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 subject 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.

Our “Sample Organization”

Throughout this course, I will use the Madison Alliance for Rebuilding Communities (aka MARC), 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, so there are no numbers to share 😉.

Madison Alliance for Rebuilding Communities - MARC

What to expect during our time together

I’m excited to share my experiences alongside technical resources that highlight the types of errors that can arise throughout an organization’s lifecycle. Together, we will follow MARC 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 instead of 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!

Laying the Groundwork

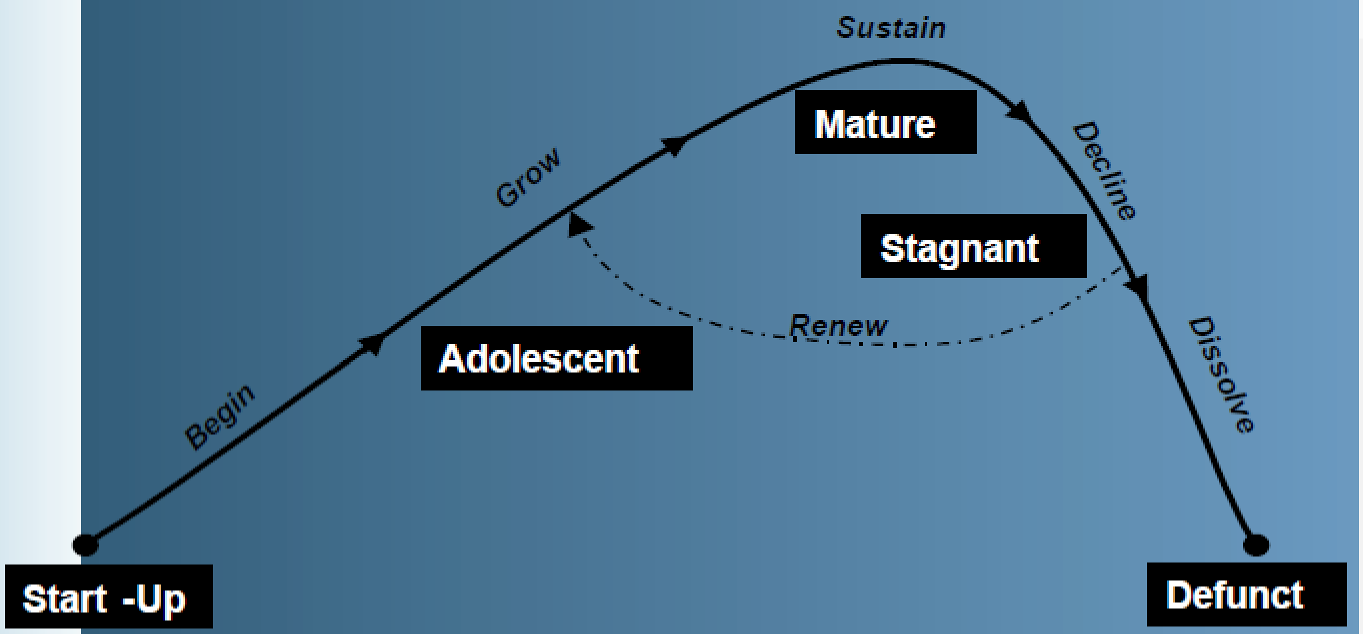
Before we can identify common errors and problems in financial statements, it is essential to reach some agreement and understanding around some key concepts and ideas. It is critical to know what financial statements are and how they relate to the stage an organization is in.

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

Financial statements communicate the overall financial condition via a snapshot in time (Statement of Financial Position) and provide a scorecard of how well the organization performed over a period of time (Statements of Activities, Functional expenses and Cash Flows). An accurate reporting framework can help drive decisions around allocating resources to best achieve the organization’s aims over the reporting period (Budget).

Without them, it’s impossible to effectively manage an organization and no chance to demonstrate transparency.

Understanding the Stages of an Organization



1 This model is adapted from Susan K. Stevens' *Nonprofit Lifecycles: Staged-Based Wisdom for Nonprofit Capacity* (Stagewise Enterprises, 2002.)

A Brand New Tool for Simplifying the Process

Before we begin reviewing and analyzing common errors and problems in NFP financial statements, I want to introduce a model I developed to help us identify the key organizational inputs and concepts.

MIRROR: Matrix for Identifying Risk in Reporting & Organizational Resources

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

Reporting– Internal

This matrix area refers to the risk inherent in the internal reporting framework and pressures from internal stakeholders. How do their needs and experiences shape the structure and presentation of the financial information?

- Management – will have desires for a lot of detail to facilitate their needs, and are most proximate to the data
- Board – Will often want information simplified and customized to make it easier for a wide range of members

Reporting– External

This matrix area refers to the risk present through the framework and pressures from reporting to external stakeholders. How do their needs shape the structure and presentation of the financial information?

- Funders – Have a need to understand your financial condition and be able to compare it against other organizations. How did you safeguard their grant funds?
- Public – Providing information to the public brings its pressures and incentives.

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People - Internal

Management– Needs to make real-time decisions regarding finances. It is important to review and understand details while also keeping the big picture in mind. Common roles and their characteristics

- Admin Staff
- Bookkeepers
- Executive Director
- Finance Director
- Other Program and Fundraising professionals

People - Internal

Board—The board is 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.

People – How do they impact risk

Skills, Knowledge, and Experience (SKE) pertains to the capability to prepare, read, and comprehend financial statements. It is crucial for us as auditors to document this competency. Furthermore, as an organization, this should be considered when assembling your team. Typically, a higher level of SKE enhances the chances of accurate internal financials. Below are some common financial roles along with their expectations.

People – How to fill SKE Gaps

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!

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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.

Environment 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.

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Organizational Resources – Financial Health

Let’s be honest, organizations with greater financial resources often exhibit stronger financial health, making it easier for them to act ethically.

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Defining and Assessing Risk

Now that we understand each of the areas covered by the matrix, how do we assign risk?

- High Risk – Weakness in this area would increase the probability that a financial statement error would occur
- Medium Risk – Mix off strengths and weaknesses in this area would create a variable probability that a financial statement error would occur. This would require the most analysis at the account level.
- Low Risk – Strength in this area would decrease the probability that a financial statement error would occur

Putting the MIRROR to use

With a clear grasp of this tool and its functionality, let's apply it to track MARC as it transitions through various organizational stages.

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

MARC is in its early stages, and everyone involved is excited to tackle the challenges the community faces post-hurricane Helene. The board is a diverse group of passionate individuals eager to make a difference. MARC has limited resources, and finances are tight, so there's no need to track financial information just yet. Once grants and donations start rolling in, the need is apparent and they get to work to put a system in place. Given thier limited time and resources, they decided to start with Excel and invest in QuickBooks later on as things “get more complicated”. Since there's only one board member with a financial background, they'll be responsible for keeping track of the finances.

MIRROR Analysis: Start-up Organizations

	Identify Risk		
	High	**Medium**	**Low**
Reporting			
Internal	No System		
External	No external reporting		
Organizational Resources			
People			
Financial Staff	Volunteer		
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		
Financial Health	Little to none		

Common Financial Statement Misstatements with Start-up Organizations

- Once a system is in place, the chart of accounts is too long and 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.
- Pro tip: These orgs would be difficult to Audit, if at all. Resources best spent getting a financial foundation in place.

Adolescent Stage: Getting the fundamentals right.

Since those early startup days, MARC has had time to mature and learn. They've made the switch to QuickBooks and developed a reporting system that meets the needs of their internal users. The accounting system is regularly used and updated, providing almost real-time reports to help their new management make informed decisions. In addition to standard financial statements, MARC also tracks its grant activity. Reporting to outside parties is infrequent, and the requirements are typically straightforward. MARC has equipped its financial team, which includes a Bookkeeper and Treasurer, with the skills to manage finances effectively. Responsibilities are clearly defined through basic policies and procedures, and there's some consideration for separating key responsibilities.

MIRROR Analysis: Adolescent Stage

	Identify Risk		
	High	**Medium**	**Low**
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	
Financial Health		Some Reserves	

Common Financial Statement Misstatements with Adolescent stage organizations

- 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
- Pro Tip – These organizations represent the best opportunity to provide meaningful advice that can have a huge impact!

Mature: The organization checks nearly all the boxes for a well-run organization.

Due to the financial team's expertise and advanced reporting metrics, MARC has reliable internal financial reports that meet its needs. As external parties increasingly review financial statements through annual audits and transparency web pages, it's even more crucial that the organization follows Generally Accepted Accounting Principles (GAAP). The financial team members have the necessary knowledge and expertise. Policies and procedures are thoroughly documented, and the staff's duties are well-segregated. MARC is committed to transparency, as shown by its open sharing of financial information.

MIRROR Analysis: Mature Stage

	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
Financial Health			Reserves + Endowment

Common Financial Statement Misstatements with Mature stage organizations

- 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
    - Some of the more common ones I see are next…

Common Financial Statement Misstatements with Mature stage Continued…

- Revenue recognition around contributions, grants and contracts. Conditions & barriers vs restrictions
- Confusing Board or internal restrictions and with donor restrictions (and vice versa).
- Lease agreements
- Complex financial instruments such as life estates and bequests.

Common Financial Statement Problems – Financial Pros

- 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 who is using the 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
- Use the MIRROR to assess whether 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