing will fall through the cracks;
- to assure that gifts made to the church with special conditions attached are consistently administered in accordance with the donors' instructions, and thus let donors know their gifts are used as intended;
- to provide checks and balances for sums received and expended.

Conducting an audit is not a symbol of distrust.

It is a mark of responsibility.

It is good stewardship demonstrated for all to see.

It is a message to local church donors that you care about their gifts.

But don't I have to be a fiscal expert to understand local church auditing?

Not on your life!

Local churches all over the United Methodist world do a great job of filling their responsibilities to make provisions for an annual audit without the benefit of formal training in accounting or fiscal management, whether it's an audit by outside professionals, or whether it's by some person in the congregation with financial knowledge or expertise, or whether it's by the treasurer of a neighboring church.

Like riding a bike, it's a learned skill. And we're here to teach you.

In the definition of a local church audit, what does "independent" mean?

"Independent" means that the auditor must not be subject to control or influence by anyone who has responsibility for the financial accounts and records of the local church. There should not be even the appearance of a relationship that may dilute the perception of the independence of the auditor.

For example, the treasurer, her husband or cousin should not conduct the audit. Nor should her best friend. Persons who handle any of the church funds should not perform the audit. Nor should the church's pastor.

To be "qualified" to audit a local church must a person be a CPA?

No. There is no requirement that a CPA or other accounting professional must perform a local church audit. This means that it is not necessary to have an audit signed off by a professional who states that the audit was performed in accordance with professional standards for the performance of audits. The keys are that the audit must be performed by a "qualified" person or persons, and that the auditor must be independent.

Who can perform a local church audit?

Generally, a person who is "qualified" to perform a local church audit will have some experience with accounting principles, such as those gained through bookkeeping, office management or accounting courses. The person must have the time to devote, have the initiative to follow through on asking banks and donors for information verifying financial data and then to complete the reports identified later in this booklet. Sometimes a small local church will agree with another small local church in the same locale to have the treasurer of each audit the other. Often churches have accounting professionals in their congregations who are not serving that church in any of its financial offices who may be willing to perform the audit as a donation of services.

We do have a recommendation about professionals, though. We suggest that churches with annual receipts in excess of about \$300,000 to \$400,000 should seriously consider engaging an outside auditing firm to perform the audit. This is a recommendation and is not binding, but it seems to us to be prudent stewardship since more complexity is involved as receipts and expenditures become larger.

Are there other definitions I should know?

Yes, there are. In particular, persons interested in church finances should know the definitions of "restricted funds" and "designated funds," and how and why each category is accounted for differently in the church's records.

What are restricted funds, anyway, and why should I care?

Restrictions come about when a donor imposes a stipulation on a gift that limits its use to a specified purpose. If a local church accepts a gift which can be used only for a specified purpose, that gift must be accounted for separately from gifts given to the organization in furtherance of its general purposes, such as money dropped in the plate on Sunday morning. The reason why you should care why it is important to account separately for restricted assets is that if they are used for purposes other than the one (or more) specified, the donor (or an heir of a deceased donor) may be entitled by law to ask for return of the gift, even years later.

Can you give me an example of a restricted gift?

You bet. Suppose member Jane Doe gives \$10,000 (hallelujah!) and simultaneously delivers a letter that her gift is to be used to help buy a new piano. If the gift is accepted, the \$10,000 would be a restricted gift to be accounted for in the church's records as a restricted asset. Jane's letter should be kept in the church's financial records and the money spent only to buy a new piano.

Here's a second example. Suppose member Jack Roe gives \$100,000 (thanks, Jack!) and writes to say that his gift is to be invested and the income from it used to buy music for the music program. The \$100,000 is a restricted asset also.

But aren't those two gifts different? One can be spent, the other can't.

Right! While both are restricted assets, the money for the piano is called "temporarily restricted." That means that the donor-imposed stipulation can be fulfilled by the action of the church in deciding to buy that new piano, then doing it. Assets that are "temporarily restricted" can ultimately be spent, though they must be spent for the specified purpose.

The money given by Jack to be *invested* is "permanently restricted," meaning that the full \$100,000 was stipulated by the donor to be held permanently. Note that the income from the gift is to be used only for a specific purpose. To make a fine point, the income is temporarily restricted in that it can be spent by action of the church in deciding to buy music, but the gift itself is permanently restricted. These two types of assets should be reported separately.

Sometimes churches do not refine their accounting records to the point of separately reporting temporarily and permanently restricted assets in financial statements because they don't have enough of either to warrant the time. That works if the records are clear enough to be able to distinguish between what can ultimately be spent and what must be held permanently. Remember that when a gift is accepted subject to a stipulation for use in a particular way, the result is a contract to use it only in that way. Keep the donor stipulations permanently so you will know what the church has contracted to do.

There's another point to remember. The local church cannot change any restriction without the specific consent of the donor, which should be written.

So how do restricted assets differ from designated assets?

Designated assets are those assets that have been voted by the local church's governing board, such as its church council or equivalent body, to be used for a particular purpose. For example, suppose the board decides this fall to set aside from money on hand the amount of \$5,000 to send five persons next year to an appropriate seminar on making disciples. Following the vote, the \$5,000 should be reported as a "designated" asset.

Because the stipulation for its particular use was made by the church itself, that stipulation (or designation), can be changed by the action of the body that put it in place. There is no other party involved as in the case of the receipt of restricted gifts. Next year, if the board decides the \$5,000 can be better used for some other purpose, such as to buy a new van, for example, it can vote to apply the money for that purpose.

Can you outline just what an audit does?

For starters, an audit should:

- Independently verify the reports of the treasurer(s);
- Follow the money and test how it is treated at different steps;
- Document that donated and earned funds of the congregation have been used as stipulated by the donors.

In addition to tracking the cash through the system, an auditor typically will evaluate:

- Accounting controls (systems that reduce the possibility of loss or errors);
- Segregation of duties (assurances that more than one person is involved in critical steps in handling money so that there can be checks and balances);
- Reasonableness of systems and procedures in the light of all factors, including the size of the church and its budget;
- Adequacy of insurance coverage;
- Systems for retaining and accessing meeting minutes that have financial implications (i.e., Finance Committee, Trustees, Charge Conference); and
- Records that show donors' stipulations for the use of gifts made to the local church.

A local church's unique circumstances may suggest that additional steps should be taken. It is important to document the financial processes of your particular local church. Additional steps will be discussed as we move on.

In the next few pages we will take you through the documents you need to examine to accomplish the foregoing.

What about auditing money held by groups within the church?

We Methodists are instructed by the Discipline to audit not only the financial officers of the local church, but "all its organizations" That means that the treasuries that are to be audited include:

- Financial Secretary;
- Church Treasurer;
- Trustees Treasurer;
- Memorial Fund Treasurer (if any);
- Local Church Foundation or Endowment funds;
- All other separate treasuries or bank accounts maintained by a group using the same tax identification number as the church, including, for example, United Methodist Men, Pastor's discretionary fund, United Methodist Youth fund, church school, and others.

The only exception is the United Methodist Women, which should be audited but may be audited separately.

What kind of information does an auditor need to look at?

The person(s) or the auditing firm must obtain access to the following information and materials:

- 1 Copies of all church policies and procedures related to finance and treasury functions and copies of minutes approving those policies.
- 2 Copies of all the minutes from the finance committee, the trustees, the administrative board, the previous charge conference(s), and the other entities listed on the prior page.
- 3 Listing of all bank and investment accounts, including the person authorized to sign on each, and including any special use accounts under the control of the pastor(s) and in the name of the church.
- 4 All financial statements for each month of the year, plus December of the prior year and January of the subsequent year (a fourteen month period).
- 5 Bank and investment account statements for the same period.
- 6 Bank reconciliations for that same period.
- 7 Original books of entry, which will be the general and subsidiary journals; for those books that are computerized, a print-out of all transactions by account for the entire year.
- 8 All paid invoices, payroll data and files (including 941's, year-end W-2's, 1099's and transmittal forms), income transmittals and deposit records for the fourteen month period.
- 9 The Financial Secretary's records and other income records for the same period.

What about confidential information?

The person(s) conducting the audit may obtain access to confidential information and must treat that information accordingly.

The auditor's work papers may contain confidential information. These work papers as well as all financial records should be retained for **at least seven years** in a secure, limited access, storage area.

How is a local church audit conducted?

After the books are closed for the year but before the audit begins, the auditor should prepare confirmation forms for banks, the annual conference, insurance companies and donors. Those confirmations are essential for providing the auditor with independent verification of bank account balances and authorized signatures, monies sent to the annual conference for benevolence funds and special gifts, the coverage level(s) and related premiums for all insurance policies and, on a test basis, donor contributions.

How does the local church auditor get bank confirmations?

For each bank and investment account, the auditor requests the balance as of December 31, and a list of the person(s) authorized to sign on that account. **Addendum III** is a standard form for obtaining this information.

How can the auditor get Annual Conference confirmations?

The auditor should send a letter or a memorandum to the annual conference treasurer requesting the person to confirm the amounts received from the church for annual conference benevolences and special gifts. We suggest the request should specify a date by which the information should be returned and that a stamped, addressed return envelope be enclosed.

How in the world can donations be confirmed?

The auditor should randomly sample about one percent of the total number of those who give. We suggest that not more than ten givers need be sampled, but they should be selected randomly. The auditor should make the selections and not suggest that the treasurer or other local church finance officer pick the donors to check. **Addendum IV** seeks to confirm the amounts received from the donor and to identify the period for which the donation is to be booked. Copies of year-end giving statements provided by the local church to donors may be used to facilitate this process.

All these confirmations are an essential piece of the auditing process. Second requests may be required if confirmations are not responded to in a timely fashion. The responses should be addressed directly to the auditor, not to the auditor in care of the church.

How will insurance companies confirm coverage?

After the auditor locates all the policies the local church officials have identified as in effect, the auditor will write a letter or memo to the insurance agent or agents. The names and addresses of the agent should be on the policy information provided by the church. The letter should request the confirmation of the policy number identified in the letter, the level of coverage and the anniversary date and premium. As with all inquiries sent, we recommend specifying a date by which the information should be returned and that a return envelope, addressed and stamped, be enclosed.

How does the actual audit process begin?

When the confirmations are all received, the auditor should be ready to dig in and get to work. A good place to start is with looking at the cash.

What's involved in auditing the cash?

Every category of cash and all other invested funds must be audited at year end: bank and savings accounts, CD's held in the name of the church or the church foundation, and any petty cash accounts held in the office of the church or elsewhere. At this time the auditor must have the list of all bank accounts and person(s) authorized to sign on each, a copy of all the financial statements for each month being audited, and the bank account statements and reconciliations for that same period. Then the steps on the next page should be followed, at a minimum:

- Review the bank confirmations to see that the ending balance as stated by the bank is the same figure used in the December statement, then check to see that the current authorized signers as listed by the bank are the same names listed in church records. If the lists fail to match, inform the treasurer, who should investigate any differences.
- Review all bank reconciliations to see that the beginning balance of one month is the same as the ending balance of the previous month. Note whether the book balance as listed on the bank reconciliation is the same balance presented on the financial statements.
- Pick a month and actually perform a bank reconciliation for each account using the original books of entry, the financial secretary's records and any subsidiary journals. If you find a discrepancy between your reconciliation of the month and the reconciliation provided by the treasurer(s), research the discrepancy to find an explanation or an error.
- The auditor should independently count cash in all petty cash accounts. The count should agree with the books. Review expense types for their appropriate charging to program area or administrative accounts. Ascertain suitability and adherence to policies.

Now that you have the cash all accounted for, we're ready to move on to income and receipts.

What about income and receipts?

Determine if the deposits as listed by the financial secretary and the treasurer match those listed on the bank statement. Verify, on a test basis, the deposits for Sundays during the calendar year using the following procedures:

Test (a random sample, not to exceed 10 times; more if discrepancies are found) the counter's documentation versus the Sunday receipt deposit slips and bank statements. Review original book of entry for correct posting of Sunday deposits.

Using the donor confirmations obtained as outlined above in this booklet, determine whether the amount paid as reported by the donor is the same as recorded and received by the financial secretary. If there is a difference, research for a timing difference, inaccurate recording or some other explanation.

Review the original books of entry to determine if other income has been recorded accurately (i.e., appropriate account, correct amount, unrestricted or designated vs restricted, etc.). Trace the entries to the financial statements.

Are we done yet?

Not yet. Be patient. It won't be long. First we have to talk about disbursements, payroll records, and even more exciting things!

So, are we ready to get into disbursements?

Yes. It is now time to move to examining disbursements. Here's how:

Ask the local church for the minutes you need. They should be keeping copies in their financial records to make it easier at audit time.

- ❖ Review the Finance Committee, the Charge Conference and other committee minutes, as appropriate, for actions concerning disbursements, including apportionment payments. Reconcile those actions with any actual payments made.
- ❖ Test to ensure that all of the disbursements have been properly authorized.
- ❖ Review the original books of entry and disbursements journal to ensure that all disbursements have been recorded appropriately.
- ❖ For the insurance premium disbursements, check to see whether the amount disbursed is the same as that listed by the insurance company as premiums due. Verify that income designated for special mission purposes has been distributed or allocated accordingly.
- ❖ If there is a purchase order system in conjunction with disbursements, note whether the purchase orders have been authorized and approved by the appropriate person(s) and matched against the actual disbursement or invoice.