What directors should consider before approving financial statements

Role of the board

Directors do need to remember that they are not expected to be experts in financial reporting requirements. Nevertheless, a director's duty is to ensure:

- appropriate expertise is applied;
- due process is sound;
- essential elements of the process are scrutinised and tested by directors.

This will lead to a director's confidence in the integrity of the outputs of the financial and management systems.

The following is a list of questions that directors should consider before approving financial statements, where relevant. This list does not attempt to examine all areas that may be 'critical' to every organisation as each organisation has its own unique critical areas.

It is envisaged that these questions would be among those posed by the audit committee, and that the answers would be obtained from management.

Overview

1. **Do the financial statements make sense and present realistically the results, cash flows and state of affairs of the company?**

   It is important to look for what is expected – if it doesn't present, the question "why?" should be asked. The better a director understand their business the easier it becomes for them to understand the financial statements.

   Many director's questions will involve the timing of when information needs to be recorded in the accounting system and if the numbers recorded are appropriate.

Assets

The major concern in this area is whether assets are recorded in the financial statements at an appropriate amount: that is, not exceeding their recoverable amount.

2. **Are any asset values too high? Has the value been impaired and must be reduced?**

   Organisations are not allowed to record an asset at a value materially higher than its recoverable amount. The recoverable amount of an asset is the higher of its fair value less costs to sell and its value in use (this involves a future cash flow estimation).

3. **Does the organisation revalue any of its assets? If yes, when was the last time an independent valuation was conducted? If an independent valuation is not carried out, how has management determined that the book value of those assets is not more than the recoverable amount?**

   Once an organisation commences revaluing its assets it must continue to assess their valuation every year. An independent valuation is not required. If the valuation is determined internally (usually by management) it is referred to as a directors' valuation. Businesses would generally have a financial policy outlining if and when an independent valuation should be sought.

   When an organisation commences the revaluation process, it must revalue all assets within a class: for example land would be a class of assets, and an organisation cannot revalue one parcel of land and ignore another.

4. **Do any non-current assets need to be recorded in the current asset section as a 'non-current asset held for sale'?**

   Non-current assets such as land should be reclassified as a current asset if it is available for sale and the recoverable amount is material to the organisation.

5. **Is the asset register up-to-date? Have fixed assets been depreciated appropriately?**

   Fixed assets (plant and equipment, furniture and fittings, buildings, motor vehicles, computers, etc.) all need to be systematically depreciated over their useful life. Is there a depreciation policy and are assets depreciated accordingly?

6. **Do all bank balances reconcile to the bank statements?**

   This is to ensure accuracy and completeness.

7. **What steps have been taken to ensure that inventories are recorded at the lower cost and net realisable value?**

   The rule for carrying inventory on the balance sheet is to value the item at the lower of cost or its net realisable value. However for NFPs that distribute their inventory free of charge, inventory at cost can be carried on the balance sheet despite the realisable amount being $0.

8. **What physical checks have been made to confirm inventories exist?**

   Despite businesses using perpetual inventory systems, it is still important to conduct a stocktake to ensure the accuracy of the system.

9. **What steps have been taken to ensure that the book value of receivables is recoverable in full?**

   The organisation must assess if it thinks any of the receivables owing to the organisation are not likely to be collected. If this is the case the bad debts need to be written-off so that receivables are not over valued on the balance sheet.

Liabilities

The major concern in this area is whether all liabilities of the organisation are included in the financial statements.

10. **How has it been determined that all creditors have been included in the financial statements?**

    The organisation needs to ensure all invoices have been recorded in the accounting system at year end so that there is a clear indication of payables owing.

11. **How has it been determined that the level of provisions is adequate?**

    Provisions are an estimate and can therefore be underestimated. It's important to ensure that the organisation is comfortable that the amount being reported is high enough.

12. **When does the organisation start to accrue long service leave for its employees? Is the current practice/policy considered to be appropriate?**

    This is a big issue for not-for-profit organisations that are heavily funded through grants. Employee costs need to be fully acquitted against grants in the year of employment, not 5/7/10 years later.

13. **Does the organisation have any grant income that spans more than one financial year or the grant income has not been fully acquitted during the financial year?**

    Whether grant income unspent or received in advance at balance date is deferred or treated as a liability on the balance sheet depends on the terms and conditions of the grant received.

    Where the grants are reciprocal and there are enforceable obligations the amount received in advance or unspent is usually recognised as a liability on the balance sheet.

    Where such terms and conditions do not exist no liability is recognised and the full amount is recognised as revenue when control of the funds is obtained.

14. **Does the organisation have any operating leases?**

    Although notes are included in the financial statements that explain operating leases exist and when payments are required, they do not appear on the face of the balance sheet.

    This means the asset value and the liability contract are not recorded. Hence, when the asset coverage of the liabilities is assessed the calculation will ignore any operating leases.

    It's important to be aware that the accounting standard on leases will change for reporting periods commencing on or after 1st January 2019. Basically, all leases that are longer than 12 months and not of low value will be required to be shown on the balance sheet.

15. **Does the organisation have any contingent liabilities?**

    This is not only necessary to record as a note to the financial statements but also for risk management purposes.

16. **Have the assets and liabilities been correctly classified between the current and non-current sections on the balance sheet?**

    The Centro case has highlighted how important it is to make sure this classification is correct.

Going concern

Before signing financial statements, directors must be satisfied that the organisation can meet its debts as and when they fall due:

17. **What coverage exists between the asset values and the level of liabilities? How liquid are the assets?**

    It is important to understand what level of solvency risk exists for the organisation both from a 12 month perspective and overall. This depends on the level of coverage the organisation has between its assets and liabilities and how easily the assets can be converted to cash if required.

18. **Has a detailed cash flow forecast for the following year been prepared and reviewed by senior management?**

    The cash flow forecast provides the picture of what is expected to happen with the organisations cash across the following 12 months. It will highlight cash flow issues in advance so that they can be addressed.

19. **What are the major assumptions underlying cash flow forecast and are all loan repayments and capital commitments included?**

    It's important to be comfortable with the underlying assumptions used and that all cash requirements are included on the forecast (that is, not just a cash projection of revenue and expenses).

20. **What other issues are relevant in determining that the company can pay its debts as and when they fall due, particularly during the next twelve months?**

    The following subset of questions should be considered:

    - *Liquidity of the asset base – can any assets be sold if required?*
    - *Is the organisation able to renegotiate milestone payment within funding agreements?*
    - *How are accounts receivables and accounts payables being managed?*
    - *Is the organisation in a position to take out a loan or does the organisation have an overdraft facility in place? It's always easier to organise these facilities when they are not really needed than to wait until they are needed.*

Compliance with accounting standards and the external auditors

Accounting standards have the force of the law and must be followed when preparing general purpose financial statements.

21. **What are the key accounting standards that affect the organisation and how does management ensure compliance with these standards?**

    Accounting standards change regularly. It's important to be aware of any standards that have changed during the year and if the changes will have a material impact on the way the organisation presents its financial information.

22. **Have the auditors expressed any concerns about how an accounting standard has been interpreted?**

    Accounting is all about interpretation of accounting rules. An organisation's accountant may have a different view to its auditor's interpretation.

23. **Will the auditors provide an unqualified opinion on their audit report?**

    A qualified opinion may not just be an interpretation issue, but may be due to other more serious concerns which will need to be investigated.

    It is recommended that the board or the audit committee have an opportunity to meet with the auditors without management present to have a free discussion about any issues that the board or the auditors want to raise.

General

This section deals with other areas of enquiry a prudent person would make before signing financial statements, and to ensure the substance (over the form) of the financial statements prevails.

24. **Have all the necessary notes to the financial statements been correctly recorded? Do the figures in the notes match the figures on the face of the statements?**

    The accounting standards also outline the information required to be included in the notes to the statements. Have these requirements been met?

25. **Are there any matters included in the financial statements that could be viewed as misleading?**

    The board of directors are accountable to the members of the organisation. Full disclosure and transparency is always the best approach.

26. **Are any of the directors aware of anything, from their personal knowledge or warnings from outside sources, which should be considered before signing?**

    Board information shouldn't just come from management. Director knowledge and understanding should involve listening to the external environment: for example are there any complaints from suppliers that invoices are not paid on time?

27. **Have the year-end financial statements been finalised by internal staff, an external accounting firm or assistance from the auditors?**

    Many small NFP organisations rely on external assistance in finalising their year-end financial statements. Be aware of what assistance may be required by the finance team at year end either due to lack of internal resources or the expertise required.

28. **How does management ensure that there have been no major breakdowns in internal controls that may have a material effect on the financial statements, either now or in the future?**

    The internal control system is an important part of protecting an organisation, including the accuracy of the financial data.

    Many not-for-profit organisations are not large enough to employ internal auditors, whose role it is to review and improve this system. It's important to be satisfied that the organisation has appropriate measures in place to review and improve these controls. This may involve using an external accounting firm to audit certain processes within the organisation on a rotating basis. Also the organisation should ensure it has process and procedures manuals in place and that they are followed and reviewed regularly.

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