Common Errors in Financial Statement Preparation And How to Avoid Them

Presented by
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FOCUS ON WHAT COUNTS

[DETERMINED]
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
Categories of Reporting & Disclosure Errors

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

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

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