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Not-for-Profit Financial Reporting 3.0: New FASB Exposure Draft

Upgrades seem to be pervasive these days, from software to electronics and even accounting standards. Some upgrades we dread, and some we welcome. For not-for-profit entities, an important accounting standards upgrade is coming with the release of the new Financial Accounting Standards Board (FASB) Exposure Draft in April. Even with the challenge of learning a new framework and educating others, this may be an update to welcome.

First, a little background. Until the FASB issued guidance for not-for-profit organizations in June 1993 (Statements No. 116, Contributions Received and Made and No. 117, Financial Statements), there were different accounting practices for different types of not-for-profit entities. These differing practices had been set forth as industry audit guides issued by the American Institute of Certified Public Accountants (AICPA) in the 1970s. The guides covered health care organizations, voluntary health and welfare organizations, colleges and universities, and other nonprofit entities.

During the 1970s the FASB also initiated studies to understand financial reporting for non-business organizations. This culminated in Concepts Statement No. 4, *Objectives of Financial Reporting by Nonbusiness Organizations*, issued in December 1980. Statements 116 and 117 were issued 13 years later after more study and deliberation, thereby creating the first comprehensive accounting standards for all not-for-profit entities and a new financial statement framework. The statements addressed a diverse range of practices, including areas such as pledges, investments and other assets, reporting donated services, and treatment of donor-restricted contributions.

This model has been rigid in the presentation of resources inflows and outflows on the statement of activities between three classes of net assets - unrestricted, temporarily restricted (time and purpose), and permanently restricted (in perpetuity). Beyond that there has been a significant amount of flexibility, even though most not-for-profit organizations have very similar statements with the columnar option.

It has now been more than 20 years since those standards were issued - just enough time to get really comfortable with them and have a hard time changing. So why go to version 3.0?

FASB Not-for-Profit Advisory Committee and proposed changes

The FASB formed a not-for-profit advisory committee (NAC) in 2010 to provide input from a broad group of financial statement users, preparers, and others, such as oversight groups. While the underlying accounting principles were generally considered to be relevant, there has been a sense that improvements could be made to the reporting model. Many felt that the statements could be more meaningful and relevant to understanding an organization's business

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operations, liquidity, and use of resources. There was also a feeling that the statements could do a better job of "telling the story" of the organization's finances by including more pertinent information, rather than disclosures that do not contribute to understanding.

The FASB initially approved two projects: a standards-setting project to consider the financial statements, and a research project to consider providing guidance on "telling the story" by encouraging or requiring some form of "management discussion and analysis" (MD&A). Public companies use MD&A, as do governmental entities. In the end, the research project was terminated and the standards project resulted in the exposure draft to be released in April.

The objectives of the standards project include:

- Refreshing the financial reporting model
- Addressing disclosure volume/ineffectiveness (disclosure overload)
- Making simplifications where possible
- Focusing on net asset classifications, liquidity, financial performance, and cash flows

Under the current model, there is a lot of different information in the statement of activity. For example, "support and revenue" includes some that is available for operations, some that must be held until time restrictions expire, some that must be held until purpose restrictions are met, and some that may never be spent. It's a hodgepodge, and all the various aspects and complexity of this information make it difficult for many non-accountant users to understand it. Further, while liquidity may be fairly discernable in the financial statements of business enterprises, for not-for-profit entities it must be divined by careful analysis and correlation of not only liquidity of assets and liabilities, but also the timing of call or use of net assets. That also is not a simple task for many users.

What if:

- Not-for-profit organizations could present a simple statement of activities with just one column reflecting the current-period operations, based on availability and connection to mission?
- A second statement (or component of one) contained all the inflows and outflows that are for future periods and purposes, or not available for current-period operations?
- The statement of activities showed both external resources and internal allocations by management (the board) that reflect how operations are managed (similar to management or budgetary reporting), to show how results compare with planned use of resources and management's responses to change?
- The statement of cash flows made more sense and there was more correlation between it and the statement of activities?
- Notes to the financial statements were streamlined, with more relevant disclosures (including liquidity, board directed transfers, and expenses by nature/type) and more information to aid in understanding the way standards and options have been interpreted and applied?

This is what the proposed changes are intended to accomplish. [Continue reading](#) for an overview of the proposed changes and reporting model. **And stay tuned - we'll be providing updates in future issues!**

We Want Your Feedback!

Do you have a question you'd like addressed? Is there a particular topic you'd like us to cover in future newsletters?

Please [email](#) us and let us know.

We Can Help!

As a national full-service CPA and consulting firm devoted to serving not-for-profit organizations, CapinCrouse provides professional solutions to organizations whose outcomes are measured in lives changed.

Since 1972, the firm has served associations, churches, denominations, foundations, higher education institutions, media ministries, community and international outreach organizations, and many others by providing support in the key areas of financial integrity and security.

This experience base allows us to quickly identify areas for improvement in many organizations. If your organization desires to improve its efficiency, please contact your CapinCrouse representative or one of our offices to discuss how we may help you.

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Author [Gregg Capin](#) is a partner at CapinCrouse and has over 30 years of experience managing audit and advisory services for a wide range of not-for-profit organizations both nationally and internationally. Gregg served for many years as a member of the AICPA Not-for-Profit Expert Panel and Audit & Accounting Guide Task Force, and serves as a member of the Financial Accounting Standards Board (FASB) Not-for-Profit Advisory Committee (NAC).

Building a Stronger Internal Audit Function

In recent years, nonprofits have been the target of increased scrutiny over governance, accountability, and compliance. Despite this, many organizations dismiss the importance of an internal audit function.

This isn't a wise move. All nonprofits face heightened expectations from regulators and the public, as well as an ever-expanding field of risks. Even though your budget may be tight, you can't afford mistakes or fraud incidents as a result of a weak or nonexistent internal audit function.

What are internal audit's roles?

On its most basic level, the internal audit function provides independent assurance of a not-for-profit's compliance with its internal controls and their effectiveness in the areas of financial and operational risk. Potential risks include fraud, insufficient funds to support programming, and reputational damage. Such risks are of concern to all types of organizations, of course, but they're particularly critical for nonprofits, which are often held to a higher standard of integrity by the public. Moreover, noncompliance with regulations could cost a nonprofit its tax-exempt status.

Internal audit is typically charged with:

- Identifying risks and prioritizing them from high to low,
- Assessing the effectiveness of internal controls through testing and other methods,
- Evaluating compliance with laws, regulations, and contracts,
- Mitigating risks with targeted audit plans that give greater attention to high-risk areas and producing reports with recommendations for improvement,
- Following up on its own recommendations and management's remediation actions to eliminate identified risks, and
- Assisting external auditors.

The overall objective is to help the not-for-profit accomplish its goals through proactive risk management and informed governance.

How do internal auditors work?

Internal auditors typically begin with an overall risk assessment of the nonprofit. Their wide-ranging review will consider everything involved in accomplishing the organization's objectives, including financial procedures and processes (from cash and banking practices to financial reporting).

When high-risk areas are identified, auditors use various methods, such as testing of transactions, interviews of staff, or electronic data extraction techniques, to assess the strength of internal controls.

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Smaller organizations aren't exempt from the internal audit imperative. Their board and management can oversee internal controls with the assistance of a qualified third party.

What ensures success?

The effectiveness of the internal audit function hinges on several factors, including:

Independence - Internal auditors should be independent from management and other functions they review to avoid bias or a conflict of interest. They should report directly to the board of directors or its audit committee.

Executive support - The board and executive management must provide clear support for the internal audit function and its activities to convey their importance to the full organization. Leadership must indicate its support both verbally and by its actions. For example, the board must meet regularly with internal auditors to discuss their findings and should visibly act on their recommendations.

Resources - Not surprisingly, the quality of the internal audit function's work is directly related to its capacity, yet one of the major handicaps suffered by many internal audit functions is insufficient resources. Even where the function is manned by individuals with extensive audit expertise, it might lack employees with the requisite knowledge of relevant program areas. For peak performance, internal audit should engage internal or outsourced staff with experience in compliance and controls, program areas, operations, and specialized areas (such as IT), especially those identified as high-risk.

Quality assurance review (QAR) - A QAR assesses the overall effectiveness of an internal audit function by applying three criteria: 1) compliance with professional standards; 2) effectiveness and efficiency of function activities, organization, resources, and skill capabilities; and 3) evaluation and fulfillment of stakeholder needs. A resulting report includes recommendations for improving and enhancing the internal audit function's role. The Institute of Internal Auditors suggests that internal auditors conduct QAR self-assessments periodically, with third-party QARs done every five years.

An indispensable function

With proper independence and support, the internal audit function can prove invaluable for nonprofits of all sizes. Proper assessment of risk - whether by an in-house or outsourced internal audit function such as CapinCrouse offers - is crucial for nonprofits that want to thrive in today's rigorous environment.

Beyond compliance: IA as a strategic partner

Although the internal audit function is often viewed mainly through the prism of compliance and internal controls, it has a lot to offer beyond risk assessments and audit plans. Savvy organizations have begun to tap internal audit for strategic purposes.

For these organizations, the internal audit function serves almost as an internal consultant, providing critical insights gathered in the course of compliance and assessment work on issues such as operational efficiencies. For example, in the course of reviewing invoices, internal audit may discover a way to streamline invoice processing.

The internal audit function's familiarity with the organization's inner workings also affords it an unusual perspective for evaluating strategic opportunities and investments. For instance, does your not-for-profit have an operational or financial weakness that could undermine plans for a new program? Your internal auditor should know the answer.

What You Need to Know About the COSO Framework Update

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) released its *Internal Control - Integrated Framework* (COSO Framework). For more than 20 years, the COSO Framework has been used to design and implement internal controls, as well as to assess their effectiveness. Since business continues to evolve - most notably in regulations and laws, reliance upon information technology, expectations for oversight, and use of service providers - in 2013 COSO began the process of updating the COSO Framework. This update, [Internal Control - Integrated Framework \(2013\)](#), became effective on December 15, 2014.

The COSO Framework is designed to provide a process of controls aimed at achieving the organization's objectives. This is similar to showing your work in math class. When implemented processes are designed correctly and the controls are operating effectively, the likelihood of achieving the desired result increases greatly.

The COSO Framework has identified three key objectives to internal controls:

1. *Operations objectives* relate to the effectiveness and efficiency of the organization's operations.
2. *Reporting objectives* refer to the timeliness and accuracy of both internal and external financial reporting.
3. *Compliance objectives* relate to the ability to operate within the laws and regulations subject to the organization.

With the revision to the COSO Framework, it is important to first understand what has not changed. The core definition of internal control has remained consistent and states:

Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

Furthermore, the five components of internal control continue to be control environment, control activities, risk assessment, information and communication, and monitoring; therefore, the use of the COSO Framework to assess the effectiveness of internal controls has not changed. Finally, the COSO Framework continues to emphasize the need to exercise judgment. It is meant to obtain reasonable, not absolute, assurance.

The COSO Framework update resulted in five significant changes:

1. **New principles and points of focus** - The updated COSO Framework has developed 17 principles and 77 points of focus. This is not intended to provide management with a checklist, but rather to encourage stakeholders to identify the aspects of internal control that apply to their organization. It is important to note that of the 17 principles, only three relate to control activities, while the

remaining 14 principles apply to the four other components of internal control. Of the three principles in control activities, one is dedicated to the internal controls over information technology.

- 2. Increased importance of information technology on internal controls** - The development of the cloud (i.e. hosted systems) and the growing number of systems that are used to generate information for operations, financial reporting, and compliance have increased organizations' reliance on information technology. The extent of the internal controls for information technology result from the complexity of that environment, and it is important to document the relationship between the use of technology and business processes and also establish security management policies.
- 3. Increased emphasis on the governance and oversight functions of the organization** - Each of the five components have points of focus related to oversight responsibilities and are meant to reiterate that the role of the board is an important part of internal control.
- 4. Non-financial information and internal reporting objectives added as principles** - This is meant to move the COSO Framework beyond external financial reporting. Non-financial information is important in identifying and developing key performance indicators (KPIs) that management and the board can use to monitor the organization's ability to meet their objectives. In addition, internal reporting should be developed to reflect the organization's activities and need for precision. This development has expanded the COSO Framework from external reporting to four different types of reporting: external financial, external non-financial, internal financial, and internal non-financial.
- 5. Increased consideration and assessment of internal controls for preventing and detecting fraud** - While the original COSO Framework included fraud prevention, the revised COSO Framework more clearly links fraud prevention with internal controls.

The objective of the COSO Framework has always been to provide organizations with the structure to achieve their goals, and the update was designed to do that more effectively in the current operational environment. The most significant revision to the Framework provides greater clarity through the development of principles and points of focus, and is intended to encourage organizations to apply consistent judgment throughout their internal controls. Most importantly, management judgment is emphasized, and not removed, in order to apply cost/benefit concepts to the COSO Framework.

If you have any questions about the update or internal controls at your organization, please contact your engagement team.

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The Stained Ceiling: Identifying Capacity Gaps within Your Organization

The visitor had just walked into the house when he looked up and asked, "What's the deal with the ceiling stain?" His friend looked up, smiled sheepishly, and confessed, "I was going to fix that when the leak first occurred, but I got busy with life, and now I don't even see it anymore. It's just become part of the house that isn't noticed. I guess we consider it normal now."

Many organizations have developed "ceiling stains" in the form of behaviors that are simply accepted as "the way we do things around here" - but that in fact are neither normal nor healthy. In reality, these behaviors may be indicative of organizational capacity gaps that could be preventing the organization from achieving the outcomes of its mission.

Does your organization have any "ceiling stains"?

The best way to identify any capacity gaps in your organization is to look for behaviors that are not typically seen in healthy organizations or that seem out of the norm. Examples include:

- A board that is deeply involved in making operational decisions despite the presence of qualified and engaged management
- Excessive turnover or shifting of under-performing employees from job to job without addressing the performance issue
- Leadership that is detached from the rest of the organization, or an organizational structure in which the lines of communication aren't clear

Why it's important to address these behaviors

A capacity gap can be defined as a significant disparity between an organization's goals and objectives (as expressed in its vision and mission) and its actual or potential ability to achieve its vision and mission. In other words, **an organization with capacity gaps is lacking in key areas that are likely to prevent it from achieving its vision and mission.** And because of those gaps, the staff and volunteers develop "workarounds," behaviors designed to achieve their goals despite the organization's shortfalls.

Capacity gaps can occur in one or more significant areas, including the organization's philosophies, board, leadership, financial management, employees, cross-functional cooperation, information technology, fundraising, and program effectiveness, among others. The behavior examples provided above could be indicative of capacity gaps such as:

- A board that is poorly trained or lacks sufficient experience to understand its role
- An ineffective hiring process
- Poor communication from leadership to the rest of the organization

Because every organization is unique, there are countless potential capacity gaps that can exist within organizations.

Addressing the gaps to achieve your vision and mission

Identifying behaviors that would appear strange to an objective outside observer may require having a third party take a look at your organization. To use the analogy at the start of this article, they need to walk into your organization's "living room" and ask about the ceiling stain. It is often easier for a third party to not only identify any unusual behaviors but to ask potentially sensitive questions about the conditions that gave rise to the behaviors. CapinCrouse has developed a methodology for identifying such behaviors and looking into the organization to understand and address the capacity gaps that may exist. If you're interested in learning more about our Nonprofit

Organization Capacity Assessment service, please [email us](#) or contact your engagement team.

Organizations that wait too long to address their "stains" are unlikely to achieve their vision and mission, and may even face irrelevance. Conversely, moving quickly to discover and address capacity gaps will enable your organization to work more effectively toward accomplishing its goals.

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Newsbits

Nonprofit CEO pay on the rise

The *Chronicle of Philanthropy's* annual compensation survey has found that executives of large nonprofits and foundations are starting to see bigger raises. This follows a long dry period during which the median annual increases basically just kept up with inflation.

For the 82 organizations on which the *Chronicle* had 2011 and 2012 data, the median change in salary was 4.9%. Since the end of the financial crisis in 2009, not-for-profits have increased top executive compensation modestly - on average about 3% per year. But, excluding the organizations that reduced pay or kept it flat, the remaining organizations surveyed boosted their CEO pay in 2012 by 6.8%. The survey also found 18 CEOs with compensation exceeding \$2 million. In comparison, chief executives of S&P 500 companies saw median compensation rise 9.5% in 2013, to \$10.1 million.

New tool assigns dollar values to social projects

Based on social-science research, a new online tool designed by the Low Income Investment Fund (LIIF) puts dollar values on the social impact of investments in areas such as affordable housing, child care centers, and improved schools in impoverished neighborhoods. LIIF developed its "social impact calculator" to assess how effective it is in creating opportunity and reducing inequality.

The calculator estimates the monetized impact of investments. For example, the impacts of a high-performing school would include boosted lifetime earnings, reduced odds of incarceration, and decreased health care costs for students. LIIF is making the calculator and its methodology fully accessible to others - or "open source" - at liifund.org/calculator.

Affordable Care Act reporting considerations

New requirements affect what you need to report under the Affordable Care Act this year, and there will be additional changes for 2016. Stay tuned for details in our Summer issue.