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# The Local Church Financial Review Guide

This booklet is given to you as a service of the Finance Office of the Pittsburgh Presbytery. We hope you will find it useful. If you have suggestions for making it better, please telephone, write, fax or e-mail the Presbytery Business Administrator, who can be reached at these numbers and addresses:

Roy Burford, CCA, PCCA  
Business Administrator  
Pittsburgh Presbytery  
901 Allegheny Avenue  
Pittsburgh, PA 15233-1701

412.323.1400 x322

[rburford@pghpresbytery.org](mailto:rburford@pghpresbytery.org)

## Disclaimer

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

# Local Church Financial Review Guide

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

## **Why not an audit?**

First, it is important to know that the Book of Order (BOO) does not require that each perform a formal audit.

An audit can be defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing the auditor perceives and recognizes the propositions for examination, collects evidence, evaluates the same and on this basis formulates an opinion or judgment which is communicated through an audit report. Financial audits are performed to ascertain the validity and reliability of information, as well as to provide an assessment of a system's internal control. The goal of an audit is to express an opinion of the person / organization / system (etc.) in question, under evaluation based on work done on a test basis. Typically, an audit should be performed by a qualified and independent public accountant or accounting firm. An internal audit could be performed as long as the individuals that are conducting the internal audit are independent and qualified.

## **So, just what is an Financial Review?**

The Book of Order (BOO) does require that each Session or counsel perform a financial review each year as an examination of the financial statements and records to determine that they present fairly the financial position and results of operation for the period then ended.

It does not say that an audit must be performed, or that the review must be performed by a professional, or that it must conform to generally accepted auditing standards, or that it must be prefaced by the usual representations and caveats that auditing firms incorporate into an audit.

We conclude that an " Financial Review", as the term is interpreted in the BOO, is meant to be a process that provides reasonable assurance that good stewardship is being used in handling and accounting for the funds and other assets of the local church.

Here is a practical, working definition of a financial review for the local church:

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

### **Why would a local church want an audit or a financial review?**

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

*why a small church with a tiny budget?*

- or -

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

- or -

*why waste the time or the money, or both, when everybody knows the church treasurer is as honest as the day is long?*

Well, here's the number one reason why - the *Book of Order* tells us in Section G-3.0113, Finances:

"Each council shall prepare and adopt a budget to support the church's mission within its area.

A full financial review of all financial books and records shall be conducted every year by a public accountant or committee of members versed in accounting procedures. Reviewers should not be related to the treasurer(s). Terminology in this section is meant to provide general guidance and is not intended to require or not require audit procedures or practices as understood within the professional accounting community."

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

An annual financial review is the best way we know of -

- ✦ to protect the volunteers that the local church elects to offices of financial responsibility from unwarranted charges of careless or improper handling of funds;
- ✦ to build the trust and confidence of the financial supporters of the church in the way their money is being accounted for (trust and confidence lead to improved patterns of financial support);

- ✦ to set habits of fiscal responsibility to assure that when there is turnover in personnel there will be continuity in accountability and nothing will fall through the cracks;
- ✦ to assure that gifts made to the church with special conditions attached are consistently administered in accordance with the donors' instructions, and thus let donors know their gifts are used as intended;
- ✦ to provide checks and balances for sums received and expended.

Conducting an financial review is not a symbol of distrust -

- ✦ It is a mark of responsibility.
- ✦ It is good stewardship demonstrated for all to see.
- ✦ It is a message to local church donors that you care about their gifts.

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

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

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

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

For example,

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

### **To be "qualified" to review the finances of a local church, must a person be a CPA?**

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

### **Who can Perform a local church audit or review?**

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

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

### **Are there other definitions I should know?**

Yes, there are. In particular, persons interested in church finances should know the definitions of "restricted funds" and "designated funds," and if the funds are "temporarily restricted" or permanently restricted" and how and why each category is accounted for differently in the church's records. The restrictions on designated funds may further be categorized as either "Board (Session) Designated" or "Donor Designated". Please ask to see and refer to the document titled "*Types Of Funds – Definitions*" which is available from the Presbytery office.

### **What are restricted funds anyway and why should I care?**

Restrictions may come about when a donor wishes to give a gift that limits its use to a specified purpose.

In order to receive a tax deduction for federal tax purposes, a donor must release control over their gift to the church. IRS code on designated donations is clear that the church must maintain control over the ultimate determination of how donated funds are used.

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

### **Can you give me an example of a restricted gift?**

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

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

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

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

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

Sometimes churches do not refine their accounting records to the point of separately reporting temporarily and permanently restricted assets in financial statements because they don't have enough of either to warrant the time. That might work if the records are clear enough to be able to distinguish between what can ultimately be spent and what must be held permanently, but we recommend that these type of funds be tracked and reported as temporarily or permanently restricted funds and that income from permanently restricted funds be tracked and reported separately from the balance of the permanently restricted fund that generated it. Remember that when a gift is accepted subject to a stipulation for use in a particular way, the result is a contract to use it only in that way. Keep a record of all of the donor stipulations permanently so you will know what the church has contracted to do. Having a document or binder that has all of this information in it on each fund that lists the source of the fund, the restrictions and the uses allowed will help in maintaining the corporate memory on these types of gifts.

There's another point to remember. The local church cannot change any donor restrictions without the specific consent of the donor in writing.

### **How do restricted assets differ from designated assets?**

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

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

### **Can you outline just what an audit does?**

For starters, an audit or review should:

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

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

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

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

### **What about auditing money held by groups within the church?**

The audit or review refers to a full financial review of all books and records relating to finances. That means the church and all of its organizations.

Records that must be included in the audit or review:

- ✦ All General Fund Transactions;
- ✦ All Designated or Restricted Fund Transactions;
- ✦ All Special Collections;
- ✦ All Payroll Transactions and Reporting;
- ✦ Personnel Records;
- ✦ Insurance Policies;
- ✦ Memorial Fund(s) (if any);
- ✦ Investment or Endowment Funds Transactions;
- ✦ All other separate funds or bank accounts maintained by a group using the same tax identification number as the church, including, for example, Pastor's discretionary fund, Youth fund, church school, and others.

The only exception is the Presbyterian Women, which should be audited or reviewed but may be done separately.

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

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

- ✦ Copies of all the minutes from the finance committee, the trustees, the administrative board, the previous charge conference(s), and the other entities listed on the prior page.
- ✦ Listing of all bank and investment accounts, including the person authorized to sign on each, and including any special use accounts under the control of the pastor(s) and in the name of the church.
- ✦ All financial statements for each month of the year, plus December of the prior year and January of the subsequent year (a fourteen month period).
- ✦ Bank and investment account statements for the same period.
- ✦ Bank reconciliations for that same period.
- ✦ Original books of entry, which will be the general and subsidiary journals; for those books that are computerized, a print-out of all transactions by account for the entire year.

- ✦ All paid invoices, payroll data and files (including 941 's, year-end W-2's, 1099's and transmittal forms), income transmittals and deposit records for the fourteen month period.
- ✦ The Financial Secretary's records and other income records for the same period.

### **What about confidential information?**

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

The auditor's work papers may contain confidential information. These work papers as well as all financial records should be retained per an official Records Retention Guide that has been adopted by the church. All retained records must be kept in a secure, limited access, storage area.

### **How is a local church audit or review conducted?**

After the books are closed for the year but before the audit or review begins, the auditor should prepare confirmation forms for banks, insurance companies and vendors. Those confirmations are essential for providing the auditor with independent verification of bank account balances and authorized signatures, monies sent to the Presbytery or the PCUSA office for benevolence funds and special gifts, and should check the coverage level(s) and related premiums for all insurance policies.

### **How does the local church auditor get bank confirmations?**

For each bank and investment account, the auditor requests the balance as of December 31, and a list of the person(s) authorized to sign on that account.

**Addendum III** is a standard form for obtaining this information.

### **How can the auditor get Presbytery remittance confirmations?**

The auditor should send a letter to the Presbytery office, Attn. Finance Secretary, requesting confirmation of the amounts received from the church for annual per capita, missions and special offerings. We suggest the request should specify a date by which the information should be returned and that a stamped, addressed return envelope be enclosed.

### **How will insurance companies confirm coverage?**

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

### **How does the actual audit or review process begin?**

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

### **What's involved in auditing the cash?**

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

Here are the steps that should be followed, at a minimum:

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

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

### **What about income and receipts?**

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

- ✦ Test (a random sample, not to exceed 10 times; more if discrepancies are found) the counter's documentation versus the Sunday receipt deposit slips and bank statements. Review original book of entry for correct posting of Sunday deposits.
- ✦ Determine whether the amount paid as reported for the donors are the same as recorded and received by the financial secretary. If there is a difference, research for a timing difference, inaccurate recording or some other explanation.
- ✦ Review the original books of entry to determine if other income has been recorded accurately (i.e., appropriate account, correct amount, unrestricted or designated vs. restricted, etc.). Trace the entries to the financial statements.

### **What about disbursements (checks)?**

Yes. It is now time to move to examining disbursements.

Here's how:

- ✦ Review the Finance Committee, the Charge Conference and other committee minutes, as appropriate, for actions concerning disbursements, including apportionment payments. Reconcile those actions with any actual payments made.
- ✦ Test to ensure that all of the disbursements have been properly authorized.
- ✦ Review the original books of entry and disbursements journal to ensure that all disbursements have been recorded appropriately.
- ✦ For the insurance premium disbursements, check to see whether the amount disbursed is the same as that listed by the insurance company as premiums due.
- ✦ Verify that income designated for special mission purposes has been distributed or allocated accordingly.
- ✦ If there is a purchase order system in conjunction with disbursements, note whether the purchase orders have been authorized and approved by the appropriate person( s) and matched against the actual disbursement or invoice.
- ✦ Ask the local church for the minutes you need. This can help to verify that disbursements for outreach, major repairs, salary increases, etc. were authorized. They should be keeping copies in their financial records to make it easier at the time of the audit or review time.

## **What should be done with payroll and tax records?**

Here are the steps needed to check out payroll and tax records:

- ✦ Reconcile all payroll with tax records and tax payments made.
- ✦ Verify that the appropriate amounts have been reported on the 941s, W-2s and 1099s and that the forms have been transmitted to the federal, state and local tax authorities on a timely basis. Also verify the existence of current W-4s and I-9s for all staff. Remember that the IRS views clergy as an "employee". The church may NOT withhold Social Security for clergy, but can make voluntary income tax withholding pursuant to a W -4 form, at the pastor's request.
- ✦ Test that the appropriate amount of taxes have been deducted from the paychecks can be traced back to the W -4 as submitted by each staff person.
- ✦ If the church is not using an accountable reimbursement plan (but, you should) for clergy, or other staff, the appropriate allowances need to be recorded on the W-2 form issued by the church to the clergy. (1099's are not recommended for use with clergy unless that person has been hired on a contractual basis for a short period of time).
- ✦ Trace the payroll and tax records to the actual disbursements made, and recorded with the original books of entry.
- ✦ If irregularities are found in any of the above, research to determine the nature of the error or cause.

## **Verify that salaries and payroll totals are accurate.**

Here are the steps:

- ✦ Check budgets and/or church committee minutes for payroll change records to verify that correct salaries or rates have been paid.
- ✦ If there are tax deferred annuities (403(b)s), Section 125 or other salary reduction agreements, verify existence of signed agreements and proper tax withholding applied.
- ✦ Verify pension contributions with the Board of Pensions. If there is a salary reduction agreement, review documents for accuracy and verify that agreements have been approved in the Session minutes.
- ✦ Verify that housing allowance resolutions are in place and have been properly applied to reduce clergy's reportable 941 and W-2 income.
- ✦ Review the Terms of Call records and verify that they agree with the payroll records.

## **Should we take a look at the control system?**

Yes. As part of the audit or review, it is essential that the internal control structure for receipts and disbursements procedures be reviewed regardless of the size of the church. The internal control structure is the process that assures the local church's operational efficiency and effectiveness, that its financial reporting is reliable, that it is complying with laws, and that its assets are safeguarded. The internal control process should be in place not just on paper but in actual operation.

Areas of concern that should be evaluated include:

### ✦ Segregation of duties.

It is important that duties be segregated among two or more persons, if possible. We understand that in very small churches this may be difficult, but it is rarely, if ever, impossible. The effort by small churches is to attain reasonable segregation under all the circumstances.

Here are some examples:

- ✦ The financial secretary and the church treasurer(s) should not be related. These should be separate offices occupied by different individuals, who are NOT related by blood, marriage or employment relationships.
- ✦ The person(s) performing the audit or review should not be related to either the financial secretary or church treasurer. Also note that at least two persons should count the Sunday morning collections and they should not be related to each other nor should either one be the financial secretary or church treasurer.
- ✦ Receipt and disbursement functions should be performed by different people. (This may not be possible in small churches but is desirable.)

### ✦ Authorizations for disbursements.

- ✦ The first point is that everyone who approves disbursements must be authorized to do so. The auditor should look for resolutions and action in the minutes of the finance committee and the governing body that address authorizations.
- ✦ The check signer should not be the authorizer of expenditures or the person who performs bank reconciliations. The auditor should examine the checks to determine who is signing and compare the results found to bank authorizations.
- ✦ Finance reports. Monthly finance and treasurers reports should agree with the general ledger and subsidiary journals. Balances as of the first day of each month should be same as the last day of previous month.

✦ Other Areas to Check:

- ✦ Does the church have at least two counters for the counting and recording of all collections.
- ✦ Have decisions with financial implications made by church committees and/or the Session been appropriately complied with?
- ✦ Are authorized signatures with banks up to date and complete?
- ✦ Is the correct church employer identification number (EIN) on all accounts?
- ✦ Are investments made only by authorized persons?
- ✦ Are transactions recorded in the correct year?
- ✦ Are checks and cash stored in the church safe, deposited or placed in a bank night depository, and not taken to private homes or elsewhere until deposited?
- ✦ Are reports such as Payroll Tax Form 941, W-2s and the like filed with appropriate authorities in a timely manner?
- ✦ Are payroll taxes being paid on time?
- ✦ Are computer software and data files backed up on a regular basis, and are back-ups kept off the premises?
- ✦ Do all appropriate persons have a clear understanding of and is there documentation on church ownership of software and data files?
- ✦ Is a current list of the contents of all safety deposit boxes maintained, and is a list of persons with authorized access likewise kept? (The auditor should confirm the contents and confirm with the depository institution the persons authorized to access the box.).
- ✦ Are reports from the treasurer, financial secretary and business manager, if any, to the finance committee accurate, timely and complete enough to provide necessary information for the committee to make prudent decisions?
- ✦ Is the finance committee providing to the church's governing body (church council or Session) sufficient information to allow it to exercise its fiduciary duties; are members of the finance committee and the governing body free to express opinions and to question management when appropriate?
- ✦ Are loan documents being read and complied with?
- ✦ Is there a current inventory of fixed assets? Is it kept current by entry of purchases and dispositions? Has the auditor verified the list? Is there a process for control for fixed assets?
- ✦ Is there a policy on records retention, and if so, is it complied with?

For a really useful audit or review check-off list with items that get to the nitty-gritty, just take a look at **Addendum I.**

Once these steps have been taken, the auditor should be ready to write an audit or review report.

### **Who will you explain the auditor's report?**

When the audit or review is complete, the auditor should deliver a written report to the Session and/or the Finance Committee. A sample copy of the form for the Annual Audit or Review Report is attached as **Addendum II**.

The report should be written and should include at a minimum:

- ✦ Documentation of steps taken;
- ✦ Report of the Annual Audit ( or review) form (**Addendum II**);
- ✦ Statement of Financial Position (balance sheet);
- ✦ Statement of changes in net assets (statement of activities);
- ✦ Statement of cash flows;
- ✦ Comments, if any, on the reliability of the treasurer's financial reporting;
- ✦ Comments, if any, on insurance policy coverage;
- ✦ Comments, if any, on compliance with donor restrictions on gifts.

When all these steps have been completed, the auditor should review the work done with the church treasurer and financial secretary, endeavor to answer any lingering questions, then consider preparation of the report.

### **How and when is the Report prepared?**

When the audit or review is complete. The audit or review is complete when the auditor is reasonably assured that the financial records are in order, financial policies have been complied with and any discrepancies have been investigated and controls have been reviewed. With that assurance, the auditor is ready to prepare the Report of the Annual Audit ( or review ) for the Committee on Finance and the Session. **Addendum II**

Finally, the auditor or audit committee should meet with the Finance Committee to discuss the audit or review report, and should assure that the audit or review report, with any responses the Finance Committee may choose to add, is delivered to the Session.



