Common Errors and Problems in NFP Financial Statements

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Course Description

This course is tailored for CPAs and nonprofit financial professionals who aim to enhance the accuracy and compliance of nonprofit financial statements. Participants will learn practical techniques to identify, address, and prevent common errors, ensuring alignment with nonprofit organizations' unique objectives. Through real-world examples from small-to-medium-sized organizations, attendees will gain actionable insights to improve financial clarity and decision-making. Experience in preparing financial statements for nonprofit organizations, including the Statements of Financial Position, Activities, Functional Expenses, and Cash Flows is recommended.

Learning Objectives

By the end of this course, participants will:

- Identify common errors and misstatements in nonprofit financial reporting.
- Apply techniques to ensure compliance with GAAP and other applicable standards.
- Enhance the accuracy and reliability of nonprofit financial statements.
- Utilize financial statement reporting to demonstrate financial transparency to stakeholders.

Background and why I'm a presenter today

You can read my bio, and I hope it conveys my dedication to working with numerous small to medium-sized not-for-profit (NFP) organizations throughout my professional life. Through this experience, I have gained valuable insights and developed a strong belief that financial information is a crucial aspect of NFP governance. I am eager to share what I have learned to help my peers in public practice and those within organizations improve their financial reporting responsibilities.

Why is this important?

Accurate financial statements are crucial for the success of a nonprofit organization and are equally important for achieving its programmatic goals. When financial information is inadequate, it can lead to a loss of trust among external stakeholders, or even worse, poor decision-making, resulting in misallocation of resources. Ensuring precise financial reporting is not only necessary; it is a fundamental element that ensures accountability and builds confidence in the organization.

What to Expect

I'm excited to share my experiences along with references to technical resources that highlight the types of errors that can arise throughout an organization's lifecycle. Together, we will follow an organization as it progresses through different stages of growth, examining how common errors in financial statements evolve over time. I want to take a fun and unique approach rather than just presenting technical information straightforwardly. I believe this journey will lead to valuable insights that will enhance collaboration between organizations and the professionals who serve this industry!

Our “Sample Organization”

Throughout this course, I will use MARC (the Madison Alliance for Rebuilding Communities), which is, in fact, a real organization, as the “sample organization” and walk through the evolution of financial reporting and the risks associated with the reach phase. I am using this organization as an example because of how personally important it is, but there is no financial data yet 😉 .

Our "Sample Organization"

Laying the Groundwork

Before we can get into identifying common errors and problems in financial statements, it is important to gain some agreement and understanding around some key areas. Who is involved and what are the objectives of financial statements anyway?

Who are the key users of financial statements, and what might their objectives be?

Management (Internal) – Needs to make real-time decisions regarding finances. It is important to review and understand details while also keeping the big picture in mind.

Board (Internal) – Responsible for exercising fiduciary duties and ensuring proper stewardship of resources. The board reviews financial information to ensure it aligns with the organization's goals and mission. Their focus is primarily on the big picture, although having access to details and being able to ask questions for further understanding is essential.

Who are the key users of financial statements, and what might their objectives be?

Funders/Stakeholders (External): It is essential for funders and stakeholders to understand your financial model, trust that the information provided is accurate, and be able to compare it with other organizations and industry expectations. You can assume they have the capability to read financial statements; therefore, the aim is to provide clarity and differentiate your organization.

Public (External): Consider how the public might perceive your organization when reviewing the financial information you provide. It's important not to assume that they will fully understand this information. Is this the audience you want to engage with? This concern is typically addressed through the use of summaries and annual reports.

Who is preparing the financial statements and are they "qualified"?

Skills, Knowledge, and Experience (SKE) refers to the ability to prepare, read, and understand financial statements. As auditors, it is essential for us to document this competency. Additionally, as an organization, you should take this into account when building your team. Generally, a higher level of SKE increases the likelihood that internal financials will be accurate. Below are some common financial roles and their expectations.

Admin Staff and Bookkeepers

Individuals trained in the fundamentals of data entry prioritize accuracy and attention to detail. They perform best when supported by an organizational culture that values financial information. While they may lack the skills for big-picture thinking or financial analysis, pairing them with more experienced colleagues can be beneficial. Numerous excellent training programs are available for those who are passionate and motivated to excel in this work.

Executive/Finance Directors

This person should have an appropriate resume and background that reflects management knowledge of the organization and experience demonstrating success at this level. It is essential to understand the role of each financial statement and how they interconnect to provide a complete financial picture. This includes knowing how summaries are presented to the Board and the details related to grant tracking and programs that contribute to those statements.

Board Members

Not everyone needs to be an expert in reading financial statements, but it is essential to understand the basics to perform their roles effectively. After all, there is a fiduciary responsibility to do so. At least one person within the organization should have a background in reading and understanding financial statements to ensure that the organization's goals are accurately reflected in the financial reports. This individual does not always have to be a CPA; financial executives and business owners can also be excellent choices. They should be familiar with the nuances of non-profit organization (NFP) reporting.

External Professionals

If there are gaps in the organization’s Skills, Knowledge and/or Expertise from the roles mentioned above, it's important to engage a financial professional to address those gaps. This professional should be expected to provide education and insight to the rest of the organization, enabling them to perform their functions effectively. When hiring, prioritize candidates with experience in not-for-profit (NFP) organizations; don't assume that all Certified Public Accountants (CPAs) and consultants are familiar with NFP operations!

What is the commitment to providing accurate financial information?

It's one thing to talk the talk, but what has the organization done to show this commitment!

Attitudes and Culture

- How do those in charge perceive the financial reporting process?
- Is it considered an afterthought, or is it regarded as a key driver of an organization’s mission success?

A common perspective holds that it is merely a requirement and not a value-added contributor.

Policies and Procedures

Understanding the roles and responsibilities across the organization is the first step. During the design process, it's important to separate as many financial responsibilities as possible, based on each position's availability and role. Once this exercise begins, the next step is to document these responsibilities in writing.

What purpose do financial statements serve, and why are they important?

Financial statements communicate the overall financial condition via a snapshot in time (SOFP) and provide a scorecard of how well the organization performed over a period of time (SOA, SOFE, SOCF). An accurate reporting framework can help drive decisions around allocating resources to best achieve the organization's aims over the reporting period (BUDGET).

- For internal stakeholders, this information is critical for a well-run organization and ensures stewardship of resources
- For external stakeholders, it's a function of accountability and transparency

Tool for Simplifying the Process

Before we begin reviewing and analyzing common errors and problems in NFP financial statements, I want to introduce a tool to help us:

MIRROR: Matrix for Identifying Risk in Reporting & Organizational Resources—a framework that reflects financial transparency. By utilizing this framework, we can swiftly evaluate the organization for the factors that influence the accuracy of its financial reporting.

MIRROR System

	Identify Risk		
	Low	Medium	High
Reporting			
Internal			
External			
Organizational Resources			
People			
Financial Staff			
Executive Director			
Board of Directors			
Commitment to Transparency			
Policies and Procedures			
Environment/Culture			

High Risk: A high-risk organization is most likely to have its financial statements misstated, often in many or all areas.

Org Assumptions: The organization is in its early stages and often relies on untrained volunteers to set up financial systems, managed by staff members who have little to no financial background. As a result, financial matters tend to take a backseat to the mission that everyone is excited about. It is likely that the financial statements are atypical and that the accounting system is either nonexistent or improperly configured. Personnel are stretched thin, leading to common mistakes, and financial reporting can be delayed. The organization has given little to no consideration to financial policies and best practices and lacks the ability to segregate duties. While everyone is learning and doing their best, financial issues are overshadowed by the focus on the organization's mission.

MIRROR Analysis: High Risk

	Identify Risk		
	High	**Medium**	**Low**
Reporting			
Internal	New to QB/No System		
External	No external reporting		
Organizational Resources			
People			
Financial Staff	Volunteer/Low SKE		
Executive Director	N/A		
Board of Directors	All Program Focused		
Commitment to Transparency			
Policies and Procedures	None Documented & No Duties Segregated		
Environment/Culture	Program Focused		

Common Financial Statement Misstatements with High Risk

- The chart of accounts is too long
- Accounting system, if any, has been set up to follow the unique perspectives of that individual. "Makes sense to me!"
- Purely cash-basis reports - Cash accounts could be reconciled and transactions accounted for, but any financial event outside of cash would not be recorded (e.g. donated property)
- Overall unreliable and would require significant professional work to be presentable to external parties and the 990 preparation. Difficult to grow org without financials to share with funders.
- Note to CPAs: these orgs would not be auditable.

Medium Risk: Getting the fundamentals right.

An organization at this stage has had time to grow and learn. It has created a reporting system that meets the needs of its internal users. The accounting system is frequently used and updated, providing nearly real-time reports to help management make decisions. In addition to basic financial statements, the organization also tracks grants. Reporting to outside parties is rare, and the requirements are usually simple. The organization has trained its financial team, giving them the skills they need to manage finances effectively. Responsibilities are clearly defined through policies and procedures, and there is some consideration for separating key responsibilities.

MIRROR Analysis: Medium Risk

	Identify Risk		
	Low	**Medium**	**High**
Reporting			
Internal		QB Used and Core Monthly Reports	
External		990 Preparation and some grant reporting	
Organizational Resources			
People			
Financial Staff		Bookkeeper (Skills)	
Executive Director		Paid position (Knowledge)	
Board of Directors		Retired Professional (Experience)	
Commitment to Transparency			
Policies and Procedures		Core Processes Documented/ Some Duties Segregated	
Environment/Culture		Understand Importance and committed	

Common Financial Statement Misstatements with Medium Risk

- Most of the misstatements will be due to a lack of understanding of cash-to-accrual concepts. E.g. Receivables and Payables.
- No or infrequent adjustment for non-operational accounts e.g. fixed assets, payroll accruals
- Recording nonroutine transactions and those that don’t flow through a cash account. Examples of these would be in-kind donations, financed property purchases

Low Risk: The organization has matured and checks nearly all of the boxes for a well-run organization.

The organization has developed accurate internal financial reports that effectively meet its needs, accompanied by advanced reporting metrics. As external parties increasingly review financial statements through annual audits and transparency web pages, consistency with Generally Accepted Accounting Principles (GAAP) has become even more critical. All members of the financial team bring specialized knowledge and expertise to the organization. Policies and procedures are well-documented, and segregation of duties is maximized with the current staff. The organization is committed to transparency, which is demonstrated by its practice of sharing financial information.

MIRROR Analysis: Low Risk

	Identify Risk		
	High	**Medium**	**Low**
Reporting			
Internal			Complete use of QB Modules, Frequent and Comprehensive Reports
External			Annual Audits and External Stakeholders
Organizational Resources			
People			
Financial Staff			Finance Director (S+K+E)
Executive Director			Exec Director (S+K+E)
Board of Directors			Finance and Audit Committee NFP Backgrounds (K+E)
Commitment to Transparency			
Policies and Procedures			Well Documented and Maximized Segregation of Duties
Environment/Culture			Transparency and Valued

Common Financial Statement Misstatements with Low Risk

- At this level most of the errors and problems will be caused by application of accounting standards and interpretations inherent to "grey areas". At this stage the errors could also be caused by external professionals as well.
    - For the CPAs out there, see the numerous areas of misstatement observed in the article published here: Common NFP financial statement errors | Resources | AICPA & CIMA
    - Revenue recognition around contributions, grants and contracts. Conditions & barriers vs restrictions
    - Confusing Board or internal restrictions and with donor restrictions (and vice versa).

Common Financial Statement Misstatements with Low Risk Continued…

- Lease agreements
- Complex financial instruments such as life estates and bequests.
- For Audits: Not following the numerous examples of financial statements provided to us by our industry partners such as the AICPA.
- Advice: Missing the opportunity to align the external financials with the internal financial statements in a way that helps the organization communicate to their stakeholders
- Be considerate: Don’t adjust clients’ financial statements in service of our industry only; consider how adjustments may impact the day-to-day operations of the organization

Conclusion

- Know the user of your financial statements and their needs
- Understand the people behind the financial statements. Where are they in their journey and how might that contribute to the financial statement presentation
- Make sure that the conditions are present for creating accurate and usable financial statements
- Financial reports are an opportunity to tell your story, so use them. Consider how the three: audit, 990 and annual report work together to accomplish this