Audit Guidance: Things that nonprofit CDFI Loan Funds should ask from their auditors

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Many audits of nonprofit CDFI Loan Funds provide information in a way that is of limited usefulness to management, board members, or external analysts – but if you ask your auditor to provide just a little more detail, you will have a powerful source of information to understand the financial sustainability of your organization and build accurate financial models. Below we identify information that auditors often leave out and that you should request they provide. When possible, we provide examples of audits that did provide this type of information. If your auditor is, for some reason, unwilling to provide this detail in the actual Statement of Financial Position, Statement of Activities, or Statement of Cash Flows, insist that they at least provide the information in the Notes.

1. Clear differentiation, preferably on the balance sheet itself, of gross loans receivable, loan loss reserve (a.k.a. allowance for loan loss or allowance for uncollectible loans), and net loans receivable.

Loan Loss Reserve should be carried as a contra-asset on the balance sheet, and the amount of the Loan Loss Reserve should be clearly shown so that stakeholders can see the difference between gross loans and net loans receivable, as well as the size of the Loan Loss Reserve relative to the loan portfolio.

Example:

Loans receivable, current (Note 3)	108,970
Prepaid expenses and deposits	46,138
Total current assets	4,666,819
LOANS RECEIVABLE	
Loans receivable (Notes 1, 3 and 7)	13,263,084
Less: discount on loans receivable	(56,251)
Less: allowance for loan losses	(663,154)
Less: current portion	(108,970)
Non-current loans receivable, net	12,434,709

Notes from example above:

Allowance for Loan Losses

The allowance for doubtful accounts represents management's estimate of probable losses inherent in the loan portfolios as of the balance sheet date. The estimate of the allowance is based on a variety of factors, including past loan loss experience, adverse situations that have occurred but are not yet known that may affect the borrower's ability to repay, the estimated value of the underlying collateral, lender requirements, and general economic conditions. The ultimate recovery of all loans is susceptible to future market factors beyond the Organization's control.

2. A breakdown of the loans receivable indicating delinquent status, number of loans, and loan principal outstanding.

Most CDFI audits do not discuss the performance of the loans outstanding. Since loans receivable is one of the largest assets of a CDFI, an audit that fails to discuss the quality of the assets loses most of its value for serious analysis of the creditworthiness of the organization. Your audit should provide a discussion of loan portfolio performance in the notes.

Example (forgiving the misspelling of loan principal as "principle"):

NOTE 4 - HOUSING LOANS RECEIVABLE (Continued)

The following schedules represents the principle balances of outstanding loans at December 31, 2009 and 2008, respectively:

Loan Status	Loan Principle	Percent of Total	Number of Loans
Current	$ 2,221,838	92.4	216
30 Days	78,154	3.3	8
60 Days	41,407	1.7	6
90 Days	61,974	2.6	6
Total	$ 2,403,373	100.0	236

Loan Status	Loan Principle	Percent of Total	Number of Loans
Current	$ 1,966,500	82.8	190
30 Days	55,234	2.3	10
60 Days	47,054	2.0	6
90 Days	307,613	12.9	42
Total	$ 2,376,401	100.0	248

Management reviews the loan receivable accounts and calculates an allowance by examining loans receivable with no activity over 120 days. The loan receivable allowance was adjusted if it was inconsistent with the estimated charge offs. Non-performing accounts are reviewed by management and then sent to collections if no additional progress can be made by the Organization. Balances that are still outstanding after management has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts receivable. The Organization has established an allowance for uncollectible accounts receivable or pledges receivable in the amount of $120,080 and $282,516 in 2009 and 2008, respectively.

3. Information about when loan principal is expected to be repaid. Also, clear statement of how much mortgage principal was repaid last year.

You and your board will have a much better sense of future cash levels in the organization if your audit provides a projection of expected principal repayments on loans. Your loan servicing / portfolio management software should be able to generate these numbers for you, or you can create a simple Excel model using the CUMPRINC function and loan-level data on your portfolio to estimate these repayments.

Example of audit notes providing information about principal repayments on Loans Receivable:

Maturities of loans receivable for the next five years are as follows:

Year Ended September 30,	Loans Receivable
2010	$ 100,011
2011	90,076
2012	89,189
2013	87,639
2013	84,583
Thereafter	8,089,105
	$ 8,540,603

For large Notes Receivable (for example, a $1 million loan to a developer), some audit notes also provide more specifics: "Anytown CDFI has a note receivable from Acme Development Corporation for construction financing for the Eagle Manor residential project in Anytown. The note receivable is due on June 2, 2012 with no principal payments required before that time. Interest is due annually at a rate of 6%. The note is secured by land."

Your audit should also distinguish whether your balance sheet includes deferred loans, and the amount of the portfolio that is deferred, since deferred loans are worth (in terms of market realities) considerably less than the book value carried on the balance sheet. Example, from the notes of an audit:

	2008
Amortizing loans	$ 4,762,650
Deferred loans	8,500,434
Total loans receivable	13,263,084

A very common practice among auditors is to provide the "net change in loans receivable" in the Statement of Cash Flows, rather than to identify the two components thereof: volume of loans made, and principal payments received on existing loans. For most CDFIs, these are two of the largest cash flows, and their management is critical to the survival of the organization. Ask your auditor to break these items out (into "loans originated" and "payments received on loans"). An example of how to do it, from an audited Statement of Cash Flows:

Cash flows from investing activities	
Equipment and land acquisitions	(12,082)
Proceeds from sale of land	544,556
Loans originated	(8,023,062)
Payments received on loans	5,330,903
Other	(5,807)
Net cash used for investing activities	(2,165,492)

Finally, while it would be very uncommon for an auditor to provide this type of information, at least internally your organization should try to study the prepayment and charge-off trends for different loan products. What percentage of your first mortgage product borrowers are pre-paying their mortgage and how many years after origination are prepayments occurring? What percentage of these borrowers are defaulting, how many years after origination, and what is the loss severity (how much of the loan amount are you unable to recover) when they do go into default?

4. Clear information about the interest rate, remaining term, payment amount, source, and purpose (why it was borrowed) of debt.

Examples of notes in an audit describing a loan payable:

- "XYZ Foundation, loan of $500,000 for development of the West End Affordable Homes development project, interest rate of 1% payable quarterly, principal due in 2015."
- "ABC Bank, Equity Equivalent Investment of $250,000 for Revolving Loan Fund Capital, interest at 2% per annum paid semi annually, unsecured and subordinate to other debt, matures June 30 2015, however lender may extend the loan term for periods of 1 year indefinitely after the maturity date."

Your audit should also provide a schedule indicating the total expected principal repayments on existing debt, as seen in the example below:

Future maturities of total debt are as follows:

2009	$ 6,367
2010	8,299,984
2011	2,907,249
2012	7,736
2013	858,255
Thereafter	3,144,847
Total debt	$15,224,438

6. Differentiate between restricted and unrestricted cash.

The balance sheet should not lump together restricted and unrestricted cash into one item called "cash," since the allowable uses of these types of cash are radically different. Furthermore, the notes to the audit should discuss the allowable uses of restricted cash – is it for lending? For investment in real estate projects? For an endowment? For expenditures on a specific program?

Example:

CURRENT ASSETS	
Cash	
Cash and cash equivalents (Note 1)	$ 2,799,157
Temporarily restricted cash (Note 2)	343,004
Permanently restricted cash (Note 2)	822,857
Total cash	3,965,018

7. Provide a sense of the use of restricted cash for lending – what is the $ volume of loans funded with restricted cash and what restricted cash remains available for lending.

In the notes to the financials, it is helpful to know how much of an organization's loans receivable are funded with restricted cash (such that when they are repaid, the "bank" of restricted funds will increase), and how fully deployed any restricted funds are for lending. The notes could simply provide a breakout of the cash and loans receivable supported by restricted funds. Example:

ABC Foundation Capital Fund

Cash	$45,000
Gross Loans Receivable	$700,000
Allowance for Loan Loss	$(50,000)
Total Assets	$695,000

8. Break down operational expenses by business line. (Even better is to break down the revenues, too). This breakdown will help you get a better sense of where your organization is making (or losing) money. An example follows of a Statement of Functional Expenses that is organized by business line.

		Lending	Education & Counseling	Foreclosure	Real Estate Development	Total Programs	Management and General	Total
Payroll and related expenses:								
Salaries	$	95,812	171,184	165,252	-	432,248	12,012	444,260
Employee benefits		15,901	22,347	26,374	-	64,622	2,409	67,031
Payroll taxes		7,502	13,584	13,247	-	34,333	865	35,198
		119,215	207,115	204,873	-	531,203	15,286	546,489
Operating expenses:								
Advertising		1,485	1,120	7,834	-	10,439	475	10,914
Amortization of rescue funded loans		21,490	-	-	-	21,490	-	21,490
Bad debts		60,000	-	-	-	60,000	-	60,000
Contractor payments		30,210	-	-	22,124	52,334	-	52,334
Credit reports		-	4,909	-	-	4,909	-	4,909
Depreciation		-	-	990	-	990	12,417	13,407
Downpayment assistance		70,035	-	-	-	70,035	-	70,035
Dues, subscriptions and licenses		2,538	-	-	-	2,538	2,680	5,218
Environmental testing		168	-	-	-	168	-	168
Equipment rental expense		438	887	266	-	1,591	569	2,160
Fees		22,444	-	-	1,548	23,992	1,035	25,027
Impairment loss		-	-	-	9,135	9,135	-	9,135
Interest		-	-	-	-	-	3,065	3,065
Liability insurance		2,098	2,398	2,437	1,316	8,249	(386)	7,863
Miscellaneous		164	7	81	-	252	640	892
Postage and printing		978	709	1,288	-	2,975	398	3,373
Professional services		13,414	9,944	12,991	-	36,349	2,022	38,371
Program supplies		-	375	-	-	375	-	375
Real estate taxes		-	-	-	3,500	3,500	-	3,500
Rent		14,096	16,073	19,643	-	49,812	3,244	53,056
Rental fees		-	1,257	-	-	1,257	-	1,257
Repairs and maintenance		996	996	1,116	3,657	6,765	450	7,215
Software expense		300	1,673	1,673	-	3,646	-	3,646
Supplies		1,217	1,559	1,515	181	4,472	8,570	13,042
Telephone		1,514	1,684	1,811	-	5,009	1,288	6,297
Title search and court fees		300	-	-	-	300	-	300
Training and development		499	1,398	171	-	2,068	347	2,415
Travel		788	695	2,211	17	3,711	1,720	5,431
Utilities		-	-	-	655	655	-	655
		245,172	45,684	54,027	42,133	387,016	38,534	425,550
Total expenses	$	364,387	252,799	258,900	42,133	918,219	53,820	972,039

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See accompanying notes to financial statements.