

internal control that might be significant deficiencies or material weaknesses and, therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses and other deficiencies that we consider to be significant deficiencies.

A deficiency in internal control 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 and correct misstatements on a timely basis. A material weakness is a deficiency, or a 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.

We consider the following deficiencies in the Company's internal control to be material weaknesses:

[Describe the material weaknesses that were identified.]

A significant deficiency is a deficiency, or a 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. We consider the following deficiencies in the Company's internal control to be significant deficiencies:

[Describe the significant deficiencies that were identified.]

In addition, during our audit, we noted certain matters involving the internal control and other operational matters that are presented for your consideration. This letter does not affect our report dated [date] on the financial statements of [client]. We will review the status of these comments during our next audit engagement. Our comments and recommendations, all of which have been discussed with appropriate members of management, are intended to improve the internal control or result in other operating efficiencies. We will be pleased to discuss these comments in further detail at your convenience, perform any additional study of these matters, or assist you in implementing the recommendations. Our comments are summarized as follows:

[Describe the general comments and suggestions that were identified.]

CHAPTER 2 CASH

INTRODUCTION

On most financial statements, cash is not one of the higher balance sheet accounts. Therefore, to some it may not seem to be an area for major concern. However, diligent auditors spend a good amount of time thoroughly understanding the flow of cash throughout a business entity and perform extensive audit testing.

The reason for such concern is the cash involved. Cash is the most liquid of assets and has the highest risk for theft, embezzlement, and misappropriation. A study by the Association of Certified Fraud Examiners found that more than 80 percent of occupational fraud cases involve asset misappropriation, and cash is the targeted asset 90 percent of the time. In general, the following rules over cash controls are especially beneficial:

- Do not allow a single employee to handle a cash transaction from beginning to end.
- The cash handling function should be separated from the function of recording cash transactions in the books of account.
- The receipt of cash should be centralized.
- Customers should obtain a receipt at the conclusion of each sale.
- Cash receipts should be deposited to the bank intact on a daily basis.
- All cash disbursements should be made by check or authorized bank transfer.
- Employees not involved with cash processing should prepare bank reconciliations.
- Bank reconciliations should be performed on a timely basis at the end of each month.

AU-C Section 265 requires the auditor to include in the written communication an explanation of the potential effects of significant deficiencies and material weaknesses that have been identified. Please note that the comments included in this guide may need wording added or revised for this attribute depending on the specific circumstances.

2.00 Cash

2.00.01 Cash: Unopened Bank Statements

There is currently no system for reviewing bank statements, and they are frequently left unopened for extended periods before they are reconciled. This

greatly increases the risk of overlooking mistakes made by the bank or the organization, and/or fraudulent activity involving cash. We suggest that unopened bank statements received in the mail be forwarded directly to the President. The President would then review the bank statements and canceled checks for any strange or unusual items and investigate these items should any be found.

2.00.02 Cash: Bank Statement Review

We suggest that the unopened bank statements received in the mail be forwarded directly to the Chief Executive Officer or other appropriate senior management of [client]. We further recommend that arrangements be made to also receive copies of the canceled checks, because [client]'s current operating cash account does not provide the canceled checks with the monthly bank statement. The Chief Executive Officer should open and review the bank statements and copies of the canceled checks and investigate strange or unusual items should any be found. Documentation of the review of the items should be made on the face of the bank statement. We believe that this process will further enhance the checks and balances necessary for strong controls over cash.

2.00.03 Cash: Bank Statement Review

During our audit procedures performed regarding cash disbursements, we noted the bank statements provided by Bank X did not include images of the canceled checks. Preparing an accurate bank reconciliation without documentation of the actual disbursement checks that cleared the bank could lead to significant errors, which will ultimately filter through to an organization's financial statements. We strongly recommend the organization request that Bank X provide the check images with the bank statements, which will help to identify any discrepancies and/or or detect fraud or theft. Without having this documentation, the ability to perform this critical step in the internal controls over cash will be significantly impaired.

2.00.04 Bank Statement Review

It was determined during our audit procedures that the President reviews the bank statements and canceled checks and investigates if any strange or unusual items are found. She also documents her review by writing her initials and the date on the face of the bank statement. However, presently the unopened bank statements are forwarded to the accounting department before they are forwarded to the President for review. We suggest that bank statements received in the mail be forwarded unopened directly to the President, rather than first going through the accounting department. We believe that this practice will further enhance the checks and balances necessary for strong controls over cash.

2.00.05 Cash: Bank Statement Review

We suggest that the unopened bank statements received in the mail be forwarded directly to the Executive Director. The Executive Director would review the bank statements and canceled checks for any strange or unusual items and investigate

these items should any be found. Documentation of their review should be made on the face of the bank statement. We feel that this suggestion will further enhance the checks and balances necessary for strong controls over cash.

2.00.06 Cash: Bank Reconciliation Approval

Currently, employees who are responsible for other cash functions also review bank reconciliations. This provides an ineffective system of cash control, because it permits the possibility of fraudulent activities due to the lack of an adequate segregation of duties. An employee independent of cash receipt and disbursement activities should review the bank reconciliations for any unusual items and document their approval by initialing the form. This will significantly improve the system of checks and balances necessary for strong cash control.

2.00.07 Cash: Invest Cash in Accounts

[Client]'s funds in bank accounts are not being invested in a way that generates the greatest returns. There was a cash balance of [high \$ amount] in an account with a low interest rate in the year ending [date]. Arrangements with the bank can assist in protecting [client] in the event of a banking failure when there are funds in excess of the FDIC insured limit of \$XXX,XXX. We suggest consulting with the bank regarding which approach may best meet the needs of [client]; however, we recommend that [client] establish the following types of accounts at the bank of its choice:

- A "sweep account" investment involves an arrangement with the bank whereby the account is cleared at the end of every business day and the balance is invested for overnight return. This type of investment vehicle can be stipulated by [client] to ensure that the invested funds are maintained in a conservative manner.
- A "zero-balance account" is a method where [client]'s bank account is maintained with a zero balance. All funds are kept in an investment account to ensure maximum earnings. As checks are presented to the bank for payments, the bank liquidates that amount from the investment account and honors the check.

2.00.08 Cash: Over Federally Insured Limit

While conducting the audit of cash we noted [client] had cash on deposit in excess of the federally insured limit in a financial institution. This presents a potential for losses to [client] in the event of bank or institutional failure. We have discussed this situation with management and we understand that due to the large deposits of cash receipts it is difficult to maintain less than \$XXX,XXX in the operating account. We strongly suggest that management closely monitor cash balances and transfer excess balances to other banks, where possible, to reduce the potential for loss of monetary amounts in excess of the federally insured level.

2.00.09 Cash: Deposits in Excess of Federally Insured Limits

During our audit, we noted that some of the special program bank accounts occasionally hold cash and investments in amounts in excess of federally insured limits. The terms of many of these contracts and agreements specifically prohibit cash in accounts that are either uninsured or above the federally insured limits. We recommend [client] take steps to either amend the terms of these contracts and agreements or otherwise resolve the issue by limiting the amounts in these accounts.

2.00.10 Cash: Daily Cash Reports Comparisons with Deposit Ticket

Currently, daily cash reports are prepared by the receptionist and then forwarded to the accounting department for preparation of the deposit ticket and entry into the general ledger. This practice, however, does not provide a complete control, because the daily report is not reconciled and agreed to the actual deposit. We feel that [client] could significantly strengthen its control over cash if an employee independent of cash processing subsequently compares the daily cash reports to the deposit ticket or the bank statement.

2.00.11 Cash: Outstanding Checks

At the time of our audit, there were several large checks that had been outstanding for several months. Tracking outstanding checks is an important control procedure that ensures that all outgoing checks are accounted for. We suggest that an accurate outstanding check list be kept for each bank account and a periodic review of the list(s) be performed on a timely basis. If necessary, stop payment notices should be sent to the bank.

2.00.12 Cash: Reconciling Statements Regularly

During the audit, we noted that bank statements for [client]'s various accounts were not reconciled to the general ledger. Most of the problems encountered within the area of cash can be avoided if a proper system of checks and balances is incorporated into the Company's procedures. We recommend that all of the bank accounts be reconciled monthly to the general ledger and that all suspicious reconciling items be promptly investigated and adjusted with adequate explanations.

2.00.13 Combining Cash Accounts

While performing the audit on cash accounts, we noted that [client] maintains separate cash accounts for all of the custodial accounts as well as several accounts for general operations. This requires that a significant amount of time be spent on the monthly accounting responsibilities and it weakens the overall cash controls due to the number of accounts maintained. To save time and money and increase the efficiency of operations, we suggest that some of these accounts be combined and otherwise eliminated. If it is necessary to track the cash balance of a particular program or fund, the features of the accounting software should be used to accomplish this task.

2.00.14 Cash: Restricted for Grants

[Client] records its cash activity through several cash accounts. We understand this situation exists partly in an effort to separate grant activity from [client]'s normal operations. We suggest, however, that this type of segregation can be accomplished through a recording function of the accounting system. The operating bank account of a cash flow system is the major link of internal accounting controls over both cash receipts and cash disbursements; if operating activity is handled through more than one bank account, internal controls tend to be weakened. To strengthen internal control, we strongly suggest that [client] deposit all receipts and disburse all expenditures from one main checking account. Any necessary segregation for grant cash and activity can be done through the accounting records.

2.01 Cash Receipts

2.01.01 Cash Receipts: Receiving Checks and Receipts

We noted that there are no standard procedures for receiving checks at the office. This is a severe weakness in internal control and should be remedied as soon as possible. The following procedures should be implemented to greatly improve internal controls:

- Checks should be immediately endorsed when they are received.
- A control list should be made of receipts when they are opened.
- Checks should be deposited to the bank on a timely basis.
- Receipts should be processed on a timely basis.
- Deposit slips should be matched against the list of receipts to ensure that all amounts on the receipts were deposited.

2.01.02 Cash Receipts: Segregation of Duties

We noted that there was a lack of segregation of duties within the cash receipts area. The objective of internal control over cash receipts is to obtain control over amounts received at the time of receipt. We feel that separating these closely related functions in the cash receipts system of [client] will result in much greater internal control in this particular area. To achieve this control, certain duties involving receipts should be handled by more than one member of [client]'s personnel. The following procedures should be enacted to ensure efficient internal control:

- One employee, preferably the receptionist, should open the mail, make a control list of all receipts, and restrictively endorse all items received as "for deposit only." This would prevent any unauthorized endorsement should the checks be misplaced or lost before being deposited.
- The receipts should then go to another employee for further processing and deposit to the bank on a timely basis.
- Then, someone who does not otherwise handle receipts should compare the deposit slips to the list of receipts to ensure that all funds reflected on the receipts were deposited.

2.01.03 Cash Receipts: Monthly Transaction Report Information

We noted during our audit that [client]'s monthly transaction report, which is used as its cash receipts listing, only shows the date each item is deposited and does not include the date each item is actually received. Recording the date that all cash receipts are received would help to ensure the timeliness of all deposits made and further enhance the usefulness of cash receipts records. To provide better documentation and stronger accounting controls over cash receipts, we recommend that [client] incorporate the date received for each cash receipt item in its monthly transaction report.

2.01.04 Cash Receipts: Making Timely Deposits

Our audit testing in the area of cash receipts revealed that [client] is not making daily deposits of cash to the bank. This practice opens [client] to the threat of a loss or theft of cash while it is on the premises. To strengthen internal controls in this area, we suggest that during times of heavy cash inflow, deposits to the bank be made on a daily basis. During periods of less cash inflow, we recommend that cash be deposited at the bank no less than once a week. This practice will firmly strengthen [client]'s internal control process over cash receipts and greatly lessen the likelihood that cash could be lost or stolen before it is deposited in the bank.

2.01.05 Processing Cash Receipts: Making Timely Deposits

Although most of the income of [client] is sent directly to a lockbox, a portion is still received at the office in the form of checks. Although we concur that this only approximates 5% of [client]'s total cash receipts, it has come to our attention during the course of the audit that these checks are not deposited in a timely manner. We recommend that deposits be made, at a minimum, on a weekly basis, either by ensuring that the deposits are made by [client] personnel or by directing these amounts to the lockbox. This practice will firmly strengthen [client]'s internal control process over cash receipts and greatly lessen the likelihood that cash could be lost or stolen before it is deposited in the bank.

2.01.06 Timely Deposits of Cash Receipts

During our audit, we noted that each department opens its own mail and all checks received are then entered into the respective departmental database before being forwarded to the Office Manager for recording in the accounting system and then deposit. At the time of the audit we also noted that checks and cash had been held in one department over an extended period of time. Because of the way the system is structured, the accounting department was not aware of these receipts and had not recorded them or deposited them in the bank. We strongly suggest that this practice of routing all receipts directly to department heads without some form of cash receipts log is a serious weakness in the system. Cash receipts should be restrictively endorsed and deposited into the bank as quickly as possible. Copies or other receipts documentation should then be utilized to facilitate recording into the accounting system and departmental records.

2.01.07 Segregation of Duties: Accounts Receivable and Past-Due Accounts

Employees responsible for maintaining the open invoice accounts receivable files and mailing statements on past-due accounts are also involved in handling cash receipts and preparing deposits. Also, the credit manager is authorized to issue credit memos, bad debt write-offs, and also has access to cash receipts. This combination of duties is inconsistent and allows for the possibility of mishandling or misappropriation of cash. To improve controls over receipts, we suggest that an employee independent of the receivable function prepare a list of daily cash receipts. Another employee should then be responsible for retaining the actual checks and for making the bank deposit. Also, the credit manager's access to cash receipts should be terminated. Only customer remittance invoices should be forwarded to the receivable department and, where none exist, a copy of the check or an internally prepared remittance form should be used.

2.01.08 Segregation of Duties

We noted that several functions related to accounts receivable such as generating billings for service income, entering invoices into subsidiary ledger, performing bank deposit runs, posting cash receipts into the subsidiary ledger, and setting up new customers are performed by the same accounts receivable clerk. The same clerk also has access to the general ledger. A lack of segregation of duties in this area indicates weaker internal controls and could result in erroneous postings as well as create opportunities for fraudulent activities. We recommend that the duties of billings, maintenance of subsidiary ledger and general ledger, bank deposit delivery, and setting up new customers be segregated to strengthen the system of internal control over accounts receivable and cash receipts.

2.01.09 Processing Cash Receipts: Restrictive Endorsement/Tape Total

Our audit procedures disclosed that at the present time, incoming checks are forwarded to the accounts receivable clerk for endorsement and crediting to the accounts receivable subsidiary detail. The checks are then given to a second employee for preparation of the bank deposit. Because more than one employee handles the checks, a system for tracking the checks is necessary to enhance control in this important area. We suggest that a restrictive endorsement be stamped on the checks in the mailroom and an adding machine tape or other log of the total amount of checks be prepared before the checks are given to the accounts receivable clerk. The tape or log should later be compared to the authenticated deposit slip by someone not associated with the cash functions.

2.01.10 Processing Cash Receipts: Restrictive Endorsement of Checks

During our audit procedures, it was noted that checks that are received by mail are not immediately restrictively endorsed when the mail is opened but are delivered to the Assistant Accountant to be endorsed. This practice exposes [client] to the threat of a loss or theft of cash while it is on the premises. In order to significantly strengthen internal controls over cash receipts, we recommend

that checks be immediately restrictively endorsed when the mail is opened by stamping checks with [client]'s full name, checking account number, and the words "for deposit only."

2.01.11 Processing Cash Receipts: Using Tapes

Control over incoming cash receipts should be established immediately upon receipt. At present, the cash register is not used as a control device. We strongly suggest that both the cash received and the cash register tape accompanying it be sent to the cashier on a daily basis for deposit.

2.01.12 Processing Cash Receipts: Timely Depositing

Contributions received in the mail appear to be recorded promptly. However, our procedures disclosed several instances where the cash was not promptly deposited. We suggest that deposits involving a substantial amount of currency be made on the day the cash is received. This will avoid the possible mishandling or misplacement of funds.

2.01.13 Processing Cash Receipts: Reconciling Lockbox Receipts

While conducting the audit, we noted that a locked receipt box is used to hold accumulated cash sales proceeds, but the receipts (sales invoices) are not subsequently agreed to the bank deposits. This agreement is a necessary procedure that ensures that all cash received is deposited. We recommend that the receipts (sales invoices) be summarized and compared to the bank deposit slips to ensure that all cash sales are properly accounted for and recorded.

2.01.14 Processing Cash Receipts: Timely Posting

We noted there is a considerable delay in posting cash receipts to the accounts receivable subsidiary. For cash collection and credit review to be at an optimum level of performance, it is imperative that cash receipts be posted on a more timely basis.

2.01.15 Cash Receipts

During our testing of accounts receivable we discovered that checks had been received from one particular vendor that were held for long periods of time before they were deposited into the bank. These checks were not safeguarded as they were in an unlocked location for a period of weeks. It subsequently came to our attention after the end of the audit that the reason this situation occurred was that the vendor had changed its method of sending refund checks to [client]. We strongly suggest that the cash receipts system be designed to ensure that all receipts are deposited intact and on a timely basis. An analysis should be made to determine the reason why the system broke down and the best way to prevent this in the future.

2.01.16 Cash Receipts Log

During the audit, we noted that cash receipts (checks) are not logged before they are passed on to be processed. This practice has the potential that actual checks could be lost or separated from the daily deposit as they progress through the system. To establish strong control, we recommend that the Company maintain a cash receipt log at the point at which the checks are opened in the mail, which is then periodically reconciled to the cash receipts journal. Any differences between the two should be investigated and resolved promptly.

2.01.17 Processing Cash Receipts: Scanning of Checks

It is our understanding that all checks received are scanned before being deposited. This document is used in place of the previous manual check log. While we concur that the use of the computer technology in this fashion is a reasonable approach, it is critical that the system provide the same elements of control and proof of documentation as the previous process.

2.01.18 Comparing Deposits with Control Totals

Daily cash control sheets prepared by the accounting department should be compared to the data processing transaction printouts to verify that transactions have been properly processed. One employee in the accounting department maintains the cash receipts records and prepares the bank deposit. Control over cash would be strengthened if receipts were totaled before checks were forwarded to accounting. Subsequently, an employee independent of cash processing should compare the total to the cash control sheet.

2.01.19 Comparing Deposits with Cash Receipts Log

Our audit procedures disclosed that the cash receipts process used by [client] is adequately designed; however, the final step of reconciling the daily cash receipt log to the actual deposit slip is not performed on a regular basis. Performing this procedure greatly strengthens controls over cash receipts and ensures that all checks received are being deposited into the bank. We strongly recommend that management insist that this procedure be completed on a timely basis and that any differences be resolved.

2.01.20 Cash Receipts: Comparison of Receipts Log

It was noted during our audit process that although lists are currently made of all cash receipts when the mail is opened, the lists are never compared to what is actually deposited in the bank. We recommend that someone who is separate from the cash receipts function compare and reconcile deposit slips to the cash receipts logs of incoming checks and cash to ensure that all the receipts were deposited intact and on a timely basis. By establishing this procedure, [client] will be able to more accurately track all incoming cash and strengthen its system of internal controls over cash receipts.

2.01.21 Review of Cash Receipts Log

We noted that the cash receipts log is not reviewed in a timely manner. During the audit, we identified that the cash receipts log was reviewed and reconciled after the year-end. We recommend that the review and reconciliation of the cash log be done on a monthly basis, because it would increase the controls surrounding cash and reduce the risk of misappropriation and misstatement of cash.

2.01.22 Unidentified Cash Receipts: Timely Deposit and Posting

The accounts receivable department pending receipt of detailed information holds customer remittances that cannot be readily matched to specific open invoices from the customer. We noted several checks that were held for periods of four or five months before being deposited. Available cash would be increased and overall cash controls would be strengthened if funds were deposited immediately. After these unidentified items are clarified, necessary corrections can be posted onto customer accounts. We urge that unidentified cash receipts be deposited daily and recorded in a separate general ledger account titled "Unmatched Cash Receipts" until sufficient information for proper posting is received. Obviously, the accounts receivable clerks should make copies of the unidentified checks as well as any other detail of the transaction.

2.01.23 Unidentified Cash Receipts

During the audit, we noted that the Company carried a substantial amount of unidentified cash receipts at December 31, 20XX. In addition, an even greater amount of cash receipts was unapplied within the accounts receivable subsidiary system. Further discussion with management disclosed that the issue arose mainly in the prior years and was caused by (1) payors not providing enough detail to allow appropriate application and (2) the Company lacked human resources to match the payments received with the appropriate invoices. This issue led to inability to determine accurate accounts receivable balances, to assess account aging, and to easily track amounts owed to [client]. We strongly suggest that management establish procedures to resolve these old items. We further suggest that management adopt a system that will track invoices billed and collected. Cash collection should be recorded in detail to determine their source and application to the accounts. When details are not readily available, it is recommended that management assign appropriate personnel to obtain the needed details from the payors. Procedures should also be established to ensure that accounts receivable balances are reconciled between the general ledger and the subsidiary on a consistent and timely basis. All differences and the reason for such differences should be investigated and resolved as soon as possible. These procedures will assist [client] in establishing reliable internal controls for the billings and collection of accounts receivable and revenues.

2.01.24 Policy for Incoming Checks

During our audit, we noted that there is no established policy for handling checks received. Currently, each department opens its own mail and administers the checks received. At the end of each day, the checks are either forwarded

directly to the accounting department or entered into the respective departmental database before being forwarded to the accounting department. The accounting department then restrictively endorses the checks once the checks arrive there. This practice allows for a significant loss of control over the entire cash receipts process. A strong system of controls should ensure that all checks received are immediately recorded and then forwarded by the most direct path to the accounting department and deposited in the bank. The responsibility of receiving checks should also belong to one employee who is also in charge of endorsing the checks, so that funds are less likely to be mishandled or misappropriated.

2.01.25 Internal Control over Cash Receipts

During our audit procedures, it was noted that checks that are received by mail are not always immediately restrictively endorsed when the mail is opened. Furthermore, checks that are not deposited timely are not secured. In order to significantly strengthen internal controls over cash receipts, we recommend that checks always be restrictively endorsed immediately when the mail is first opened by stamping them with [client]'s full name, checking account number, and the words "for deposit only." Furthermore, checks must be appropriately secured in a locked safe or drawer until they are deposited.

2.01.26 Segregating Duties: Cash Receipts

We noted that duties involving cash receipts were combined during the year, whereby one employee is now completely responsible for the entire cash receipts process. To improve the internal controls over cash receipts, we recommend that [client] establish new procedures for handling incoming checks. We recommend that one employee, independent of the accounting department, such as the receptionist or office manager, open the mail and restrictively endorse all incoming checks. This person should keep a daily log of all incoming checks. Copies of the checks should be forwarded to the appropriate departments for processing and the checks should be forwarded to the accounting department for recording in the accounting system and timely deposit. A third person should periodically compare and contrast deposit slips to the daily log of incoming checks to ensure that all the receipts were deposited. By segregating the cash handling, recording, and depositing functions, [client] will be able to more accurately track all incoming checks and strengthen the system of internal controls over cash receipts.

2.01.27 Internal Control over Cash Receipts

Presently, the receptionist, who also prepares the deposit slips and takes the deposits to the bank, extracts cash receipts from the mail. In some instances, other staff members do receive copies of checks, and the staff person responsible for membership processes membership checks. The objective of internal control over cash receipts is to obtain control over amounts received at the time of receipt. To achieve this control, we suggest that one employee, preferably the receptionist, open the mail, make a control list of all receipts, and restrictively endorse all items received "for deposit only." The receipts should then go to another employee for further processing and deposit on a timely basis into the

bank. Someone who does not handle the receipts should compare deposit slips to the list of receipts to ensure that all receipts were deposited. Separating these closely related functions in the cash receipts system would reduce the risk that receipts could be improperly deposited or lost, and [client] will gain greater internal control over this particular area.

2.01.28 Cash Receipts: Coordination with Reconciliation Process

While conducting cash receipts testing, we noted that the process to reconcile cash receipts to the deposits in the bank is overly complex. We suggest that management review the current accounting procedures in this area and consider changes in procedures to make this process more efficient. The ultimate system should allow for easy identification of cash receipts and reconciliation between the books and the bank at any point in time.

2.01.29 Cash Management

We noted during the audit process that supporting documentation for cash receipts and cash disbursements was frequently lost or misplaced. This documentation is an important part of the books and records, and effective internal control procedures should not allow for this to occur. We strongly suggest that [client] establish and consistently maintain a regular, systematic filing system.

2.01.30 Cash Management

Cash receipts were posted with the check or document date rather than the actual date of receipt at [client]. This makes the reconciliation to the bank statement much more difficult and in some cases, virtually impossible. The bank reconciliation process is an extremely critical part of any system of internal controls and procedures should be established that allow for this to be done as easily as possible. Cash receipts should always be recorded as of the date of receipt. Related documentation should also reflect the date of deposit to the bank as well so that the transaction can be completely traced.

2.01.31 Cash Management

Our audit procedures disclosed a high volume of manual checks being issued from the payroll bank account. [Client] should rarely need to issue manual checks from its payroll account. The payroll account should only be used to receive the exact amount needed for a payroll and as payroll checks (transfers for direct deposits) are presented, the account should clear to a zero balance. We strongly suggest that no manual checks be issued on the payroll account and, if this does occur, management should closely review the transaction that gave rise to this situation before the release of those checks.

2.02 Lockbox System

2.02.01 Use a Lockbox System

Currently, customer payments are made to the receptionist, who processes and deposits them. To more effectively manage cash, we suggest that a lockbox

system be established. This process, while perhaps somewhat more costly in terms of bank charges, is more efficient and will ensure maximum cash control and the timely deposit of all customer remittances.

2.02.02 Lockbox System: Process Checks on Location

During a recent week, a large percentage of all remittances relating to the [place] location were actually received at that location. The present procedures provide that these receipts then be forwarded to the credit/accounts receivable department for review and mailing to the lockbox. To provide the control and cash flow benefits envisioned in the adoption of the lockbox system, we suggest the following:

- The lockbox address should be displayed prominently on both the top and bottom of all invoices to ensure that customers send payment to this address.
- Remittances received at the other locations should be forwarded directly to the lockbox.

2.02.03 Lockbox System: Centralization of Non-Lockbox Receipts

Clearly, there has been an increasing trend toward the use of lockbox systems and procedures for handling cash receipts. We concur with this practice, especially in situations of heavy inflows of cash receipts, as a method to better safeguard the cash receipts process and improve cash flow. However, under existing procedures, a number of different employees may handle those remittances that are not routed through the lockbox system. Any remittances that continue to come directly to the [department] office should be handled by one individual, because this is the most effective means of ensuring effective centralized cash control. Also, efforts should be put in place to better utilize the lock-box process and to minimize the number of cash receipt items received directly at the [department] office.

2.03 Cash Disbursements

2.03.01 Cash Disbursements: Cancel Invoices

As a result of our audit procedures in the cash disbursements area, we found that invoices were not effectively canceled after payment was made. In some instances, invoices were paid twice due to this lack of a notation system for paid invoices. To maintain stronger controls over cash disbursements, we suggest that invoices be canceled by stamping "PAID" on the face of the invoice upon receipt of final payment.

2.03.02 Disbursements

In our review of procedures over cash disbursements, we noted that the supporting documentation, including departmental approval of invoices, is not available and reviewed when checks are signed. Rather, simply a listing of invoices is reviewed and only unusual invoices are reviewed further. The review and approval of the invoices is the function that authorizes the disbursement to take

the cause should be investigated and assessed for reasonableness. This approach to the computation of the interim cost of sales will provide [client] with much more accurate financial information on an interim basis so that the results of operations can be more in focus and relied upon to effectively guide the organization.

5.05.02 Automation of Cost of Goods Sold

Currently, [client] uses a manual approach to record cost of goods sold. Based upon the extent of adjustment required at year-end, the entry for cost of goods sold is prepared inaccurately. There are acceptable approaches to inventory and cost of sales computations that can be maintained without computer software intervention. We suggest that [client] explore some of the available perpetual inventory systems. Such systems can assist with the maintenance of inventory, and effectively adjust all related accounts (such as inventory and cost of goods sold) based upon a sale of merchandise occurring. [Client] has had substantial growth and successful operations over the past few years and all indications signify that this will continue. Because inventory is a major component of [client]'s assets and critical to its future, we strongly suggest that such a perpetual inventory system be investigated regarding the benefits it could provide.

CHAPTER 6 FIXED ASSETS

INTRODUCTION

For certain small to medium-sized businesses, fixed assets may constitute an investment of substantial amounts; for others, the necessary fixed assets are much fewer in number and less costly. Related accounting and internal control matters, however, tend to be much the same no matter what kind of fixed assets the business may require. A strong system of controls for fixed assets for most businesses would include the following attributes:

- A subsidiary ledger or schedule that records important identifying information for individual fixed asset components.
- Authorizations for approvals for the acquisition of new fixed assets from senior management. (In general, all such purchases should be required to go through the same purchasing procedures as other purchases.)
- A written policy regarding capitalization of assets and expensing.
- Periodic physical inventory of all fixed assets and reconciliation with the subsidiary ledger.
- Authorizations for approvals of dispositions of fixed assets.

AU-C Section 265 requires the auditor to include in the written communication an explanation of the potential effects of significant deficiencies and material weaknesses that have been identified. Please note that the comments included in this guide may need wording added or revised for this attribute depending on the specific circumstances.

6.00 Fixed Asset Accounting

6.00.01 Maintain Fixed Asset Records

At the present time, fixed asset records are not maintained by [client]. We recommend that [client] maintain detailed fixed asset records and reconcile these records to the general ledger on a timely basis to ensure accurate accounting for assets. Specifically, fixed asset records should include the following data:

- Description of the asset;
- Cost, voucher number, and vendor name;
- Date placed in service;
- Estimated useful life;
- Depreciation method (for both accounting and tax purposes);
- Depreciation expense and accumulated depreciation for the year (for both accounting and tax purposes); and
- Date asset retired and selling price if applicable.

Complete information such as the above on all fixed assets would provide excellent control for the safeguarding of these assets, which are significant in costs. Better assessment and evaluation could also be made regarding the reliability of certain fixed assets and the need for replacements, etc.

6.00.02 Procedures for Disposal of Fixed Assets

[Client] does not have a formal procedure to ensure that disposals of fixed assets are reported to the accounting department as they occur. Without such a procedure, the likelihood increases that disposals are not being recorded. This often leads to a situation where fixed assets that physically exist within a business enterprise and the asset listing used for accounting and tax purposes are completely out of synch. A formal policy to ensure the reporting of fixed asset disposals should be adopted and should include the necessary level of approval for the disposal. This information should be reported to the accounting department on a timely basis. A simple standardized form could be developed to provide adequate accounting documentation and to provide evidence of adherence to [client] policy.

6.00.03 Reconciling Fixed Assets to the General Ledger

At the present time, there is no procedure for reconciling detailed fixed asset records to the general ledger on a regular basis. The lack of such a procedure has led to inaccurate reporting of fixed asset cost and depreciation expense in monthly financial statements. To prevent the need for major adjustments to the property accounts at the end of each year, we suggest that the general ledger fixed asset accounts be reconciled to the detailed records on a monthly basis.

6.00.04 Convert to Computerized Asset System

Currently, manual records are kept for all fixed assets. We strongly recommend [client] convert to a computerized system designed to accumulate asset cost and calculate depreciation expense. These types of fixed asset accounting systems have been refined over the years and now can be purchased at a very reasonable cost. This will eliminate a significant amount of manual record-keeping duties, make operations more efficient, and provide more accurate information with which to make business decisions regarding fixed assets.

6.00.05 Maintain Individual Fixed Asset Records

At present, individual fixed asset records are maintained for each piece of fixed assets. While this procedure provides for control over fixed assets, we do not feel it provides the level of control, detail, and efficiency that can be achieved with a computerized asset system. We recommend that [client] investigate maintaining its fixed asset records on such a system. This will eliminate a significant amount of manual record-keeping duties, make operations more efficient, and provide more accurate information with which to make business decisions regarding fixed assets.

6.00.06 Maintain a Detailed Schedule of Balances for Property and Equipment

During our audit, we noted [client] did not maintain a detailed schedule of the balances in property and equipment. While a large portion of the recorded property and equipment is fully depreciated, assets could be potentially misappropriated without the proper records being maintained and controls in place. Also, any obsolete property or property with no value should be properly removed from the books and records. To address this situation, we recommend that [client] perform an inventory of all property and equipment currently in use. We further suggest that [client] prepare a detailed schedule that supports the cost, book value, and depreciation schedule for each item and deletes all obsolete or unidentified assets. This schedule should then be maintained on a current basis.

6.00.07 Maintain a Detailed Schedule of Balances for Property and Equipment

While performing audit procedures for fixed assets, we were unable to obtain a schedule of property and equipment, which includes cost, date acquired, estimated life, beginning accumulated depreciation, depreciation, and ending accumulated depreciation by asset. We strongly recommend that the Company begin to maintain such a schedule of property and equipment.

6.00.08 Maintain a Detailed Schedule

During our audit, it was noted that many fixed assets have been grouped together by the date of acquisition on the fixed assets control schedule. However, the fixed assets are physically in many different locations. The fixed asset schedules should be grouped by location and allow enough detail to give the Company control over them. In addition, should a particular location be sold, the Company would have detailed information to properly record the sale of the correct assets.

6.00.09 Supporting Documentation Needed

During our audit, we noted [client] was missing supporting documentation that supported a majority of the additions to property and equipment for the year, including original invoices. Adequate documentation for such additions to fixed assets is critical and should be retained without exception. Lacking supporting documentation in this area is of extreme concern because purchases tend to be of relatively high value. Also, concerns regarding proper approval for purchase, obtaining bids for price comparison, and evidence of receipt of the goods in satisfactory condition all become more evident in this case. We strongly suggest that provisions be implemented to retain supporting documentation for purchases of fixed assets in all cases.

6.01 Physical Inventory of Fixed Assets

6.01.01 Physical Inventory of Fixed Assets Is Needed

Our discussions with management and our review of the detailed fixed asset records reveals that numerous assets recorded on [client]'s records have been disposed of or are no longer in use. We believe that this indicates the need for a complete physical inventory of fixed assets. This procedure will provide [client] with an accurate inventory of fixed assets. The resulting fixed asset listing also will provide a strong source of detail and control to establish a future system of safeguards for fixed assets.

6.01.02 Physical Inventory of Fixed Assets Needs to Tie to General Ledger

We were pleased to note that a complete physical inventory of fixed assets was taken during the fiscal year. However, this information has not been used to adjust [client]'s books. We suggest that valuations be applied (as best as they can be determined) based on the physical inventory of fixed assets, and the resulting total be agreed to the amounts recorded in the general ledger. Significant discrepancies in fixed assets based on the physical inventory should be investigated and resolved as best as possible. This information should then form the foundation for the fixed asset listing or schedule from which to record future acquisitions and disposals.

6.01.03 Physical Inventory of Fixed Assets Needs to Be Taken Periodically

During the last fiscal year, physical inventories of fixed assets were taken for the first time in many years and significant amounts of fixed assets were written off because numerous assets had been disposed of or otherwise taken out of operation in prior years. These transactions have not yet been adjusted on the books. We suggest that physical inventories of fixed assets be taken periodically and related records be timely and appropriately updated, to prevent large abnormal write-offs in the future. Also, a complete and accurate inventory of fixed assets will provide for much stronger control to detect any future fixed asset removal or disposition without proper authorization.

6.01.04 Physical Inventory of Fixed Assets and Maintenance of Fixed Assets Records

Our review of the certain fixed asset records reveals that there may be assets that have not been correctly recorded in the organization's records and/or there may be assets recorded on the organization's records that are no longer in use. We believe that this indicates the need for a complete physical inventory of fixed assets, which will be the best and most efficient method for developing an accurate listing of all fixed assets. Additionally, this will allow the organization to develop procedures whereby the fixed asset listing is reconciled to the general ledger, which will ensure an accurate accounting for assets. Specifically, the listing should include the following data:

- Description of the asset;
- Cost, voucher number, and vendor name;
- Date placed in service;
- Estimated useful life;
- Depreciation method;
- Depreciation expense and accumulated depreciation for the year; and
- Date asset was retired and selling price if applicable.

Complete information such as the above on all fixed assets would provide excellent control for the safeguarding of these assets, which are a significant cost. A better assessment and evaluation could also be made regarding the reliability of certain fixed assets, and the need for replacements, and so on.

6.01.05 Detailed Property Records Need to Be Established

[Client] does not maintain property records for its office furnishings. To improve control over office furnishings, detailed property records should be established. Specifically, property records should include the following data:

- Description and unit number assigned;
- Location of property unit;
- Cost, voucher number, and vendor name;
- Condition: new or used;
- Date placed in service;
- Useful life;
- Depreciation method (for accounting and tax purposes);
- Depreciation provision for each year (for accounting and tax purposes);
- Date retired or traded; and
- Additional first-year depreciation information.

6.01.06 Fully Depreciated Assets

During our audit, we noted that a significant amount of fully depreciated assets were included in property, plant, and equipment at year-end. A further investigation disclosed that these assets are no longer in use and, in many instances, were not present at the expected location. This may indicate that financial statements are misstated in that fixed assets and the related accumulated depreciation are overstated. We strongly suggest that the Company perform a physical inventory of all fixed assets and make adjustments as necessary to properly reflect the related book values on the balance sheet.

6.02 Fixed Asset Purchases

6.02.01 Fixed Asset Purchases Need to Be Approved

Our audit procedures disclosed that [client] does not require major acquisitions of fixed assets to be approved prior to their purchase. This allows for the ordering,

receipt, and payment for fixed asset purchases to take place without the approval of a responsible key employee. This practice allows for substantial manipulation to take place within this area that could potentially damage the organization. We suggest that [client] require prior written approval by way of a purchase order signed by a responsible company official for all major fixed assets purchases. Also, receiving reports indicating receipt of the asset in good working condition should be available before the vendor invoice is approved for payment.

6.02.02 Acquisition of Fixed Assets with Related Debt

Our audit procedures disclosed that certain fixed assets were purchased through financing arrangements that were not recorded on the date of purchase. Rather, the payments made on these notes payable were recorded as increases in property and equipment. In a situation where fixed assets and the related debt are not recorded timely, the impact includes a potential inadequate determination of asset value as well as related debt. We strongly recommend where assets are purchased under financing arrangements, that the asset and related debt should be recorded on the purchase date. The asset cost should be depreciated over the estimated useful life and subsequent payments on the debt should be recorded as reductions of the liability accrued.

6.02.03 Acquisition of Fixed Assets through Lease

Our audit procedures disclosed that certain fixed assets were acquired through leasing arrangements that were not recorded on the date of execution of the lease. Rather, payments made on these leases were recorded as increases in property and equipment. In a situation where fixed assets and the related obligations are not recorded timely, the impact includes an inadequate determination of asset value and understatement of potential liabilities. We strongly recommend that the asset and leasing arrangements be recorded on the lease execution date and subsequent payments on the lease be recorded as reductions of the lease obligation.

6.02.04 Acquisition of Fixed Assets through Lease

Our audit procedures disclosed that certain fixed assets were purchased through financing arrangements that were not recorded on the date of purchase. Rather, the payments made on these notes payable were recorded as rent expense. In a situation where fixed assets and the related debt are not recorded timely, the impact includes a potential inadequate determination of asset value as well as related debt. We strongly recommend that in the future, asset acquisition and the related financing arrangements should be recorded on the purchase date. Subsequent payments on the debt, generally monthly, should be recorded as reductions of the liabilities accrued. Related lease details, such as monthly payments, interest rates, term and minimum lease payments, should be documented as well for future disclosure purposes within the financial statements. This practice will ensure that management has more up-to-date and accurate information with regard to lease transactions throughout the entity, as well as providing necessary documentation to prevent misstatements from occurring in the financial statements.

6.03 Capitalization Policy

6.03.01 Capitalization Policy Needs to Be Implemented

At present, no formal capitalization policy exists for the [client]. This creates a possible situation whereby the following may occur:

- Asset purchases of individually significant amounts not being recorded as such and not on the schedule of fixed assets.
- Asset purchases of immaterial amounts being considered as purchases of fixed assets and included on the schedule of fixed assets.

We suggest the implementation of a policy that would designate expenditures over a certain dollar value as capital expenditures that are to be recorded as depreciable fixed assets. This will set a company standard regarding the level of fixed assets that will need to be recorded as fixed assets with appropriate accounting treatment. This will allow for much stronger control of existing fixed assets, to ensure company assets are properly safeguarded.

6.03.02 Capitalization Policy Needs to Be Implemented

During our audit, we noted that [client] has no formal policy for the capitalization of property and equipment purchases. This leaves the organization open to the possibility that fixed assets will not be appropriately recorded, depreciated, or reported for accounting or tax purposes. We suggest that [client] implement a written policy requiring all assets costing more than an established amount, such as \$1,000, to be capitalized and depreciated over the assets' useful lives.

6.03.03 Adhere to Capitalization Policy

Our audit procedures revealed that capital expenditures less than \$200 have been capitalized in several cases during the year. This is a violation of [client]'s capitalization policy, which requires that only asset purchases of greater than \$1,000 be recorded as fixed assets. We recommend that [client] adhere to its written policies so there is a consistent application of the capitalization of fixed assets within the organization.

6.03.04 Capitalization Policy Needs to Be Implemented

At the present time, there are no formal asset capitalization policies in effect. During our audit, there were several instances in which fixed asset purchases were expensed rather than capitalized. Failure to capitalize fixed asset acquisitions distorts the interim financial statements, not to mention the understatement of assets. We recommend that a policy be implemented that would designate expenditures over a certain dollar value, possibly \$1,000, as capital expenditures to be recorded as depreciable fixed assets.

6.03.05 Capitalization Policy Needs to Be Implemented

We noted that fixed assets purchased during the year were expensed, and an adjustment at year-end was made to capitalize all fixed assets purchased during the year. The cost of fixed assets should be capitalized and depreciated over their

estimated useful lives. It may be helpful for [client] to establish a dollar limit whereby any furniture, fixture, or equipment purchase exceeding that limit would be capitalized on the books of [client]. If these assets are capitalized throughout the year when purchased, interim reports and the budgeting process may be enhanced.

6.03.06 Capitalization Policy Needs to Be Implemented

We also noted that [client] has no formal policy for the capitalization of furniture and equipment purchases. We suggest that [client] implement a written policy requiring that all assets costing more than an established amount, such as \$1,000, be capitalized and depreciated over the assets' useful lives.

6.03.07 Capitalization Policy Needs to Be Formalized

At present, no formal fixed assets capitalization policy exists. We suggest a policy be implemented to more effectively control and account for [client]'s property and equipment. We suggest the present capital expenditure policy be reviewed to more effectively regulate and control [client]'s practice in this area. To accomplish this goal, we suggest the following:

- Establish a minimum dollar amount for capitalization within the various property accounts.
- Prepare written guidelines for proper account classification of all routine fixed asset additions (furniture and fixtures, leasehold improvements, etc.).
- Formalize [client]'s policy to differentiate between maintenance and repair items and long-term improvement items.

Implementation of the above recommended policies will create much more consistent accounting treatment for purchases of fixed assets.

6.03.08 Capitalization Policy Needs to Be Consistent

We noted during our audit of the furniture and equipment areas that [client]'s depreciation method and capitalization policy were not consistently followed during the year. Consistently applied policies assist in the establishment of a strong overall control system within any organization. We recommend that [client] consistently follow the capitalization and depreciation procedures that are currently established.

6.03.09 Capitalization Policy Needs Revision

During our audit, we noted that [client]'s policy for the capitalization of property and equipment purchases begins with any asset purchase over \$250. As of December 31, 20X3, [client]'s total assets approximate \$50 million. We believe that the level of capitalization is much too low for an organization of this size. We suggest that [client] significantly increase its capitalization policy, perhaps requiring that all future asset purchases costing more than \$2,000 be capitalized and depreciated over the assets' useful lives.

6.03.10 Capitalizing Equipment

We noted during our audit that certain equipment was recorded as an expense for items over the organization's capitalization policy threshold. We recommend that the person responsible for coding the invoices be aware of the policy so equipment is properly classified. We also recommend that procedures be put in place to analyze expense accounts such as equipment expense or maintenance accounts as part of the closing procedures to determine if items are found that should be capitalized.

6.04 Depreciable Lives of Property, Plant, and Equipment

6.04.01 Depreciable Lives of Equipment Need to Better Match Actual Lives

Our audit procedures disclosed that a significant amount of fully depreciated assets are included in property, plant, and equipment at year-end. This indicates that the asset lives used for recording depreciation for financial statement purposes are perhaps somewhat shorter than the actual useful life of the asset. We suggest that [client] review this area and make adjustments in useful lives as deemed necessary.

6.04.02 Consistent Useful Life

During our audit, we noted that useful lives of similar fixed assets were not consistent for all related entities. The estimates of the useful lives of the fixed assets drive depreciation, which directly affects the reported net income of the entities. To ensure proper, consistent financial reporting, we recommend that management review and assign proper useful lives to the fixed assets across entities.

6.05 Fixed Asset Disposals

6.05.01 Fixed Asset Disposals Policy Needs to Be Implemented

At present, [client] does not have a formal procedure to ensure that disposals of fixed assets, whether by destruction, sale, scrapping, or trade-in, are reported to the accounting department. Without such a procedure, the likelihood of a disposal going unrecorded increases substantially. A formal policy to ensure the reporting of fixed asset dispositions should be adopted and should require the necessary level of approvals based on the value of the asset. We suggest that a simple yet standardized form be developed to provide adequate approvals for disposal, details, and other pertinent information as evidence of adherence to [client] policy. This form would also provide the necessary accounting documentation for recording the disposal into the books of account.

6.05.02 Fixed Assets Disposed of: Remove from General Ledger

A number of fully depreciated assets that are no longer in use are being carried in the fixed asset accounts. This causes the balance of fixed assets to be higher than it actually is. We recommend that a periodic review be instituted to ensure that fully depreciated assets no longer in use are removed from the fixed asset accounts.

6.05.03 Fixed Asset Disposal Approval Process

For many regions, asset retirement forms are received in the fixed asset department directly from the regional manager. The fixed asset department personnel are then responsible for reviewing the nature of the retirement for overall reasonableness, etc., and they are then to approve the form. We suggest that to make this process more efficient and effective, the regional manager should also approve the asset retirement forms before they are forwarded to the fixed asset department. The department personnel could then review the form, note the proper approvals, and only pursue further investigation if it is considered necessary.

6.05.04 Asset Retirement Obligations

[Client] estimated the asset retirement obligations at December 31, 20X1. [Client]'s estimate and analysis was not complete and in accordance with the accounting standards on asset retirement obligations. [Client] does not have adequate internal controls and procedures to estimate and evaluate the asset retirement obligations, calculate the related depreciation and accretion expenses, and prepare the required disclosures in accordance with the applicable accounting standards. The lack of such controls and procedures may result in recording asset retirement obligations incorrectly, which could result in the financial statements materially being misstated and important disclosures being omitted. We recommend that [client] put in place necessary controls and procedures to estimate and account for the asset retirement obligations in accordance with the applicable accounting standards.

6.06 Depreciation Calculations

6.06.01 Depreciation Calculations When Changing Methods

Our audit procedures disclosed that [client] has been changing depreciation methods as well as useful lives to achieve the best advantage for financial statement purposes. Changes in depreciation methods do require the application of provisions of FASB Accounting Standards Codification (ASC) Topic 250, relating to accounting changes. Essentially, disclosure of such accounting changes for depreciation and their effect on net income is necessary. In the future, we strongly suggest that this disclosure requirement be taken into account in making the decision to change from the established depreciation method.

6.06.02 Depreciation Calculations Policies Are Not Being Followed

Our audit testing revealed that the corporate depreciation policy relating to the half-year convention for acquisitions and dispositions has not been followed for all assets. We strongly suggest that consistently followed company policy is critical for any organization. Such a policy sets the standard regarding the way a particular issue is to be handled. It is not left up to the necessity for a decision because the answer is clear. Wavering from company policy, however, creates a climate of uncertainty among employees and causes confusion.

6.06.03 Depreciation Calculations Do Not Need to Be Performed Manually

Depreciation calculations for book and tax purposes are currently prepared manually by the bookkeeper. This is extremely time-consuming and costly and errors are easily made and not found. These calculations are well adapted to a software application for fixed assets and depreciation. This will free time for the bookkeeper to perform more important tasks, expedite the annual year-end closing, as well as provide more accurate depreciation amounts for interim and year-end financial statements.

6.06.04 Same Depreciation Method Should Be Consistently Used for All Assets in the Same Asset Class

During our audit, we noted that the Company used different depreciation methods to depreciate assets of the same class. For example, purchased computer software was depreciated over the software's estimated economic life using the straight-line method, while leased software was depreciated using the declining balance method. We suggest that the Company adopt a policy that uses the same depreciation method over assets of the same class.

6.06.05 Adopt Depreciation Method that Equitably Allocates Asset Costs over Useful Life

During our audit, we noted that the Company is depreciating substantially all of its tangible assets using the declining balance method. The declining balance method is a tax reporting method and may be an acceptable method of depreciation. U.S. generally accepted accounting principles recommend the use of this method only if evidence indicates that the decline in value of the property is greater in the earlier years of its life or maintenance costs increase significantly as the asset ages. When these factors are absent, the straight-line method is more desirable. Given that the majority of the Company's tangible assets are furniture, fixtures and office equipment which appear to lack the required factors for using the declining balance method, we suggest that the Company review its depreciation policy and adopt a depreciation method that more equitably allocates the asset cost over its useful life.

6.07 Allocation of Depreciation Expense

6.07.01 Allocation of Depreciation Expense to Proper Departments

At the present time, [client] is charging all depreciation expense relating to buildings and building improvements to overhead, of which inventory may be taken. Because the buildings and building improvements accounts include the general accounting offices, sales offices, and administrative offices, inventory costs are overstated. Depreciation expense should be allocated to the appropriate departments to result in a more accurate reporting of income and expenses and the ability to see the true costs of each departmental operation.

6.07.02 Depreciation Expense Should Be Recorded Monthly

Depreciation and amortization expense was not recorded until the year-end audit and based upon the computations of the auditors. We suggest that we

could prepare an estimate of the next year's depreciation and amortization for you to use. Then, to provide more accurate monthly financial statements, we recommend that the estimated annual depreciation and amortization expense be recorded on a monthly basis.

6.08 Amortization of Leasehold Improvements

6.08.01 Amortization of Leasehold Improvements Needs a Separate Account

Presently, the amortization of leasehold improvements is being recorded as a credit in the same account used to record the cost of these improvements. Due to reporting requirements and the need to readily obtain information related to accumulated amortization, we suggest accumulating the amortization in a separate account, as is currently being done for other fixed asset accounts. The general ledger will then provide a continuing record of the original cost and the related accumulated amortization.

6.09 Valuation of Land and Plant Facilities

6.09.01 Valuation of Land and Plant Facilities

Our opinion on the financial statements for the year ended [date] is qualified due to certain land and fixed assets not being capitalized on the books of account, which is a departure from U.S. generally accepted accounting principles. While we understand that it was not practical this year to determine the acquisition cost value of these assets because records are not available, we feel it would be in the best interest of [client] to follow U.S. generally accepted accounting principles. As such, we recommend that an effort be implemented to develop acceptable cost basis valuations for all fixed assets, to allow for the expression of an unqualified audit opinion on future financial statements.

6.09.02 Valuation of Land and Plant Facilities

It is our understanding that [client] is planning to have a walk through appraisal of all property and equipment made at the completion of the expansion and renovation. We encourage [client] to have an accurate appraisal because, in certain instances, a complete valuation of this nature would provide the most adequate means of deriving or estimating an accounting cost value of certain existing fixed assets. Also, this type of appraisal would be most effective for insurance coverage and security purposes.

6.09.03 Valuation of Land and Plant Facilities

A complete listing of fixed assets does not currently exist in the records of [client]. A complete listing of all fixed assets and their related cost is necessary to facilitate the computation of depreciation expense, which is required for all organizations to recognize in their financial statements under U.S. generally accepted accounting principles. [Client] should develop and maintain such a list, and agree it to the general ledger on a regular basis. This listing most likely can be incorporated into the computer system of [client] as a subsidiary system to the general ledger. As a subsidiary in the computer system, the fixed asset listing should virtually automatically agree to the general ledger and also provide a means of control over an entity's fixed assets.

13.01 Purchase and Retirement of Outstanding Stock*13.01.01 Retirement of Previously Issued Stock*

During the [year] fiscal year, [client] reacquired and retired all shares of its previously issued and outstanding Class A (nonvoting) stock. We suggest that legal counsel be consulted on these transactions to make certain that all steps have been taken to retire this stock from a legal perspective. At a minimum, we suggest that the board minutes include and document the decision to retire these shares and the transaction that facilitated the retirement.

13.02 Earnings per Share Computation*13.02.01 Earnings per Share Computation*

Our audit testing disclosed that the earnings-per-share data included in [client]'s interim financial statements are not computed on the basis of the weighted average number of common and common share equivalents outstanding. To reflect interim financial information on a basis comparable with the year-end statements, we believe that the computation methodology for the earnings-per-share calculation should be revised. U.S. generally accepted accounting principles stipulates that earnings per share be computed in this fashion, and we strongly suggest that this method be followed.

CHAPTER 14 GRANTS

INTRODUCTION

Not-for-profit organizations that receive grant and contract funds from various funding agencies can have very specific internal control and operational complications. These situations necessitate a strong accounting system to record specific grant and contract activities. The systems should facilitate the reporting requirements of each contract and grant as well. Also, consideration must be given to compliance with laws and regulations that are a component of any grant or contract accepted. Some of these requirements are extremely rigid and onerous, and they must be accepted with a full understanding of what is actually expected of the grantee. Federal grants and contracts, depending on the amount, also carry a separate audit requirement that must be satisfied generally on an annual basis.

AU-C Section 265 requires the auditor to include in the written communication an explanation of the potential effects of significant deficiencies and material weaknesses that have been identified. Please note that the comments included in this guide may need wording added or revised for this attribute depending on the specific circumstances.

14.00 Accounting*14.00.01 Separate Cost Centers for Federal Grants Suggested*

Currently, a single general ledger cost center is used for numerous sources of federal funding. This practice makes it extremely difficult to determine the funds expended for each of the separate grants and contracts. To more clearly reflect activity on a grant-by-grant basis, we strongly suggest that [client] maintain separate cost centers for each federal funding source. This practice will also facilitate the reporting requirements for grants and contracts.

14.00.02 Grant Accounting

During our audit procedures, we reviewed the grant schedule prepared by management and noted that it did not properly reconcile to the grant activity as recorded. Consequently, we proposed significant adjustments to properly record the grant activity. We recommend that management establish controls to properly reconcile the grant activity and ensure that this agrees to the books of account.

14.01 Audits

14.01.01 Uniform Guidance Audit Requirements

The Office of Management and Budget (OMB) has issued *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (commonly called "Uniform Guidance"), which requires institutions of higher education and nonprofit institutions that expend \$750,000 or more in federal funds to annually conduct a detailed, organization-wide audit that complies with the established criteria. This audit requirement became effective for fiscal years beginning on or after December 26, 2014. To ensure that all such requirements are completely fulfilled, we suggest that [client] closely review its obligations under any programs in which federal funds are received.

14.02 Federal Grants Reporting

14.02.01 Federal Grants Reporting Requirements

We noted an increased involvement of [client] in the area of federal grants. While federal funds are a valuable source of revenue within the community, they impose very specific and stringent reporting requirements that consume considerable staff time and related overhead expense to administer them. Also, where cumulative federal funds are over a certain limit, an additional audit performed in accordance with Government Auditing Standards may be required.

14.02.02 Federal Financial Reports

During our analysis of the quarterly government reports required by government grantees, we noted that two of the four reports for the year had mathematical errors. Extreme care should be taken with these reports, because they are government documents. We suggest that a careful review of these reports take place before they are filed. Amounts reported in these reports should always agree with the general ledger.

14.02.03 Student Financial Aid Program Reports

[Client] has received numerous reports from various divisions of the U.S. Department of Education regarding its Student Financial Assistance Programs. These reports, in the aggregate, assess [client] in excess of [\$ amount] of potential disallowed costs. We understand that special legal counsel and an SFA consultant have been engaged to represent [client] in these matters and that many of these matters are currently on appeal within the proper administrative channels of the Department of Education. As we suggested in the prior year's letter, we very strongly suggest that these SFA matters be given the absolute highest priority and that whatever actions necessary be taken to resolve them. In our opinion, the resolution of these issues is critical to the future of [client].

14.02.04 Federal Grants Reporting: Timely and Accurate Reporting

Our audit procedures revealed that there were instances where reports required to be filed under the grant agreement were either not filed at all or filed after the

due date. We strongly recommend that [client] institute policies and procedures that stipulate that the required reports must be filed by their respective due dates. It is critically important that timely and accurate reports be produced to ensure that the goals and purposes of the grant have been achieved and accounted for properly.

14.03 Grants Regulations

14.03.01 Grants Compliance with Agreements

There is currently no review procedure for grant agreements. We feel that a review procedure is necessary to ensure understanding of and compliance with specific terms identified by the funding source. We recommend that appropriate personnel review grant agreements on a timely basis.

14.03.02 Grant Compliance and Related Accounting

Accounting principles promulgated over the years for not-for-profit organizations require substantial interpretation and judgment relating to the proper classification of net assets as well as the difficult question regarding the determination of whether grant funds are to be recorded as a contribution or an exchange transaction. Currently, the College has no formal procedure for the review and analysis of its grants and for making these classification decisions. We suggest that, in order to ensure understanding of and compliance with specific grant terms as well as consistency of reporting for all such grant agreements, the appropriate personnel review grant agreements on a timely basis and establish documented and consistent procedures pertaining to the appropriate accounting for all grants. We believe that this process will make accounting for and classifying of grants an easier and more routine task. Thus, this should also achieve more consistent accounting and financial statement presentation.

14.03.03 Maintain Summary Schedule of Grants

There is no summary schedule kept for [client]'s grants. A summary schedule helps to keep track of the various aspects pertaining to grants. We suggest that [client] maintain a summary schedule of its grants, which should include the amount, term, dates of receipt, reporting requirements, any restrictions, and other pertinent information.

14.03.04 Procurement Policies

The issuance of the revised Uniform Guidance relating to federal grants and contracts dictates an increased emphasis in the area of policies and procedures relating to the procurement of goods and services. Although [client] has a policy in place regarding procurement, we suggest that the policy be revised to more completely address the process and criteria as detailed in applicable federal regulations.

14.03.05 Procurement Policy and Procedure

The Office of Management and Budget's (OMB's) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (commonly called "Uniform Guidance") requires all not-for-profit organizations receiving federal funds to have a written procurement policy that includes various required policies and procedures. Although [client]'s management has a good understanding of the rules and regulations regarding procurement, we suggest that the procurement policy be written so that the compliance requirement as explained in Uniform Guidance can be satisfied.

14.03.06 Subrecipient Monitoring

During our audit procedures, it was determined that [client] did not sufficiently monitor subrecipient awards, and there was no formal written agreement between [client] and the subrecipient to document the terms and conditions of the award. We recommend that [client] better monitor all subrecipient awards as well as develop written agreements, signed by both parties, that fully explain the federal grant requirements and includes other appropriate language to protect [client] and document [client]'s compliance regarding subrecipient monitoring.

14.03.07 Subrecipient Monitoring

During our audit process, it was determined that certain program managers for federal grants were not aware of the requirements and their responsibilities regarding subrecipient monitoring under federal grants. It is necessary under U.S. Office of Management and Budget (OMB) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (commonly called "Uniform Guidance") and under most federal grant agreements that any federal funds passed through to a subrecipient be appropriately monitored and that the subrecipient is properly informed of the grant requirements, including the need for an audit in accordance with Uniform Guidance when required. We strongly recommend that all federal program managers or other responsible staff be properly trained in managing federal grants, particularly in the area of subrecipient monitoring.

14.03.08 Subrecipient Monitoring

During our audit procedures, it was determined that although the Association did sufficiently monitor subrecipient awards, there was no formal written agreement between the Association and the sub-recipient to document the terms and conditions of the subrecipient awards. We recommend that the Association have written agreements signed by both parties that fully explain the federal grant requirements and include other appropriate language to protect the Association and to further document the Association's compliance regarding subrecipient monitoring.

14.03.09 Federal Grant Expenditures: Disallowed Costs

During our audit procedures involving federal expenditures, it was noted that there were instances of unallowable expenses being charged to a federal grant.

Management has corrected these errors, but it is strongly recommended that federal expenditures be more closely monitored to ensure that only allowable expenses are charged to federal grants. Upon audit of the federal grant or contract, disallowed costs such as these can be required to be refunded to the government. In many cases this can have a serious negative financial effect on an organization.

14.03.10 Maintaining Proper Support for Grants

Based on our audit testing we found that controls over grants of federal and state funds should be improved. Although a system is set up to account for expenses by various grants, this information is not reconciled to the overall trial balance and does not reflect an accurate accounting of the grant expenses. We suggest that [client] structure a better system, capable of properly accounting for the transactions and restrictions relative to these grants as well as maintaining more accurate and complete documentation for all grant revenue and expenses. The accounting system in place made it difficult to determine the funds received and expended for each individual grant. Establishing a better accounting system will also facilitate the reporting requirements for grants and greatly improve internal control.

14.03.11 Support for Grant Expenses

During our audit procedures, we noted certain instances in which proper supporting documentation was not maintained for expenses. For transactions related to federal grants, without the appropriate supporting documentation, charges may be disallowed. This is clearly a critical weakness in internal controls. We strongly recommend that management establish controls and implement policies to ensure that support is obtained and maintained for all expense transactions.

14.03.12 Oral Commitment to Modify and Extend Contract Terms

During the audit of contracts, we noted that [client] has performed work on the "ABC" task and continued billing under the task "at-risk." Based on our review of the contract file, the period of performance for the "ABC" project terminated September 30, 20X1. Based on an oral commitment from the contracting officer, [client] continued to perform under the project until December 31, 20X1. Although [client] obtained oral authorization from the contracting officer, we recommend that [client] always obtain a formally executed contract modification before incurring any cost.

14.03.13 Oral Commitment to Award Contract

During the audit of contracts, we noted that the Company has performed work on the "ABC" task that was awarded December 31, 20XX. According to our review of the contract file, however, the period of performance for the "ABC" project started September 30, 20XX, which was before the contract was awarded. Further investigation revealed that based on an oral commitment from the contracting officer, the Company started to perform under the project in advance of the formal award. Although the Company obtained an oral authorization from

the contracting officer, oral commitments can be nonbinding on the federal government. We recommend that the Company always obtain a formally executed contract before starting a project or incurring any cost.

14.04 Loan Fund

14.04.01 Loan Fund Activity Should Be Reported Monthly

During our audit procedures in the Loan Fund, we noted that [client] failed to record much of the [account name] account activity in the general ledger. [Client] received monthly statements from the [company] showing loan collections and current balances of students with open accounts. To reflect accurate account balances in the general ledger, we suggest [client] record all the activity reported to it each month. This practice will provide a much better review and reconciliation process over the outstanding loan balances and thereby safeguard school assets. Also, this information will cause the interim as well as year-end financial statements to be more accurate and reliable.

14.04.02 Report Loan Fund Activity to the Servicing Agent

We noted on several occasions that students with outstanding [name of loan] loan balances made payments on their accounts directly to [client]. [Client], however, did not report these payments to the loan servicing agent. We suggest that when [client] receives [name of loan] loan payments in the business office, it should notify the servicing agent so that the student's accounts can be properly credited. This practice will provide a much better review and reconciliation process over the outstanding loan balances and thereby safeguard school assets. Also, this information will cause the interim as well as year-end financial statements to be more accurate and reliable.

14.04.03 Formal Periodic Review of the Aged Trial Balance

The year-end student accounts receivable subsidiary indicated that a significant number of receivables are over two terms old. We strongly suggest that a formal periodic review of the aged trial balance and more formalized collection procedures be established. In addition, the University should develop and enforce policies and procedures to prevent the subsequent registration of students whose tuition obligation to the University from prior terms remains unpaid. The implementation of these recommendations and the monitoring of all aspects of student accounts receivable, including monthly reconciliations and collection procedures, are critical elements in a strong system of internal controls and will be of extreme benefit to the University when implemented.

14.04.04 Formal Periodic Review of the Aged Trial Balance

Currently, subsequent payments are being recorded in the term in which they are received. This practice impairs the comparability on a term-by-term basis of the accounts receivable subsidiary ledgers. Procedures should be implemented that allow for recording student payments on outstanding accounts receivable against the term in which the charge originated.

14.04.05 Organization and Reconciliation

Our audit procedures revealed certain complications with the loan and restricted funds that could have been resolved with simple coordination and reconciliation of business office records to financial aid records. Such a practice would provide the University with strong control over both its accounting function and the financial aid areas. This would also greatly enhance the effectiveness of existing internal control and the reliability of the financial records produced.

14.04.06 Default Rate on Loans

With respect to the loan funds, our testing disclosed that the overall rate of default is very high. We suggest that continued action be taken to lessen this excessive default rate. All past-due loans should be reviewed, with collections made where possible and write-offs taken when a loan is deemed uncollectible. This practice will be most beneficial to the organization in monitoring the outstanding loans and protecting its assets.

14.04.07 Cooperation with Federal Agencies

Discussions with Department of Education officials should be pursued until all major unresolved problems of the loan funds from the past are cleared. The servicing agent's report of [name of loan] loans outstanding should continue to be reviewed and updated so that a more accurate picture of [name of loan] loans in-school, out-of-school, delinquent, etc., is available. It is critical to the future of the loan program that these matters be resolved in concert with the federal agency.

14.04.08 Identification of Grantors

Our audit procedures revealed that in many instances the restricted net assets are not adequately identified to ensure that the wishes of the grantors are being carried out. This potentially jeopardizes the organization because grant and contribution agreements have not been followed. There may be monetary implications as well, because funds could be required to be returned to the donors in cases where it is determined that such provisions have been violated. We recommend that some effort be made to identify each separate grantor comprising the total restricted net asset balance. This type of information might be especially useful in the event that a grantor requests an accounting of his or her donated funds or that disclosure of this information is needed at some future point.

14.04.09 Overdrawn Restricted Funds

Throughout the year, amounts were drawn out of the restricted net assets to fund the operations of the unrestricted fund. As a result, amounts have not been used for their intended purposes and are due back to the restricted net asset programs from which they came. This includes substantial overdrawn amounts in the federal grant and contract program accounts at year-end. These overdrawn amounts represent a liability to the federal government. The University needs to discuss, review, and resolve these issues through negotiations with the Department of Education. Strong accounting procedures and controls should be developed and implemented to prevent this problem from occurring again. There may

be serious implications for these actions, some of which may include violations of laws and regulations that can carry stiff fines and/or penalties. We highly recommend that you discuss these matters with legal counsel knowledgeable and experienced in this area.

14.04.10 Federal Agency Program Review

During [date] the University underwent a program review by the Department of Education. After the on-site review was completed, the Department removed the University from the drawdown method of obtaining federal funds and placed it on the reimbursement method. The University must also provide the Department with certain reconciliations of expenditures and documentation prior to requesting any future federal reimbursements. We suggest the University promptly provide the Department with all required documentation and begin negotiations concerning any potential liability as soon as possible. There may be serious implications for these past actions, some of which may include violations of laws and regulations that can carry stiff fines and/or penalties. We highly recommend that you discuss these matters with legal counsel knowledgeable and experienced in this area.

14.05 Other

14.05.01 Grants: Controls Inadequate

Controls over grants of federal and state funds are inadequate. Compliance with laws and regulations regarding federal grants and contracts is of the utmost importance. Violation of these laws and regulations can impose significant operating and financial penalties on an organization and should be avoided at all cost. We suggest that [client] structure a system capable of properly accounting for the transactions and restrictions relative to these grants as well as maintaining more accurate and complete documentation for all restricted grant revenue and expenses.

14.05.02 Grant Controls

Our audit disclosed that controls over grants of federal and state funds are weak and need improvement. Compliance with laws and regulations regarding federal grants and contracts is of the utmost importance. Violation of these laws and regulations can impose significant operating and financial penalties on an organization and should be avoided at all cost. We suggest that [client] structure a system capable of properly accounting for the transactions and restrictions relative to grants as well as maintaining more accurate and complete documentation. Additionally, we discovered that currently there is no accurate summary schedule kept for the organization's grants. Such a schedule, when periodically reconciled against the general ledger, helps to keep track of the various aspects pertaining to grants. We suggest that the organization maintain a summary schedule of their grants, which should include the amount, term, dates of receipt, reporting requirements, any restrictions, and other pertinent information.

14.05.03 Grants: Need to Maintain Time Sheets

[Client] currently charges direct expenses to applicable grants and estimates personnel time spent to allocate salaries and related costs against the grants. We strongly suggest that [client] maintain employee time sheets or effort reports (actual or estimated) to allocate personnel costs. Time sheets are typically used to facilitate the allocation of these expenses to each cost center. This approach will provide much better information to make these types of allocations and will be more in compliance with applicable regulations.

14.05.04 Inactive Grant Receivables and Grant Deferrals

Based on our review of the schedule of grants and contracts, we noted that there are many balances of both receivables and deferrals from grants and contracts that have been inactive for many years. These items simply clutter the accounting records and can cause confusion regarding the true level of activity. We recommend that management investigate and review these balances and take the appropriate action to close out these old amounts.

14.05.05 Timely Invoicing of Grant Expenditures

During our audit, we noted that there are no set procedures for the invoicing of grant expenditures and that the current invoicing practice has contributed to the [client]'s delay in recording revenue in a timely and accurate manner. We suggest that invoices be sent to grantors at least on a quarterly basis, which should increase cash collections and better maintain the accuracy of the grants receivable balance. We strongly suggest that management begin to investigate this problem and we further suggest that a formal policy and procedure be adopted so that accounting personnel have a clear responsibility and involvement in the approval of invoices sent to the organization's grantors.

14.05.06 Time Sheets for Grant Personnel Costs

[Client] currently uses a method of estimating personnel time spent based on grant agreements and budget proposals to allocate salaries and benefits to each grant. We recommend that [client] use time sheets, which indicate actual time spent, to allocate personnel costs to each individual grant. This approach would provide more accurate information for these allocations.

14.05.07 Time Sheets for Federal Programs

It was noted during our audit procedures that [client] is charging time to federal programs based on budgeted fixed percentages rather than on actual time reported by employees on their time sheets. We recommend [client] adopt a policy to ensure that all grants are appropriately charged for time worked. Time worked on federal programs should be charged to the appropriate program as the actual activity of each employee is incurred.

14.05.08 Federal Grant Expenditures: Indirect versus Direct Costs

During our audit procedures involving federal expenditures, it was noted that certain expenses charged to federal grants were incorrectly charged as direct

expenses. In these instances, the nature of the expenses indicates they would be more appropriately classified as indirect costs. We strongly recommend that expenditures be more closely reviewed so that they are classified properly as direct or indirect expenses for federal grant and contract purposes. Upon audit of the federal grant or contract, disallowed costs such as these can be required to be refunded to the government. In many cases this can have a serious negative financial effect on an organization.

14.05.09 Labor Costs

Labor costs (salaries etc.) are usually the most significant costs charged to a government contract, and they usually comprise the base used for the allocation of related indirect costs. The accuracy of the labor cost allocation is directly dependent on the accuracy of the Company's employee (salaried and hourly) labor hours charged to contracts, indirect accounts, and other costs. Also, hours recorded on an employee's time sheet must be adequately supported and documented if they are to be accepted as the basis for reimbursable labor costs on government contracts. We strongly suggest that appropriate and proper policies and procedures be implemented and strictly followed in this area.

14.05.10 Cost Classification

Our audit procedures disclosed that in many instances allowable and unallowable costs are frequently not distinguished, and they become confused in cost submissions related to federal grants. We suggest that the Company's accounting procedures be in writing and provide that all costs are properly classified as allowable or unallowable, including direct and indirect costs that should be excluded from proposals, billings, and claims submitted the government. It is important that the classification of costs as allowable and unallowable to be communicated to those individuals within the Company who are responsible for acting on them. This communication involves not only making sure that appropriate employees are aware of established policies and procedures but also providing the necessary training to ensure they understand how to interpret and execute them.

14.05.11 Classification of Grant Income

During the audit, we noted that income received as grants and contributions was not properly classified as unrestricted or restricted. If they are not properly classified, there is increased risk of restricted grants being used for purposes other than their specified purpose. We recommend that the person who reviews the cash log also review the classification of income as restricted or unrestricted. This would help the organization identify any mistakes in recording and also allow proper handling of grants and contributions.

CHAPTER 15 ORGANIZATIONAL/GOVERNANCE STRUCTURE

INTRODUCTION

Organizational issues and structure can have a dramatic effect on any business enterprise. Experience has shown that an organization that is well defined in its mission and goals, with a strong corporate policy and effective communications, will likely be more successful in accomplishing its objectives. In contrast, organizations that lack a clear mission and have poor communication within the employee ranks seem to have much more difficulty in achieving even the simplest task. Deep political division, ranging from employees to members of the board, can be a strong indication that the organization's future is in jeopardy.

AU-C Section 265 requires the auditor to include in the written communication an explanation of the potential effects of significant deficiencies and material weaknesses that have been identified. Please note that the comments included in this guide may need wording added or revised for this attribute depending on the specific circumstances.

15.00 Corporate Minutes

15.00.01 Corporate Minutes: Improvement

We noted that [client]'s board minutes are not current. Minutes serve as a record of the events of the board meetings and should document all important topics discussed and decisions reached. Board minutes can be a crucial document in the event of future legal matters and in documenting compliance with IRS regulations and other regulatory issues. We suggest that the Board Secretary (or an appointed record-keeper) be responsible for taking board minutes, so that every meeting will have one set of corresponding minutes.

15.00.02 Corporate Minutes: Missing Signatures

Our audit testing disclosed that the condition and content of the corporate minutes has improved over that of the prior years. Minutes for all Board meetings were prepared and available for our examination upon arrival. However, signatures were missing on most of the minutes, and the minutes that were signed were frequently signed several months after the date of the meeting. Minutes should be signed by the Board Secretary to serve as an authentication of them.

15.00.03 Board Minutes

Our audit procedures disclosed that minutes of the meetings of the Board of Directors are not maintained. As a result, there is no assurance regarding the discussion that may have taken place at a meeting of the board and likewise, no assurance regarding official actions of the Board that may have had a financial impact. We very strongly suggest that, in the future, minutes be promptly prepared and retained for all meetings of the Board of Directors.

15.00.04 Executive Committee Minutes

Our audit procedures disclosed that minutes of the meetings of the Executive Committee are not maintained. As a result, there is no assurance regarding the discussion that may have taken place at a meeting of the committee and, likewise, no assurance regarding official actions of the committee that may have had a financial impact. We strongly suggest that, in the future, minutes be promptly prepared and retained for all meetings of the Executive Committee.

15.00.05 Committee Minutes

Our audit procedures disclosed that minutes of the meetings of certain Board committees are not maintained. As a result, there is no assurance regarding the discussion that may have taken place at a meeting of the committee and, likewise, no evidence regarding official actions of the committee that may have had a financial impact. We strongly suggest that in the future, minutes be promptly prepared and retained for all meetings of Board committees, including the Executive Committee and the Finance Committee.

15.00.06 Board Committee Minutes

Our audit procedures disclosed that minutes of the meetings of the Board of Directors are maintained and in very good order. However, there are no minutes maintained for the meetings of the various committee meetings. As a result, there is no assurance regarding the discussion that may have taken place at a meeting of the committee and, likewise, no evidence regarding official actions of the committee that may have a financial impact. We strongly suggest that in the future, minutes be promptly prepared and retained for all meetings of Board committees, including the Executive Committee, the Audit Committee, and the Finance Committee.

15.01 Organizational Structure

15.01.01 Organizational Structure

[Client] currently relies on a part-time Administrator and temporary help on an as-needed basis to perform its administrative and accounting functions. In the past, [client]'s minimal staff size has required the Board of Directors to remain involved in its financial affairs to provide needed oversight and to perform independent review functions. While this has served [client] in a positive fashion, certain other Board responsibilities have not been achieved. We suggest that [client] consider the addition of a permanent part-time Administrative Assistant,

whose duties would relate to daily office operations. This would have the effect of relieving the Administrator of those duties, and thereby allowing him or her to perform the more important components of his or her position. This also eliminates the need for the Board of Directors' involvement in these areas of the accounting function.

15.01.02 Organizational Structure

We noted that the Office Manager has complete control of many responsibilities essential for the smooth and efficient operation of [client]. Executive skill and knowledge of critical areas should not be centralized in any single employee, because this substantially increases the potential risk of loss in the event of that employee's incapacity or leaving the employment of the organization. We strongly recommend that [client] ensure continuity of its operations through a better segregation of duties in these critical areas. Providing a mechanism that allows for other employees to back up one another can be a very effective means of accomplishing this objective. We suggest that a redistribution of responsibilities to appropriate employees and otherwise ensuring that there is a sufficient "backup knowledge base" in other employees will greatly benefit [client] in the event of a loss of a single critical employee.

15.01.03 Organizational Structure

We noted that the Administrator has exclusive executive skills, knowledge, and responsibilities that are essential for the smooth operation of [client]. We recommend the Board of Directors consider developing a succession plan in the event the Administrator is unable to perform his or her duties for a length of time due to illness, attrition, or any other reason. The succession plan should outline procedures to be implemented and a redistribution of responsibilities in the event of a temporary or permanent change. This plan will ensure that the organization will be able to conduct its operations in the orderly and efficient manner that has been the basic ingredient for its past success.

15.01.04 Organizational Structure

Like many similar nonprofits, [client] functions quite well with a small staff. This minimal staff size has always required the Board of Governors to remain involved in the financial affairs of [client] to provide needed oversight and independent review functions. Likewise, a lot of institutional knowledge, strategic oversight, and responsibilities for critical day-to-day operations are vested with [client]'s Executive Director. Although other staff members can provide some additional coverage with respect to daily office operations in the absence of the Executive Director, [client] needs to ensure to the extent possible an appropriate distribution of executive skill and critical area knowledge such that a loss of its Executive Director will not severely affect the operations and/or financial affairs. We recommend the Board of Governors consider developing a succession plan in the event the Executive Director is unable to perform her duties for a length of time due to illness, attrition, or any other reason. This plan should outline procedures to be implemented and responsible persons to be in place whether the situation is determined to be temporary or permanent.

15.01.05 Executive Management

We strongly recommend that the Foundation consider hiring an Executive Officer or Director who would be an actual employee of the Foundation. This individual would be solely devoted to the Foundation and would manage day-to-day activities, including the oversight of the [name] management services provided to the Foundation by the vendor. We believe that this structure would help to emphasize and strengthen the Foundation's organizational structure as well as its independence from [name].

15.01.06 Organization Chart

Our audit testing disclosed that [client] does not have an organization chart. There is a natural tendency in a small business to dismiss the need for an organization chart. In such organizations management deals directly with each employee more than in large organizations, the personnel tend to know one another, and employees are generally familiar with the responsibilities of other employees. However, the lack of an organization chart can cause confusion about who is accountable for particular areas and to whom certain employees are responsible. This has the potential for a negative effect in which certain areas or functions are overlooked, efforts are duplicated, or functions are inefficient. A well-designed organization chart can prevent such misunderstandings and also increase administrative efficiency and control in the following ways:

- Indicate whether there is appropriate allocation of operating and supervisory responsibility;
- Indicate whether there is adequate separation of duties;
- Inform management, new employees, and others of [client]'s management and operating style; and
- Provide information for management, enabling them to monitor and inquire into operations and procedures, assign new duties or responsibilities that might arise (particularly in a growing business), or make reassignments when employee turnover, promotions, operational needs, desire for better separation of duties, or other circumstances require it.

We recommend that management prepare and maintain a complete and accurate organization chart in sufficient detail to indicate [client]'s major areas of operations, the person responsible for each area, and who each supervisor reports to as well as which employees report to each supervisor.

15.02 Audit Committee

15.02.01 Audit Committee Needed

In an effort to improve communications between management, Board Members, and the auditor, we suggest the establishment of an audit committee to assist the Members of the Board in accomplishing their fiduciary duty and responsibility to [client] in the financial realm. The audit committee would be responsible for engaging the independent auditors, reviewing the overall audit plan, reviewing the audited financial statements and the related management letter; creating a

summary and conclusion; and reporting the resulting summary and conclusion to the Board of Directors. Statements on Auditing Standards require, in certain circumstances, that the independent auditor have a direct contact with such a committee of the governing board. An audit committee is advantageous because it ensures direct communication between the independent auditor and the Board. Our experience has been that Board Members generally approve of audit committees because these committees prove to be the most effective and time-efficient method of communication within the Board.

15.02.02 Redefine Finance Committee Functions

While the finance committee has many functions, it lacks the power and authority to accomplish the typical objectives of such a committee. We suggest that its powers and authority be redefined to include the various responsibilities associated with the audit of [client]'s financial statements. Because the organization currently does not have an audit committee, the finance committee could also be responsible for reviewing the audited financial statements and the related management letter and reporting the resulting summary and conclusion to the Board of Directors. Statements on Auditing Standards require, in certain circumstances, that the independent auditor have a direct contact with such a committee of the governing board. By using this committee in this fashion, much better communication will take place between management, the members of the finance committee, and the independent auditor.

15.03 Routine for Acquisition of Businesses

15.03.01 Routine for Acquisition of Businesses

As a component of its business, [client] acquires various other similar businesses to expand its operations. During the past year, [client] acquired several domestic businesses. We feel that a routine should be developed that would assure the assimilation of future acquisitions into [client] on an efficient basis and ensure that all required information for historical and current financial reporting purposes is acquired on a timely basis. We recommend that this routine include, at a minimum, the following points:

- [Client] should obtain financial statements (audited, if possible) of the acquired company for each of the last five fiscal years.
- [Client] should obtain copies of federal and state income tax returns of the acquired company for each of the last five fiscal years, including any reports for IRS audits and related closing agreements that affect those years.
- Appropriate accounting personnel should visit the acquired company shortly after acquisition date in order to explain reporting requirements, review systems of internal control, and initiate any changes that have to be instituted to conform the acquired company's reporting and control systems to those of [client].
- An accounting department employee at the appropriate level should be named to coordinate all accounting considerations surrounding the assim-

ilation of the acquired company's reporting and accounting systems into that of [client].

- An internal review should be performed at six months after the acquisition date. The primary purpose of this process should be to determine that all required changes have been made and that the acquired company is conforming to [client]'s policies and procedures.

15.03.02 Acquisition Accounting

[Client] acquired 52 sites on [date] and paid approximately \$XX million, including approximately \$XX million acquisition-related costs. Although [client]'s management is knowledgeable and has prior experience in dealing with acquisition transactions, it was not aware that the business combinations accounting standards were recently revised. During our audits, we noted that [client] prepared acquisition-date accounting entries that were not in accordance with the revised accounting standards for business combinations. [Client] does not have adequate internal controls and procedures to analyze, evaluate, account for, and prepare the required disclosures for the new acquisition transactions in accordance with the latest applicable accounting standards. The lack of such controls and procedures may result in recording an acquisition transaction incorrectly, which may result in the financial statements being materially misstated and material disclosures being omitted. We recommend that [client] put in place the necessary controls and procedures to account for the acquisition transactions in accordance with the new applicable accounting standards.

15.04 Conflicts of Interest

15.04.01 Conflicts-of-Interest Policy Needed

We noted that [client] does not have a formal policy regarding employee conflicts of interest. In recent years, issues of conflicts have become much more visible and many companies have elected to develop or formalize such a policy. We recommend [client] adopt a formal policy covering potential conflict-of-interest situations. This policy should identify all business relationships and other dealings between [client] and its officers, directors, key employees, and other such parties with whom [client] conducts business.

15.04.02 Obtain Written Statements of Conflicts

We noted that [client] has a formal policy regarding conflicts of interest. In recent years, issues of conflicts have become much more visible, and many companies have elected to develop or formalize such a policy to be more in synch with current sound business practices. We recommend, however, that [client] adopt a formal policy of obtaining written conflict-of-interest statements from all officers, directors, and key employees on an annual basis. This written statement should identify all business relationships and other dealings between [client] and such parties. We strongly recommend that this policy be implemented and followed through to ensure that [client] is practicing acceptable methods of protecting itself from potential self-dealing issues.

15.04.03 Obtain Written Statements of Conflicts

We noted that [client] has implemented a formal policy regarding conflicts of interest. However, we recommend that [client] adopt a formal policy of obtaining written conflict-of-interest statements from all officers, directors, and key employees on an annual basis. We strongly recommend that this policy be implemented and followed through to ensure that [client] is practicing acceptable methods of protecting itself from potential self-dealing issues.

15.04.04 Obtain Written Statements of Conflicts

We noted that [client] has implemented a formal policy regarding conflicts of interest. However, we recommend that [client] adopt a formal policy of obtaining written conflict-of-interest statements from all officers, directors, employees, and major vendors on an annual basis. We strongly recommend that this policy be implemented and followed through to ensure that [client] is practicing acceptable methods of protecting itself from potential self-dealing issues as well as certain fraudulent practices.

15.04.05 Obtain Written Statements of Conflicts

We noted that the Company has implemented a formal policy that completely disallows conflicts of interest. However, in order to better monitor compliance with this policy, we recommend that the Company also adopt a formal policy of obtaining written conflict-of-interest statements from all officers, directors, and key employees on an annual basis. We strongly recommend that this policy be implemented and followed through on to ensure that the Company is practicing acceptable methods of protecting itself from potential prohibited related-party transactions and self-dealing issues.

15.04.06 Appearance of Conflicts of Interest Must Be Addressed

[Client]'s present relationship with [company] appears to create an inherent conflict-of-interest situation for management. The differing interests, together with the interrelationship of ownership and the businesses conducted by each entity, create conditions under which the common management must continually participate in non-arm's length dealings. These dealings leave [client] open to the charge that the ultimate decisions reached are biased and made in the best interests of those other than [client]. We recognize the difficult theoretical and practical problems that must be addressed in considering a change or realignment of the corporate structure. However, the significance of the possible problems caused by the conflicts of interest far outweigh the necessary efforts to eliminate this entire issue.

15.04.07 Identify Related-Party Transactions

Financial reporting standards require disclosure of significant related-party transactions, including the nature of the relationship, a description of the transactions, dollar amounts of the transaction, and amounts due to or due from the related party at the financial statement date. We recommend that management adopt a formal policy to identify and monitor these types of transactions for

proper inclusion of the appropriate financial statement disclosures. Also, such information should be shared with the organization's governing Board to obtain appropriate approval.

15.04.08 Intercompany Transactions

During the audit, we noted that [client] has extensive related-party transactions. The relevant cash receipts and disbursements were recorded through the accounting system. However, the transactions were not always reflected in the correct accounts. In addition, the relevant supporting documents were not maintained for all transactions. To minimize the risk of possible material misstatement, we recommend that management establish a monitoring system, which tracks both sides of a related-party transaction and maintains the intercompany balances with all supporting documentation attached. We also suggest that this information be regularly reconciled to the general ledger accounts and the accounting records of all entities.

15.04.09 Intercompany Accounts

Due to the increase in the intercompany account activity and the related balances, specifically the increase in the amount of funds due to parent from subsidiary, we recommend that the organization should execute a note payable from subsidiary to parent. As a result, this will provide documentation of the debt as well as a payment schedule for principal and interest, which would facilitate the accounting process and reporting for intercompany balances. Better documentation of these intercompany balances will facilitate reporting between the entities and prevent misstatements in these areas from occurring within the financial statements.

15.04.10 Related-Party Activities

During our audit, we noted an extensive amount of related-party transactions, some of which were not supported by relevant documentation. We recommend that the Company keep all supporting documentation for related-party transactions. We also recommend an accurate reconciliation with the related party's detailed balances on a regular basis. For management analysis, we recommend developing a listing of the details of all related-party transactions to facilitate this process.

15.04.11 Related-Party Transactions

During the audit, we noted that related-party transactions are not regularly reviewed by management. Also, certain intercompany balances do not agree with the balances on the other entities' financial records. The lack of a reconciliation process for these amounts indicates a weakness of the internal control structure and could cause errors to occur in the books of account. Accounting standards contain detailed reporting and disclosure requirements for related-party transactions. To ensure proper accounting, it is recommended that the Company designate an appropriate staff member to oversee the transactions and reconcile the accounts on a regular basis.

15.04.12 Leasing Office Space from a Related Party

[Client] is currently leasing office space from a related party. This is currently done under oral agreements concerning all aspects of the leasing arrangement. In order to protect [client] and to eliminate potential problems that can arise from oral agreements, we recommend that written lease agreements be prepared and signed. The lease agreements should name the parties involved and list the terms of the lease and the office space leased. We suggest that this practice will avoid potential misunderstandings in the future and be well worth the effort.

15.05 Business Planning

15.05.01 Business Planning

[Client] has experienced large operating deficits in recent years due to both weak revenue results and excessive expenses. Continuation of this situation will erode the Company's net worth and, depending on the depth of deficits, could force its ultimate liquidation. The budget process is driven by the overall business plan, and recent [client] budgets have not accurately reflected actual operations and results. In light of this situation, we suggest that management consider revisiting [client]'s overall business plan and restating the current year budget. We highly recommend the strategy of concentrating on [client]'s core businesses. These programs and products are the center of [client]'s business, and are clearly in demand. If these programs and products are fiscally strong and profitable, [client] will be as well.

15.05.02 Business Planning

[Client] has experienced large operating deficits in recent years due to both weak revenue results and excessive expenses. Continuation of this situation will erode the Company's net worth and, depending on the depth of deficits, could force its ultimate liquidation. The budget process is driven by the overall business plan, and recent [client] budgets have not accurately reflected actual operations and results. In light of this situation, we suggest that management consider revisiting [client]'s overall business plan and restating the current year budget. We highly recommend the strategy of concentrating on [client]'s core businesses. Any new activities for fiscal [year] and [year] should be thoroughly and conservatively planned and budgeted for prior to initial investment. New activities should be evaluated with regard to whether they add value to and/or strengthen [client]'s core purpose and strategic plan. Then, when initiated, these activities should not be expected or budgeted to be self-supporting for a certain length of time. Plans should be incorporated that cover these initial start-up expenses.

15.05.03 Growth of the Company

During our audit procedures, we discussed with management several significant new programs and services that [client] is considering starting in the near future. These programs and services would greatly increase the volume and complexity of [client]'s accounting as well as the overall administration. We strongly suggest that management consider the increased demands that are going to be assumed