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Common Errors in Financial Statement Preparation And How to Avoid Them

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FOCUS ON WHAT COUNTS [DETERMINED]

December 1, 2016

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What do we want to achieve today?

- Identify common errors found in not-for-profit financial statements

- Understand the impact errors could have on financial reporting

- Identify how to avoid these errors

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Categories of Reporting & Disclosure Errors

- Revenue Recognition
- Net Asset Classification
- Financial Statement Presentation
- Disclosure Errors in the Notes to Financial Statements

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Revenue Recognition

- Contribution vs. exchange transaction
  - Gray area - open to judgment

Indicator	Contribution	Exchange Transaction
NFP's intent in soliciting the asset	NFP asserts that it is soliciting a contribution	NFP asserts that it is seeking resources in exchange for specified benefits
Resource provider's expressed intent about the purpose of the asset to be provided	Resource provider asserts that it is making a contribution to support the NFP's programs	Resource provider asserts that it is transferring resources in exchange for specified benefits
Method of delivery of the asset to be provided by the NFP to third-party recipients	Delivery method is at the discretion of the NFP	Delivery method is specified by the resource provider
Method of determining payment amount	Resource provider determines the amount of the payment	Payment by the resource provider equals the value of the assets to be provided by the recipient NFP, or the assets' costs plus markup
Penalties assessed if the NFP fails to make timely delivery of assets	NFP is not penalized for non-performance	NFP is penalized for non-performance
Delivery of assets to be provided by the NFP	Assets are to be delivered to individuals or organizations other than the resource provider	Assets are to be delivered to the resource provider or to individuals or organizations closely connected to the resource provider.

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Revenue Recognition

- Contribution vs. Exchange
  - If $$$ is advanced, recognition is different:
    - ✓ Contribution = net assets
    - ✓ Exchange = deferred revenue until earned
- Conditional vs. unconditional
  - Recognize unconditional contributions
  - Recognize conditional contributions when the conditions are substantially met
- Promises to give vs. intentions
  - Intentions to give are not recorded until contribution is received (inclusion in a will)
  - Contributions receivable that are paid by donor-advised funds should not be recognized until the payment is received

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Revenue Recognition

- Discounting of multi-year contribution receivable
  - Use a risk adjusted discount rate
  - Rate determined at the date the promise to give is initially recognized – *do not* subsequently revise
  - Amortize discount as a component of contribution revenue
  - *Remember* – this is an estimate…
- Grant accounting vs. GAAP
- Restrictions
  - *Remember* - only donors impose restrictions that create temporarily and permanently restricted net assets

Revenue Recognition

- Contributed services
  - GAAP recognition criteria
    - Create or enhance nonfinancial assets
    - Require specialized skills, are provided by those who possess those skills and would typically need to be purchased if not contributed (typically professionals and craftsmen)
    - Whether or not the organization could afford the services at fair value is ***not*** a factor
  - Improper recognition driven by:
    - Matching requirement of a grant
    - Desire of an organization to show “true” program costs
  - Improper omission driven by:
    - Inability of an organization to afford the services at fair value

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Net Asset Classification

- Debit balances in temporarily or permanently restricted net assets
  - It is not possible to release funds greater than the net asset class balance (even if you anticipate future funds)
- Board designated net assets recorded as temporarily or permanently restricted net assets
  - Even if funds are designated/restricted for a purpose ***by the Board***, they are *still* unrestricted for GAAP purposes
- Contributions receivable due in future years recorded as unrestricted
  - Multi-year pledges carry an implicit time restriction even if the gift is unrestricted for general operations

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Net Asset Classification

- Improperly presenting expenses as temporarily or permanently restricted net assets
  - All expenses must be categorized as unrestricted
  - Expenses that satisfy a donor restriction related to temporarily restricted net assets are unrestricted
  - Recognize the satisfaction of donor-imposed restrictions on net assets through “net assets released from restriction” on the statement of activities
- “Choosing” when to release temporarily restricted net assets in a period other than when event of release has occurred
  - If expenses are incurred for which both restricted and unrestricted net assets are available, the organization is required to use the restricted net assets first

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Financial Statement Presentation

- Failure to account for an operating lease using straight-line (sofp & soa)
- Improper capitalization and amortization of leasehold improvements (sofp & soa)
  - Amortize over the shorter of:
    - ✓ Useful life of the asset
    - ✓ Lease term
- Failure to report fundraising expenses (soa)
  - If an organization receives contributions, it should have FR expense

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Financial Statement Presentation

- Failure to report gifts-in-kind (soa)
  - Free use of program space is most commonly overlooked
- Reporting activity "net" in the statement of cash flows
  - Purchase and sales of investments
  - Borrowings and repayments on long term debt
    - ✓ Includes borrowings on LOC throughout the year, even if balance is $0 at year end
- Failure to include a statement of functional expenses when required
  - Currently all voluntary health and welfare organizations are required to have this

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Disclosure Errors in Notes to Financial Statements

Failure to disclose:

- Adequate description of organization's activities and programs
  - Tell your story!
  - Take credit for all the important work that you do and the amazing programs you operate!
  - Make sure all information is consistent. Remember – there is quite a bit of information available for public consumption… (Website, 990, UFR, etc.)
- Information about contributed services
  - Nature and extent of contributed services
  - NFP's are encouraged to report the fair value of contributed services *NOT* recognized in the notes

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Disclosure Errors in Notes to Financial Statements

Failure to disclose:

- Policy on whether restricted contributions & investment income are treated as unrestricted if the restriction is met in the same year
- Endowment disclosures
  - *Remember* – this includes all funds "acting as endowment" which includes unrestricted board designated as well as temporarily and permanently restricted funds.
  - Should ***not*** include permanently restricted net assets related to outstanding contributions receivable
- Information about temporary restrictions
  - Nature and amounts of restrictions

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