February 2017

Private Foundations Bulletin

Assessing the Merit of Grant Recipients: What Every Foundation Manager Should Know

Understanding the financial health of a prospective and/or a recurrent grant recipient is an essential function throughout the grant management process. Generally, this is accomplished by reviewing copies of the grant recipient's financial statements, budgets and/or tax returns. Focusing on effective interpretation of this data will help in the determination of the merit of the potential recipient and the success of the grant award — all while mitigating the foundation's reputational risk in the process.

Types of Financial Statements

Financial statements provide a picture of the financial health of an organization at a specific point in time. Before reviewing the financial statements for any potential risks, the foundation manager should assess the reliability and accuracy of the financial data. Though not necessarily required, most organizations produce one of four types of financial statements, ranging from no assurance to a high (but not absolute) level of assurance regarding whether the financial statements are free from material misstatement:

1. Internally Prepared Financial Statements – No assurance; lowest quality.

2. Compiled Financial Statements – No assurance; the financial statements are prepared by an outside CPA and are generally considered of greater value than internally prepared financial statements for this reason.

    - Note: Formal report is issued by CPA and it will be clearly noted that "no assurance is provided" on the financial statements. Additionally, the CPA is required to disclose independence, and must consider whether the financial statements appear appropriate in form and are free from obvious material misstatements.

3. Reviewed Financial Statements – Limited assurance; the financial statements are prepared by an independent CPA who is required to understand the organization's industry and the accounting principles and practices used in the industry such that he/she can identify areas in the financial statements that are more susceptible to material misstatement. The independent CPA performs analytical procedures, inquiries, etc. to obtain "limited assurance" on the financial statements and provide a measure of comfort on their accuracy.

    - Note: Formal report is issued by CPA which includes a conclusion as to whether he/she is aware of any material modifications that should be made to the financial statements in order for them to be in accordance with the applicable financial reporting framework.

4. Audited Financial Statements – Reasonable assurance (i.e., highest level); the financial statements are prepared by an independent CPA who is required to go beyond the aforementioned review procedures such that he/she corroborates the amounts and disclosures

included in the financial statements by obtaining audit evidence via inquiry, physical inspection, observation, third-party confirmations, examination, analytical procedures, etc.

- Note: Formal report is issued by CPA which expresses an opinion on whether the financial statements are presented fairly, in all material aspects, in accordance with the applicable financial reporting framework. In addition, the CPA is required to report on any identified significant or material weaknesses in the organization's system of internal control.

If the financial statements are other than audited, the foundation manager should inquire as to the reason why the organization does not request an audit, and should determine if additional steps can be taken to ensure that the organization is providing accurate and reliable financial data.

Audited Financial Statements

If audited financial statements are provided, the foundation manager should assess what type of audit opinion has been issued. There are four types of audit opinions:

1. Unmodified Opinion – Often referred to as a "clean opinion," expressed when reasonable assurance has been obtained that the financial statements are free from material misstatement and in accordance with the applicable financial reporting framework; thus can be relied upon.

2. Qualified Opinion – This type of opinion highlights certain matters affecting the organization. It is not necessarily "bad," but is usually:

   a. expressed due to a limitation of scope or inability to obtain sufficient appropriate audit evidence such that the possible effects of undetected misstatements, if any, could be material but not pervasive to the financial statements; or

   b. expressed after auditor has obtained sufficient appropriate audit evidence to conclude that the misstatements, individual or in the aggregate, are material but not pervasive to the financial statements.

3. Adverse Opinion – Expressed after auditor has obtained sufficient appropriate audit evidence to conclude that the misstatements, individual or in the aggregate, are material and pervasive to the financial statements; thus cannot be relied upon.

4. Disclaimer of Opinion – Expressed due to inability to obtain sufficient appropriate audit evidence such that the possible effects of undetected misstatements, if any, could be both material and pervasive to the financial statements; thus cannot be relied upon.

Interpreting the Financial Data

Once the foundation manager has determined whether the financial data may be relied upon, the data must be interpreted. Trends, ratios, funding sources, percentages of expenses allocated to programs, administration and fundraising (functional expenses), deficits, percentages of restricted versus unrestricted net assets, cash flow issues, etc. should be examined on an individual basis. However, issues such as receiving unaudited financial statements or receiving audited financial statements with an opinion other than unmodified may cause the foundation manager to conclude that the grant recipient is high risk and should not be awarded funding.

Budgets

Unlike financial statements which provide financial data at a specific point in time, budgets provide a forward-looking perspective of an organization. In order to develop a budget, an organization needs appropriate monitoring systems in place to create a baseline as well as the capacity to timely and accurately evaluate results. However, obtaining a budget from a potential or current grant recipient is often not enough. To properly vet a grant recipient, the foundation manager should ascertain whether the grantee has prepared a realistic budget with reliable sources of revenue and reasonable estimates of expenses, as well as an understanding of how the organization would respond to any unexpected revenue shortfalls or cost overruns. Asking for some of the assumptions used in developing the budget will aid in determining the future outlook of the organization.

Additionally, the foundation manager should evaluate the organization's ability to budget, possibly by asking for the analysis of prior period budget vs. actual numbers, and, if any material variances exist, inquire as to what they have done to plan more effectively in the future. If consistent budget deficits are observed, it may indicate that the organization has cash flow challenges or going concern considerations, which may in turn cause the foundation manager to conclude that the grant recipient is high risk and should not be awarded funding.

Tax Returns

The foundation manager should check whether the organization is in good standing and eligible to receive tax-deductible charitable contributions by visiting the IRS website, and using the Exempt Organizations Select Check Tool. The majority of charitable organizations must file a Form 990, 990-EZ, 990-N or 990-PF. The organization's forms are required to be available to the public and can be obtained through online resources such as Guidestar or directly from the organization itself.

Conclusion

Grant making is a foundation's primary exempt function. Awarding grants to an organization without properly assessing and documenting an understanding of the financial health of the grant recipient may expose the foundation to significant financial losses, reputational risk, and potentially jeopardize the achievement of its mission. To mitigate the risks associated with assessing the merit of a grant recipient, it is recommended that the foundation manager first determine the reliability of the data provided, and then interpret the financial and nonfinancial data within the financial statements, budgets, and/or tax returns.

Contact Us

Should you have any questions regarding evaluating a grant recipient's financial data, please contact the following experienced professionals in our Philanthropic and Private Foundation Services Practice: Thomas F. Blaney, CPA, CFE, Partner and Co-Director at tblaney@pkfod.com or Christopher D. Petermann, CPA, Partner and Co-Director at cpetermann@pkfod.com.