Financial Statements & Bookkeeping

Church Accounting Fundamentals, Cash Flow & Budget Management

Fund Accounting, Reconciliation, Internal Controls & Best Practices (2025)

Church Clergy Tax Management & Compliance

Today's Agenda

- The Big Three Financial Statements (Activities, Position, Cash Flows)
- Fund Accounting: Restricted vs. Unrestricted Funds
- Chart of Accounts & General Ledger Structure
- Bank Reconciliation Procedures & Fraud Prevention
- Monthly & Annual Closing Processes
- Budget Development & Cash Flow Forecasting
- Internal Controls & Segregation of Duties
- Accounting Software Tools & Implementation

Why Financial Statements Matter for Churches

- **Tax-Exempt Compliance:** Must maintain accurate records to defend 501(c)(3) status (Form 990-N filing)
- **Donor Trust & Transparency:** Congregants give to see resources used for mission (transparency = more giving)
- **Leadership Decision-Making:** Financial statements show where you've been, guide where you're going (budget planning)
- **Fraud Prevention:** Regular reconciliation & internal controls prevent embezzlement (3-5% of nonprofits experience fraud)
- **Lending Requirements:** Banks require financial statements for loans/lines of credit (building expansion, renovation)
- **Operational Efficiency:** Identifies cost savings, program profitability, cash shortages before they become crises
- **Legal Liability:** Board members liable for financial mismanagement (fiduciary duty); accurate records = legal defense

The Big Three Financial Statements

1. Statement of Activities

- Profit & Loss (P&L)
- Revenue - Expenses
- Monthly/Annual snapshot
- Shows surplus/deficit

2. Statement of Financial Position

- Balance Sheet
- Assets = Liabilities + Equity
- Point-in-time snapshot
- Financial health indicator

Statement of Activities: Profit & Loss (P&L)

- **Purpose:** Shows revenue received vs. expenses paid during specific period (month/quarter/year)
- **Revenue Sources:** Tithes/offerings, grants, rental income, interest, fundraising events
- **Expense Categories:** Salary/benefits, utilities, facility maintenance, ministry programs, missions, administration
- **Net Income/Loss:** Total Revenue minus Total Expenses = Surplus (profit) or Deficit (loss)
- **Fund Accountability:** Separate P&L for restricted funds shows how restricted donations were used
- **Variance Analysis:** Compare actual vs. budgeted (shows where overspending/underspending occurred)
- **Frequency:** Prepare monthly for leadership review, quarterly for board, annually for congregation

Statement of Financial Position: Balance Sheet

- **Purpose:** Snapshot of church's financial position at specific date (e.g., Dec 31)
- **Structure:** Assets = Liabilities + Net Assets (Equity)
- **Assets:** Cash, checking/savings, pledges receivable, property/equipment, investments
- **Liabilities:** Mortgages, loans, accounts payable (unpaid bills), accrued expenses
- **Net Assets (Equity):** Unrestricted funds (general operations) + Restricted funds (designated purposes)
- **Fund Balances:** Building fund, missions fund, rainy day reserve, endowment (shown separately)
- **Year-over-Year Comparison:** Shows if financial position improving/declining (assets growing, debt shrinking?)

Statement of Cash Flows: Liquidity Assessment

- **Purpose:** Shows actual cash received & paid (different from P&L which records accrual basis)
- **Why Important:** A church can be profitable on paper but have no cash (accrual vs. cash basis)
- **Operating Activities:** Cash from donations, tithes, grants MINUS cash paid for payroll, utilities, supplies
- **Investing Activities:** Purchases of property/equipment, sales of investments, capital expenditures
- **Financing Activities:** Loan proceeds, mortgage payments, capital campaign contributions
- **Net Change in Cash:** Starting cash + operating + investing + financing = Ending cash (per bank statement)
- **Cash Reserves Goal:** Maintain 3-6 months operating expenses in liquid reserves (emergency buffer)

Fund Accounting: Restricted vs. Unrestricted

- **Why Fund Accounting?:** Churches receive funds with donor restrictions (missions, building, specific ministry)
- **Unrestricted Fund:** General operating fund - can be used for any church purpose (tithes, regular offerings)
- **Restricted Funds:** Designated by donor for specific purpose (missions, building fund, youth group, disaster relief)
- **Accountability:** Track restricted funds separately to ensure donations used as intended (legal requirement)
- **Example Restricted Funds:** Building expansion fund, mission trip, missions budget line items, scholarship program
- **Financial Reporting:** Separate fund lines on balance sheet show restricted vs. unrestricted balances
- **Donor Transparency:** Annual statement to donors showing their restricted fund balance & how used

Chart of Accounts: Organizing Financial Transactions

- **What is it?:** Complete list of account names/codes used in general ledger (organizing system)
- **Account Categories:** Assets, Liabilities, Equity, Revenue, Expenses (5 main categories)
- **Numbering System:** 1000s = Assets, 2000s = Liabilities, 3000s = Equity, 4000s = Revenue, 5000s = Expenses
- **Expense Subcategories:** Salaries, benefits, utilities, facility, missions, ministry programs, office, insurance
- **Revenue Breakdown:** Tithes, offerings, grants, rental income, fundraising, interest, donations
- **Fund-Based Codes:** Add prefix for fund (General Fund, Building Fund, etc.) to track restricted spending
- **Chart Consistency:** Once established, keep consistent year-to-year for accurate historical comparison

Bank Reconciliation: Monthly Critical Process

- **Purpose:** Compare bank statement against church accounting records to verify accuracy & detect errors/fraud
- **When:** Monthly, ideally within days of bank statement receipt (before month-end close)
- **Who:** Finance person (or bookkeeper) prepares; separate person reviews/approves (segregation of duties)
- **Steps:** (1) Get bank statement, (2) Compare deposits/checks to accounting records, (3) Identify uncleared items
- **Uncleared Items:** Outstanding checks (not yet cashed), deposits in transit (not yet cleared), bank charges/interest
- **Fraud Detection:** Reconciliation catches unauthorized checks, missing deposits, processing errors quickly
- **Resolution:** Update accounting records for bank charges; reconcile when cleared items show on statement

Bank Reconciliation: Step-by-Step Example

- **Bank Statement Balance:** $15,400 (per bank, as of Jan 31)
- **Church Records Balance:** $14,800 (per accounting records, as of Jan 31)
- **Difference:** $600 - need to investigate!
- **Investigation Steps:** (1) Check for outstanding checks not yet cashed, (2) Look for deposits in transit, (3) Bank charges
- **Finding:** Outstanding check #2891 ($500) + Bank service fee ($100 not yet recorded) = $600 difference
- **Resolution:** (1) Record bank service fee in accounting records ($15,300 new balance), (2) When check #2891 clears, remove from outstanding
- **Lesson:** Reconciliation found that $100 fee was missing from records - prevents balance sheet errors

Month-End Closing: Essential Procedures

- ☐ Complete bank reconciliation (all accounts)
- ☐ Record bank charges/interest income (per reconciliation)
- ☐ Review accounts payable (unpaid bills due/overdue?)
- ☐ Record outstanding payroll/benefits accruals
- ☐ Review restricted fund balances (are restrictions still applicable?)
- ☐ Verify all donations recorded & deposited (match deposit slips to P&L)
- ☐ Verify all expenditures approved & properly classified (correct account codes)
- ☐ Prepare Statement of Activities (P&L) - compare to budget
- ☐ Prepare Statement of Financial Position (Balance Sheet) - verify assets/liabilities
- ☐ Calculate month-end fund balances (restricted + unrestricted)

Annual Budget Development: Strategic Planning

- **Timeline:** Start 2-3 months before fiscal year begins (Sept-Oct for Jan 1 fiscal year)
- **Step 1 - Historical Review:** Analyze prior 3 years' actual revenue/expenses (trends, seasonal patterns)
- **Step 2 - Revenue Forecast:** Project tithes/offerings growth, grant prospects, special fundraising events
- **Step 3 - Expense Estimate:** Project salaries (% increase), utilities (seasonal), ministry programs, fixed costs
- **Step 4 - Departmental Input:** Get ministry leaders' input (youth group events, missions trip, building maintenance needs)
- **Step 5 - Board Approval:** Board reviews draft, approves balanced budget before fiscal year starts
- **Step 6 - Congregational Communication:** Share budget summary with congregation (transparency builds trust & giving)

Cash Flow Forecasting: Planning for Seasonal Needs

- **Why Forecast?:** Churches have seasonal giving patterns (low summer, high Dec/Jan); prevents cash shortages
- **Example Pattern:** Jan-Feb high (New Year giving), May-Aug low (summer vacations), Nov-Dec high (holidays)
- **Forecast Method:** Project monthly cash inflows (donations, grants) vs. outflows (payroll, utilities, fixed)
- **Identify Shortfall Months:** If Aug cash drops below minimum reserve, plan (loans, expense cuts, fundraising event)
- **Cash Reserve Goal:** Maintain 3-6 months operating expenses liquid (emergency buffer for unexpected needs)
- **Example Reserve:** $10k/month operating expenses = $30-60k minimum reserve needed
- **Update Regularly:** Monthly compare actual to forecast (adjust subsequent months if patterns change)

Budget vs. Actual: Variance Analysis

- **Purpose:** Compare actual spending to budget; identify areas of overspending/underspending
- **Variance Calculation:** (Actual - Budget) / Budget = % Variance (positive = spent more, negative = spent less)
- **Revenue Analysis:** Tithes budgeted $50k, actual $47k = 6% shortfall (concerning trend?)
- **Expense Analysis:** Utilities budgeted $1,500, actual $1,650 = 10% overage (investigate spike)
- **Investigate Significant Variances:** >10% variance warrants investigation (one-time cost? permanent change?)
- **Year-to-Date Trends:** Look at cumulative variance (first 6 months cumulative shortfall suggests budget adjustment needed)
- **Leadership Reporting:** Present variance analysis to board monthly (shows stewardship, accountability)

Internal Controls: Fraud Prevention Framework

- **Segregation of Duties:** Separate people for (1) approval, (2) execution, (3) reconciliation of transactions
- **Example - Check Processing:** (1) Manager approves bill, (2) Treasurer writes check, (3) Finance reviews bank reconciliation
- **Cash Handling Controls:** (1) Collection counted by 2+ people, (2) Deposit slip prepared, (3) Bank deposit within 1-2 days
- **Authorization Levels:** (1) Checks under $500 = pastor approval, (2) $500-2,500 = board chair, (3) Over $2,500 = board vote
- **Documentation Requirements:** All transactions have supporting documents (invoice, receipt, approval form)
- **Periodic Review:** Board/audit committee reviews reconciliation, transactions, expense reports quarterly
- **Background Checks:** Finance team members should have background checks (especially those handling cash)

Red Flags: Signs of Potential Fraud/Theft

⚠️ WARNING SIGNS

- Reconciliation unexplained variances
- Missing receipts/documentation
- Donations recorded late/not at all
- Unusual check amounts/frequency
- Personal expenses mixed in

RESPONSE ACTIONS

- Investigate immediately (don't assume error)
- Request detailed documentation
- Involve board/audit committee
- Consider external review/audit
- Consult legal counsel if needed

Case Study: Reconciliation Catches Embezzlement

Scenario: Large church with 500-member congregation, $800k annual budget, volunteer finance team

- **Situation:** During monthly reconciliation, bookkeeper noticed bank balance $5,000 lower than records
- **Investigation:** Found 5 checks ($1,000 each) written to "Building Maintenance" contractor that didn't exist
- **Discovery:** Assistant treasurer had been issuing unauthorized checks to personal account for 6 months
- **Total Loss:** ~$15,000 embezzled before internal controls detected it
- **Root Cause:** Lack of segregation of duties - same person approved AND wrote checks (no oversight)
- **Resolution:** (1) Reported to police, (2) Changed signatories, (3) Implemented dual approval, (4) Monthly board review
- **Lesson:** Regular reconciliation + segregation of duties prevents fraud. Without these controls, embezzlement can go undetected for years

Financial Statement Review: Leadership Checklist

- ☐ Is Statement of Activities balanced? (Revenue - Expenses = Surplus/Deficit)
- ☐ Compare actual revenue to budget - are projections accurate?
- ☐ Are major expense categories on track? (Salaries, utilities, missions)
- ☐ Statement of Financial Position: Do assets match bank balances?
- ☐ Are restricted funds properly segregated? (Building fund, missions fund balances correct?)
- ☐ Has debt decreased? (Mortgage principal paydown, loan balance trending down?)
- ☐ Cash reserve sufficient? (3-6 months operating expenses available?)
- ☐ Accounts payable reasonable? (Outstanding bills, payment terms being met?)
- ☐ Year-over-year comparison: Is church's financial position improving or declining?
- ☐ Are there any unusual/unexplained variances requiring investigation?

Implementation Plan: 90-Day Financial System Upgrade

Days 1-30

- Audit current records
- Define chart of accounts
- Select accounting software
- Identify finance team

Days 31-60

- Set up accounting software
- Train finance team
- Establish reconciliation procedures
- Document internal controls

Days 61-90

- Perform first full reconciliation
- Prepare P&L & balance sheet
- Present to board
- Plan annual budget process

Key Takeaways: Financial Statements & Bookkeeping

- The Big Three statements (Activities, Position, Cash Flows) show complete financial picture
- Fund accounting tracks restricted funds separately (legal requirement & donor accountability)
- Monthly bank reconciliation is critical fraud-prevention control (catch errors/theft early)
- Budget development & cash flow forecasting prevent seasonal cash shortages
- Internal controls (segregation of duties) prevent embezzlement (nearly half of nonprofits experience fraud)
- Regular reconciliation & board review of statements show financial stewardship to congregation
- Accurate financial statements required for Form 990-N filing & tax-exempt compliance
- Monthly month-end closing procedures maintain data accuracy & prevent period-end errors

Building Congregational Trust Through Financial Transparency

- **Quarterly Reports:** Share P&L, balance sheet summary with congregation (shows stewardship)
- **Annual Report:** Comprehensive financial statements, budgets, accomplishments communicated annually
- **Budget Presentation:** Explain how offerings used (40% salaries, 20% facility, 15% missions, 25% administration)
- **Visual Reports:** Use charts/graphs showing revenue sources, expense breakdown (makes data accessible)
- **Restricted Fund Updates:** Communicate status of building fund, missions giving (shows progress toward goals)
- **Challenge with Transparency:** Must balance openness with privacy (don't disclose staff individual salaries)
- **Trust Impact:** Churches with transparent finances see 30%+ higher giving & member engagement

Thank You

Accurate Records • Transparent Reporting • Strong Internal Controls

Next: Attest Services & Compliance Reporting (Form 990-N, Audits)