

During 2021, Prager Metis Senior Advisor Lou Mezzina presented *Enhancing NFP Financial Reporting: A Critique of Audited Financial Statements and Disclosures* on four occasions at programs offered by CPA Societies in Greater Washington, D.C.; New York State, New Jersey and Oregon. In this issue of Not-for-Profit Focus we share some high level observations and recommendations that we hope will be valuable to preparers, auditors, audit committees, and others interested in the general purpose financial reporting of not-for-profit organizations.

The focus of the aforementioned programs was on NFP general purpose external financial reporting – those financial statements made available to a broad group of users for a broad range of activities, and generally audited. The management and board of a reporting entity has access to far more information than that commonly needed by external audiences and much of the specific information used to manage or oversee an organization goes beyond what is needed by current or potential donors, lenders, or other resource providers.

While management is responsible for the preparation and fair presentation of the general purpose financial statements, for NFPs of all sizes the structure and content of the financial statements and related footnote disclosures is a collaborative effort of management and auditors. We believe both preparers and auditors would benefit from more discussion regarding areas where generally accepted accounting principles offer acceptable choices that may not be well understood by current financial management, or options previously selected are more reflective of auditor preference than that of management.

Materiality and relevance are two important concepts in financial reporting. Information is material if omitting it or misstating it could influence user decision making. The FASB has been clear that materiality cannot be reduced to a numerical formula but must consider both quantitative and qualitative factors. Relevance is a general notion (not entity specific like materiality) about what information is capable of making a difference in the decisions made by users. It is important to remember that virtually all accounting standards are subject to the overriding concept of materiality and that immaterial, irrelevant, and even redundant information can obscure more important information, reducing the usefulness of the financial statements. Auditors may be influenced by a perception, perhaps formed by experience with peer review or their own firm's quality control reviews, that omitting information can have more severe consequences than including immaterial information, and may drive some of the unnecessary disclosures.

There are three primary sources of entity-developed information about a NFP organization that those outside the entity, including the general public, access: the organization's website, its IRS Form 990, and its annual audited financial statements. Although for many NFPs the financial statements may be accessed less often than the other two sources, they represent an important opportunity to tell the organization's story, particularly its financial story. Users access these statements to help them make decisions about the allocation of resources to NFP organizations, to help in assessing services rendered and the ability to continue to provide those services, as well as stewardship. Whether the frequency with which these statements are accessed is modest or great, each access should be viewed as an opportunity to present useful information in a clear, understandable and well structured manner. For many organizations, we have seen opportunity for greater consistency in the messaging across the three venues and, in a good number of cases, the content of the general purpose financial statements would have been enhanced by "borrowing" language from the website and/or Form 990.

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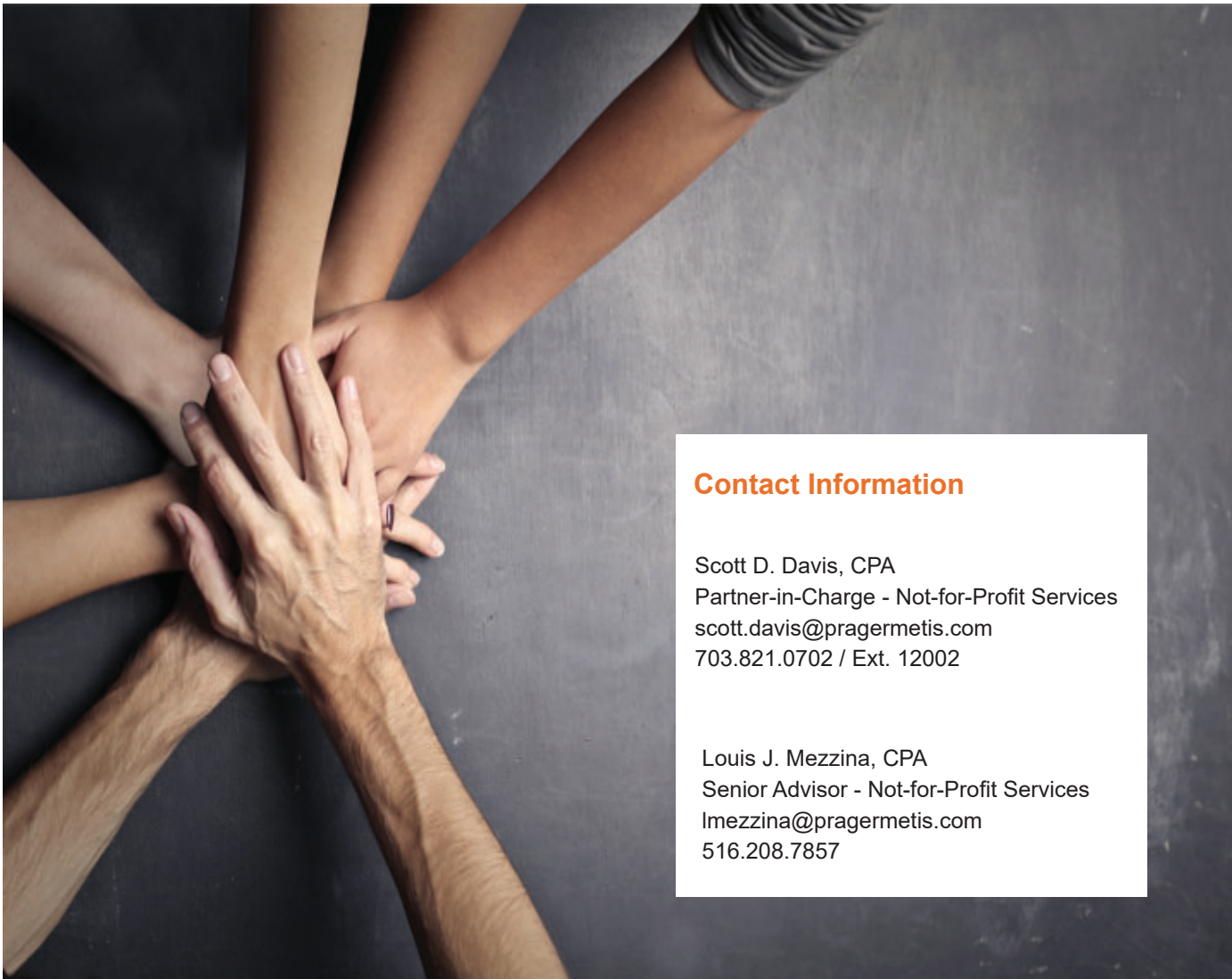
Getting a bit more granular, here are some specific observations for your consideration:

- While a Statement of Financial Position is presented by a substantial majority of NFPs, many (e.g. Harvard, American Cancer Society, Lincoln Center) choose instead to present a Balance Sheet.
- While a substantial majority of NFPs choose to sequence their assets and liabilities to present information about liquidity, many opt to present assets and liabilities as current and noncurrent, adding subtotals and many more lines to the display.
- While most NFPs choose to present the Statement of Activities in a columnar format, a good number choose a stacked or “pancake” format. The latter better facilitates a fully comparative two year presentation and leaves less blank space in the display.
- Before finalizing ASU 2016-14, FASB contemplated requiring an intermediate operating measure in the Statement of Activities, but ultimately decided not to mandate this presentation. While not required, many NFPs choose to present an operating measure, but we believe more should consider this option. Particularly when investment return (whether or not the entity reports an endowment) is significant to financial performance, without an operating measure the reported “bottom line” often varies significantly from year to year and is not consistent with the internal measure of performance. If an operating measure is presented, consideration should be given to viewing it as FASB originally recommended – a subset of the change in net assets without donor restriction.
- In the footnotes, many organizations include more detail of the underlying basis for GAAP (reading like an accounting textbook) than seems necessary. Areas where this was seen most often include uncertainty in tax positions, impairment of long-lived assets, and donated services.
- Prior to the effectiveness of ASU 2016-14 only voluntary health and welfare organizations were required to include the statement of functional expenses as a basic financial statement. Now, all not-for-profit organizations are required to provide an analysis of expenses by their natural classification (such as salaries, professional fees and insurance) as well as their functional classification (i.e. major classes of program services and supporting activities) in one location. This analysis can be presented in a separate statement, in the notes to the financial statements or even the rarely practical option of within the statement of activities. Interestingly, most NFPs have chosen the separate statement presentation, often with far more delineation of natural classification information than external audiences require or, perhaps, desire. We have seen as many as 32 natural classification line items and as few as three. If the amount of the detail is provided to meet the needs of a funding source or regulator and including it in the audited financials is preferred by such third party, of course satisfy that request. Otherwise, a presentation of more than 12 natural classification line items is likely including information that is immaterial.
- Among the most impactful changes to FASB guidance in the last 20 years was the 2006 issuance of SFAS 157, *Fair Value Measurements* (now ASC 820 in the FASB codification). Almost annually since its effective date in 2008, the FASB has amended its fair value guidance contributing to disclosures that are often redundant. Among its important elements, SFAS 157 provided a three-level hierarchy that distinguishes the input data for determining the fair value of an asset or liability (Levels 1, 2 and 3 based on the relative observability and reliability of those inputs).

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One area in particular that many organizations and their auditors can revisit is the disclosure of hierarchy levels of those assets and liabilities reported at fair value. For many NFPs, investments is the only asset or liability measured at fair value and often the inputs to determine fair value are 100% Level 1. Despite this, the disclosure too often includes columns for each level with no information in the Level 2 and 3 columns. While FASB guidance and related examples call for a table presenting this information, a table need not be presented if the required information can be presented effectively in a different manner. In fact, the AICPA's Example Charity financial statements simply included the following sentence in the Investments footnote: As of December 31 20XX and 20XX, all investments were considered level 1 investments. One university with more than \$3 billion of investments includes the hierarchy information quite effectively in a brief narrative presentation.

While the annual audited financial statements may not contain any incorrect information, the format and content of the statements and footnote disclosures can often be made less cumbersome, offering a crisper, clearer, easier read for users looking to better understand an NFP's financial story.



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