

Financial and Accounting Guide for Not-for-Profit Organizations

Seventh Edition

Malvern J. Gross, Jr., CPA

Retired Partner, PricewaterhouseCoopers LLP

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Partner, PricewaterhouseCoopers LLP



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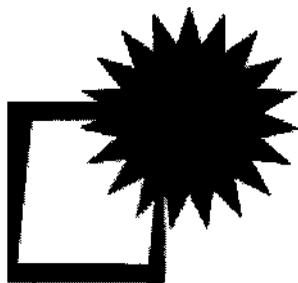
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Malvern J. Gross, Jr. was the author of the first edition of this text and a significant contributor to many of the subsequent editions. He is a retired partner of Price Waterhouse (a predecessor to PricewaterhouseCoopers LLP) and a nationally recognized authority on accounting and financial reporting for not-for-profit organizations. He was chairman of the AICPA Subcommittee on Nonprofit Organizations that wrote the 1978 landmark Statement of Position for Certain Nonprofit Organizations, and of the Accounting Advisory Committee to the Commission on Private Philanthropy and Public Needs. He was a member of the committee that wrote the second edition of *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, and a coauthor of the *Museum Accounting Handbook*. He served as an advisor to the Financial Accounting Standards Board in the early phases of its work on setting accounting standards for not-for-profit organizations, and to the New York State Charities Registration Office, as well as an adjunct professor of accounting at Lehigh University, his alma mater. After retirement from Price Waterhouse he was president of a not-for-profit organization, the National Aeronautics Association. He now lives in the San Juan Islands off of the state of Washington.

John H. McCarthy served as the National Leader of PricewaterhouseCoopers' Education & Nonprofit Practice before his retirement in 2005. He was a coauthor of the sixth edition of this text. He also is the coauthor of *Understanding Financial Statements: A Strategic Guide for Independent College and University Boards*, published by the Association of Governing Boards of Universities and Colleges (1998), as well as several publications by PricewaterhouseCoopers including: *The Changing Role of the Audit Committee* (2004); *Leading Practices for Colleges, Universities and Other Not-for-Profit Educational Institutions* (2004); *A Foundation for Integrity* (a 2004 guide for codes of conduct, conflicts of interest, and executive compensation); *Meeting the Challenges of Alternative Investments* (2004); *Understanding Underwater Endowment Funds* (2003); and *Financial Reporting and Contributions: A Decision Making Guide to FASB Nos. 116-117* (1996) among others. He is a CPA who, for more than 36 years, served PricewaterhouseCoopers' education and not-for-profit clients, including many of the most prestigious institutions in the United States. He currently serves on several not-for-profit boards. He is a past president of the Massachusetts Society of CPAs, Inc. (MSCPA) and a two-term member of the Governing Council of the AICPA. He has received numerous honors for his involvement in the community. He graduated from Boston College and has an MBA from the University of Michigan Business School.

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Contributors

We also want to recognize the many past contributions of **Richard F. Larkin**, who was a coauthor of the fourth, fifth, and sixth editions of *Financial and Accounting Guide for Not-for-Profit Organizations*. Prior to his retirement from PricewaterhouseCoopers, he served as a technical director for the Education & Nonprofit practice. We are very grateful to Dick for his efforts on prior editions of this Guide.

The seventh edition of this Guide represents the collaborative efforts of many PricewaterhouseCoopers professionals who work with our not-for-profit clients throughout the United States. The authors wish to very gratefully acknowledge the contributions of the following PricewaterhouseCoopers partners, directors, and managers to this Guide: Emily Bernhardt; Ted Budge; Amy Cloud; Ralph DeAcetis; Diane Duncan; Kaye Ferriter; Cheryl Fletterick; Kevin Fordyce; Martha Garner; Elaine Garvey; Dorian Gregory; Paul Hanley; Julie Henderson; Sandra Johnson, Elisabeth Lippuner; Riva Mirvis; Layne Pinkernell; Christos Poullos; Robert Spear; Gwen Spencer; Jessica Vronman; and Frederick Wentzel, Jr. Their assistance has been invaluable.

Preface

The authors have substantially revised the *Financial and Accounting Guide for Not-for-Profit Organizations* to create this seventh edition. The changes in the text reflect the ongoing evolution in not-for-profit accounting, financial reporting, and the systems that support it. The sixth edition was published when Financial Accounting Standards No. 116 (accounting for contributions) and 117 (financial statements of not-for-profit organizations) were still relatively new and as a result it was written from the perspective of organizations that were making the transition from “fund accounting” and financial reporting to the new “net asset” based financial reporting. The intent of the authors in the seventh edition is to present a perspective of organizations that have now more fully integrated “net asset” accounting into their financial reporting. The authors have also attempted to streamline all chapters to the extent appropriate while updating them for the latest professional standards.

Like its predecessors, the seventh edition has several objectives. The first objective is to help not-for-profit organizations better manage their financial resources. This starts with *understanding*—it’s easier to manage what you understand. Financial and accounting principles are often intimidating, but this Guide covers the basics and shows that the principles make sense. The second objective is to help not-for-profit organizations better communicate their financial activities and financial condition to their stakeholders and the public.

A common thread running through the chapters in the seventh edition is the need for greater accountability and transparency in financial reporting by not-for-profit organizations. More than ever before, not-for-profit organizations must be accountable to their stakeholders, including, among many others, donors, lenders, regulators, and sponsors. Adapting to the new environment is a challenge, but one that the most successful not-for-profit organizations will understand and embrace.

The seventh edition incorporates the current version of the new chapters introduced in the cumulative supplements to the sixth edition:

- “The External Financial Statement Reporting Model for Public Colleges and Universities and Other Not-for-Profit Organizations Reporting under GASB” (now Chapter 15), and
- “E-Business for Not-for-Profit Organizations: How Can Not-for-Profits Manage the Risks to Manage E-Business Opportunities?” (now Chapter 27)

PREFACE

The other significant changes to the sixth edition include:

- Consolidation of former Chapters 6 and 7, each of which dealt with fixed asset accounting matters, into a single new Chapter 5, "Fixed Assets and Depreciation."
- Consolidation of former Chapters 4 and 5, each of which dealt with fund accounting, into a single new Chapter 4, "Fund Accounting and Internal Financial Reporting."
- Chapter 28, "Principal Tax Requirements," in this edition includes all of the relevant information on taxes for not-for-profit organizations. Relevant information from former Chapter 29, "Principal Federal Tax Forms Filed," has now been included in new Chapter 28. The actual tax forms have been deleted since these forms change each year and the authors feel that readers would be better served to examine the actual forms issued each year by the Internal Revenue Service together with the applicable instructions.
- Former Chapter 30, "State Compliance Requirements," has been deleted from the Seventh Edition. Compliance requirements differ substantially by state, and with the impact that the Sarbanes-Oxley Act is having on various state regulations, the diverse issues that result are really beyond the scope of an accounting and financial guide.

The FASB's project on combinations of not-for-profit organizations remained open when text went to print. As discussed in Chapter 7, the FASB expects to issue an exposure draft on this in early 2005.

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CHAPTER ONE

Responsibilities for Fiscal Management

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Not-for-profit organizations are among the most influential and powerful institutions in our society. They range in size from small and local to large and national—or even international. Their scope incorporates a wide range of activity: health and welfare, research, education, religion, social, and professional associations. They include foundations, membership societies, churches, hospitals, schools, and sports and political organizations. By any measure, not-for-profit organizations comprise a significant share of national income and employ a significant percentage of the national workforce.

All not-for-profit organizations are defined by their mission. Executive management and the board of directors have the responsibility to

RESPONSIBILITIES FOR FISCAL MANAGEMENT

execute the mission. Financial stewardship is in the care of a financial officer employed by, or who serves as a volunteer for, the not-for-profit organization. The size and kind of organization determines the breadth and depth of the role for the individuals who are assigned fiscal management responsibility. Likewise, the size and kind of organization, and even the laws applicable to its state of incorporation, shape the fiduciary oversight provided by or required by the board.

The typically descriptive title of the fiscal officer varies among organizations. Large organizations may employ a Chief Financial Officer, Treasurer, *and* a Director of Accounting. Other organizations have a Controller, Business Manager, or Accounting Manager responsible for financial activities. In a very small organization, a volunteer will be assigned as treasurer. For the purpose of this chapter, we use the term "treasurer" to describe the person who assumes responsibility for the fiscal management of the not-for-profit organization.

The treasurer has significant responsibilities:

1. Keeping financial records for the organization
2. Preparing accurate and meaningful financial statements
3. Implementing a budget and anticipating financial problems
4. Safeguarding financial assets and providing effective internal controls
5. Complying with federal and state reporting and regulatory requirements
6. Communicating with executive management and the board of directors

These roles are discussed in the following sections.

1.1 KEEPING FINANCIAL RECORDS FOR THE ORGANIZATION

The treasurer is charged with the responsibility for the proper maintenance of the organization's financial records. If the organization is small, the treasurer may oversee the activities of a part-time bookkeeper who records daily, weekly, and monthly transactions using off-the-shelf software or spreadsheet ledgers. Larger organizations have increasingly complex systems and numerous staff hired to keep accurate financial records. A large accounting staff may include several layers of support staff. Computer systems may be customized or several systems may be integrated to properly record the financial activity.

The treasurer is ultimately responsible for keeping reliable records. As such, detailed procedures are delegated to others; but the treasurer

1.2 PREPARING ACCURATE AND MEANINGFUL FINANCIAL STATEMENTS

must determine that procedures are followed and records are accurate. For the small organization, this responsibility may extend to the examination of supporting documentation and asking rigorous questions of the bookkeeper. For the large organization, the treasurer's oversight may be more structured to include regular staff meetings, authority for approval of sensitive transactions, and the review of intermediate accumulated data including the examination of supporting documentation.

Regardless of size, the ultimate responsibility for adequate and complete financial records belongs to the treasurer. This means that the treasurer must have a working knowledge of bookkeeping and accounting concepts. Bookkeeping and accounting are largely matters of common sense and, with the guidance in this book, there should be no difficulty in understanding the basic procedures and requirements necessary for management of a small organization.

1.2 PREPARING ACCURATE AND MEANINGFUL FINANCIAL STATEMENTS

The treasurer is responsible to prepare complete and straightforward financial reports for management, for the board and for others, including regulatory authorities, who have an interest in the financial position and the financial activities of the organization. The statement of financial position is equivalent to the balance sheet of a for-profit entity. The statement of activities and changes in net assets are equivalent to the income statement and changes in equity of a for-profit entity. The statement of financial position, the statement of activities, and changes in net assets along with the statement of cash flows are the three basic statements required for not-for-profit organizations under the guidance of the Financial Accounting Standards Board (FASB) and its Statement of Financial Accounting Standard (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*.¹ Reports as required under specific accounting and reporting guidance are not the only way to present financial information and may not be the best format to convey financial information to decision makers and others who turn to the treasurer for meaningful, financial reports.

Characteristics of meaningful financial reports include the following:

- They should be easily comprehended so that any person of reasonable intelligence, taking the time to study them, will understand the financial picture of the organization.

¹ Health and welfare organizations are also required to prepare a statement of functional expense by natural categories.

RESPONSIBILITIES FOR FISCAL MANAGEMENT

- They should be concise so that the user will not get lost in the detail. The information should be presented in a consistent format each time the reports are prepared.
- They should be all-inclusive in scope and should embrace all activities of the organization. Individual funds, departments, or account balances should be reported in context of the entire organization.
- They should have a focal point for comparison so that the user has some basis for making judgments and understanding the context of the information. The presentation might include comparative information for the current reporting period and period-to-date budget, the annual budget, and the prior-year reporting period.
- They should be prepared on a timely basis to encourage timely corrective actions in response to the users' review. Two weeks after an interim month-end and three weeks after year-end are considered appropriate and timely.

Naturally, the reporting particulars for each organization can differ; but the general guidelines as described in the previous list are the foundation for comprehensive comparative reports. The treasurer is encouraged to work directly with users to explain or develop meaningful financial reports.

(a) Nonaccountant Test

Because the purpose of any set of financial statements is to communicate to the reader, a good test of whether they accomplish this objective is the "nonaccountant test." Can these statements be clearly understood by any interested nonaccountant of average intelligence who is willing to take some time to study them? After studying them, will he or she have a good understanding of the overall financial activities for the year? If not, then the statements are not serving their purpose and should be revised and simplified until they do meet this test.

1.3 IMPLEMENTING A BUDGET AND ANTICIPATING FINANCIAL PROBLEMS

The treasurer is responsible for identifying financial trends and events. The annual budget is a tool prepared by the treasurer as a planning roadmap. A well-developed and carefully prepared budget will provide decision makers with important information about the financial objectives for the year. Upon review of the annual budget or selected budgeted information, the board or management is positioned to take steps to resolve fiscal issues on a timely basis. Preparation of budgets for multiple years

1.4 SAFEGUARDING FINANCIAL ASSETS

is also useful as part of longer term planning exercises. Based on the budget, the organization may implement actions to increase or decrease staffing, obtain a loan, begin a capital campaign, or reduce discretionary spending.

Generally a budget must be developed in sufficient detail and presented in a format so the users may readily identify the veracity of the budget including those variable assumptions that were used to develop the budget.² Best practice would align the format of the budget in context of the accurate and meaningful financial statements as described in Section 1.2 of this chapter. Furthermore, the treasurer will typically be responsible for explaining variances against the budget throughout the year.

1.4 SAFEGUARDING FINANCIAL ASSETS AND PROVIDING EFFECTIVE INTERNAL CONTROLS

An effective internal control environment provides for the prevention and timely detection of material errors, omissions, or irregularities in the normal course of operations. Thus, an effective internal control environment includes a series of processes and policies that serve to protect the organization from loss and serve to ensure that financial information is accurate. Additionally, the treasurer is responsible for providing physical safeguards to protect assets against unauthorized use or theft and to regularly evaluate the sufficiency of insurance coverage.

Internal accounting controls involve delegating duties and record-keeping functions that readily identify deviations from authorized procedures. Internal control procedures are also designed to remove undue temptation from employees and volunteers. Best practice requires internal control procedures that are documented in a written policy.³

The system of internal controls should be understood by executive management and the board. Internal controls for a large organization will be regularly tested or monitored and may include an internal audit department that reports directly to the board. Organizations may also include antifraud programs as part of an effective internal control environment.

Included under the umbrella of internal controls and safeguards unique to not-for-profit organizations are the special requirements for accounting for endowment fund assets. State law, donor intention, or board designation may define the accounting methods that are required when cash is invested or pooled by the organization.⁴

² For additional information on budgeting, see Chapter 20.

³ For additional information on internal controls, see Chapter 23.

⁴ For additional information on investment of endowment funds, see Chapter 6.

Executive management, the board, and the donor community look to the treasurer to demonstrate and implement ethical practices and fiscal safeguards for the organization. The internal control environment is a key component of this responsibility.

1.5 COMPLYING WITH FEDERAL AND STATE REPORTING AND REGULATORY REQUIREMENTS

The treasurer is charged with compliance under the numerous federal and state reporting requirements. Most tax-exempt organizations, other than churches, are required to file annual information returns with the Internal Revenue Service (IRS), and some are even required to pay tax on unrelated business income. Organizations may be subject to register and file information returns with state governments even if they are not resident in the state. Reporting and filing requirements are complex; and the complexity is increased for ordinary activities typical to many not-for-profit organizations; raffle events, advertising sales, and holding investments in real estate to name but a few.⁵

Not-for-profit organizations that receive more than \$500,000 a year, directly or indirectly, from the federal government are required to implement special accounting and reporting procedures and to have an independent audit in accordance with the regulations under the Office of Management and Budget (OMB), Circular A-133.⁶

Other regulatory requirements are prescribed by the Securities Exchange Commission (SEC) for not-for-profit organizations with public debt. Legislative actions by states, to mirror the provisions of the Sarbanes–Oxley Act, may also impose special reporting or filing requirements by the treasurer.

1.6 COMMUNICATING FISCAL INFORMATION TO THE BOARD OF DIRECTORS AND THE AUDIT COMMITTEE

The articles of incorporation and bylaws describe how the board of directors of a not-for-profit organization is composed and the legal obligations of its membership. Every board member has a fiduciary responsibility for the affairs of the organization. For some organizations, the board or selected members of the board may act in the role of the audit committee. In fact, as a result of the dramatic changes in corporate America precipitated by the Enron scandal and other accounting fraud crimes and investigations in recent years, all SEC registrants are required to have audit

⁵ For additional information on reporting and filing tax information, see Chapter 28.

⁶ For additional information on federal audit requirements, see Chapter 29.

committees. Several states have adopted similar legislation, or are in the process of doing so, that requires not-for-profit organization also have audit committees. A sophisticated organization will have an audit committee charter that mandates the following under the purview of its membership:

- Overall purpose and objectives of the Audit Committee
- Authority—board authorization of its scope of services
- Organization:
 - Composition of its membership (only independent directors including, at least, one director familiar with financial reporting)
 - Nature and frequency of its meetings
- Roles and responsibilities:
 - Oversight of the internal control environment
 - Overall effectiveness of risk management
 - Transparency of financial reporting
 - Compliance with laws and regulations
 - Retention of external auditors and review all services provided
 - Supervision of internal auditors
 - Oversight of code of conduct and conflict of interest policies
 - Effective process for reporting complaints (“whistle blowing”)
- Reporting responsibilities—update the full board on its activities
- Evaluate performance—evaluate committee performance and efficacy of its charter

Necessarily, management must be independent from the board. However, the treasurer will have a close relationship to the audit committee when communicating financial and other required information. Typically the treasurer will help board members understand and interpret fiscal reports by communicating variances or explanations for activities against the approved budget. For larger organizations the treasurer will prepare a monthly or quarterly fiscal package for timely audit committee review.

Thus, the treasurer is responsible for the day-to-day, week-to-week, and month-to-month fiscal activities of the organization; while the board brings to bear experience and insight from a variety of life’s experience. There is a fine balance between board oversight and micromanagement. The best organizations are those with a well-defined charter to help the board exercise its appropriate fiduciary duties in concert with well-defined accounting and reporting policies to guide the responsibilities of the treasurer.

1.7 TEN KEY POINTS TO CONSIDER IN NOT-FOR-PROFIT FISCAL MANAGEMENT

(a) Accounting Principles

(i) Not-for-Profit Accounting Is Not Very Different from For-Profit Accounting. Most of not-for-profit accounting is no different from for-profit accounting. The primary area which is different for not-for-profit organizations is accounting for contributions. For-profit corporations make gifts, but they do not receive them. Accounting for gifts received, especially pledges, restricted gifts, split-interest agreements and noncash gifts (gifts-in-kind) is unique and may be complicated.⁷

(ii) Not-for-Profit Organizations Must Report Fundraising Expense. Accounting guidelines are very precise about what may be reported and what must be reported as fundraising expense. Donors and watchdog groups pay close attention to fundraising expense as a percentage of total expense. They are anxious to know how much of every donated dollar supports programs, fundraising, management, and general expense. Under certain conditions the cost of a fundraising appeal may be shared between fundraising and program expense. Under certain conditions, direct donor benefits may be netted against the cost of a fundraising event. Because this measure is sensitive, a treasurer is well advised to be familiar with accounting rules for recording fundraising expenses.⁸

(b) Financial Reporting

(iii) Audited Financial Reports Are Prepared by Management. Management is responsible for preparing financial reports for an organization, just as management is responsible for keeping the underlying records that support the reports. A complete set of financial reports including notes that contain required disclosures, may be subject to audit procedures as performed by an independent accountant. As a result of the audit, the auditor renders an opinion on the complete set of financial statements as prepared by management. The highest level of assurance the auditor can provide is an unqualified opinion, in contrast to an opinion with an exception, an adverse opinion, or a disclaimer of an opinion. The auditor's opinion is not a guarantee that the financial statements are accurate. Rather, the auditor performs procedures and tests to determine that the financial statements are fairly presented in accordance with the applicable, generally accepted accounting standards in all material respects.

⁷ For additional information on accounting for pledges and gifts, see Chapter 8.

⁸ For additional information on fundraising expense, see Chapter 9.

1.7 TEN KEY POINTS TO CONSIDER IN NOT-FOR-PROFIT FISCAL MANAGEMENT

(iv) **A Healthy Not-for-Profit Organization Makes Money.** While not *as* important to a not-for-profit as for a business, the “excess of revenues over expenses” or “changes in net assets” (the amount in a not-for-profit’s financial statements closest to the equivalent of the profit of a business) has significance to management and the governing board of a not-for-profit, and to other readers of the financial statements. For example:

- This amount helps to assess whether the organization is better off or worse off financially at the end of the current year than it was the previous year.
- It tells whether the organization “lived within its means” during the year.
- A large negative amount (or continuing smaller negative amounts) could be an early warning sign of financial or management problems.
- A large positive amount may indicate that the organization could be doing more to achieve its purpose.
- Comparison of the actual to the budgeted amount can indicate the extent to which management engaged in adequate advance planning, and the extent to which the organization’s affairs were effectively managed to achieve planned goals.

(c) Budgeting and Resources

(v) **A Not-for-Profit Organization Might Budget a Deficit.** While a budgeted deficit is not something that should be undertaken lightly or regularly, it should not be dismissed out of hand. Circumstances where this can be appropriate include the following:

- The organization has unrestricted net assets in an amount far in excess of needs foreseeable in the near future, and resource providers (members, donors, fee payers, etc.) are questioning the organization’s need for additional funding.
- The organization is pursuing certain sources of funding that appear likely to come through, and expenditure of certain budgeted expense items can be made contingent on actual receipt of the funding (i.e., if the funding is not received, these budgeted amounts will not be expended).
- An immediate need for the organization’s services is so important (for example, relief for victims of a disaster) that the board is willing to commit to an activity even though funding is not presently in sight. There are adequate resources to survive in the short term, and the board makes realistic plans for quickly seeking the needed additional funding.

RESPONSIBILITIES FOR FISCAL MANAGEMENT

- A deficit can be budgeted in one program, if resources to cover the deficit are available from privately funded surpluses in other programs, such as from contributions or endowment income. Funding from federal or government sources generally restrict the use of funds to a specific program for a specific period.

(vi) **There are Three Categories of Endowment Funds; Permanently Restricted, Temporarily Restricted, and Quasi-Endowment Funds as Designated by the Board.**⁹ What most organizations call an “endowment” is really composed of three parts: true endowment, term endowment, and quasi-endowment. The true, or permanent, endowment can never be spent. This endowment is restricted by the donor in perpetuity in accordance with the terms of the gift. The term, or temporary restricted, endowment can be spent after the passage of time or for a specified purpose. Accounting rules require that temporarily restricted resources be expended, to the extent they are available, prior to the expenditure of unrestricted resources.¹⁰ The quasi-endowment, or board-designated endowment, is legally unrestricted and can be spent at any time as directed by the vote of the governing board. Some organizations fortunate enough to have accumulated large unrestricted endowments may feel uncomfortable admitting to donors (or faculty or orchestra members) that they have such large unrestricted resources. They believe that donors will be less likely to contribute (or faculty or orchestra members will demand higher pay) if the true financial picture is known. However, board-designated funds may be clearly described as such even as they must be included with unrestricted net assets. Furthermore, the policy of the board to designate unrestricted net assets may be elaborated in the notes to the financial statements.

A board cannot create a restriction where no *donor*-imposed restriction exists. A board can “designate” the unrestricted endowment; it can segregate the assets in a separate investment account; and it can “appropriate” the assets for some future purpose (such as being held to produce investment income). However, it cannot “restrict.” Only an outside donor can cause a gift to be reported as temporarily or permanently restricted in the financial statements. Board-designated endowments must be reported as part of the unrestricted net assets. A donor-imposed restriction can only be changed by the donor, *if* the donor can be located *and* is willing to modify restriction.¹¹

⁹ For additional information on accounting for unrestricted, temporarily restricted, and permanently restricted net assets, see Chapter 13.

¹⁰ See Chapter 5, *Not-for-Profit Organizations*—AICPA Audit and Accounting Guide (Section 5.44 2004 ed.).

¹¹ There is a legal procedure, known as *cy pres*, which can lift a restriction; but this is very cumbersome and will not be approved by a court except in very rare cases of extreme financial emergency.

(vii) A Not-for-Profit Organization May Be Required to Consolidate Reporting with Related Organizations. Sometimes, in an attempt to subvert or shield resources from one not-for-profit, a new organization or foundation is created. The requirement to report the related entities in a consolidated report depends on the real nature of the relationship between the organizations. Even if formal legal control does not exist, there may be effective control through overlapping board membership, the parent having the power to appoint board members of the affiliate, or to dictate how the affiliate uses its resources. Under certain conditions two related entities may be required to consolidate.¹² If consolidated reporting is not required, the two entities may be considered “related parties,” and information about the nature of the relationship and transactions with the other organization is required to be included in the footnotes for each organization’s financial statements.

(d) Financial Management

(viii) Strong Internal Controls, Antifraud Programs and an Ethical Tone at the Top Help Deter Fraud for Organizations of Every Size and Kind. Unfortunately, people do steal from organizations that serve the needy. If anything, internal controls are more important to a not-for-profit than to a business because limited resources may be impossible to replace, especially if supporters are not satisfied that the resources are protected from unauthorized use. Failure to establish and monitor an adequate control environment is a certain recipe for failure.¹³

(e) Government Regulation

(ix) Board Members and Management Are Personally Liable for Unpaid Payroll Taxes Related to Employees of the Not-for-Profit Organization. Small organizations may omit the withholding, reporting, and payment of payroll taxes on behalf of those providing by the organization because employees are improperly classified as contract workers, or when benefits such as certain insurance premiums are omitted from compensation in the determination of an employee’s taxable income. If the bookkeeper fails to pay the withheld payroll taxes to the government, the Internal Revenue Service can and will hold board members and managers personally liable for unpaid payroll taxes regardless of a declaration of bankruptcy or the corporate form of organization.

¹² Statement of Position 94-3.

¹³ For additional information on internal controls, see Chapter 24.

(f) Contributions

(x) A Stringent Gift Policy Is Good Business. Accepting some gifts is a bad business decision. An organization that receives gifts must define a policy to prevent unwanted gifts:

- Gifts restricted for a purpose inconsistent with the organization's mission will divert the organization's attention from its priorities.
- Gifts with onerous limitations on exactly how the activity must be conducted can result in the recipient effectively ceding control of its operations to the donor.
- Gifts from a donor with a bad public image, and with whom the organization would be embarrassed to be publicly identified, may hurt the organization's fundraising efforts.
- Gifts of a building, without adequate provision for paying the ongoing expenses of maintaining and operating the building, can expose the organization to considerable unbudgeted and unfunded liabilities.
- Gifts of land, under which lies an old toxic waste dump, can require the organization to pay for expensive remediation to clean up the waste.
- Gifts of an annuity that requires the organization to pay out more than the value of the annuity is not a good deal.

1.8 CONCLUSION

The treasurer of a not-for-profit organization has a unique opportunity to be part of a social mission while exercising the aptitudes and talents inherent in the discipline of accounting and finance. For volunteers or paid professionals who assume the role of treasurer, the guidance in this volume will assist you in the effective discharge of your important responsibilities.

P A R T O N E

Key Financial Concepts

CHAPTER TWO

Accounting Distinctions between Not-for-Profit and Commercial Organizations

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Many businesspersons, as well as many accountants, approach not-for-profit accounting with a certain amount of trepidation because they are unfamiliar with such accounting. There is no real reason for this uneasiness because, except for a few troublesome areas, not-for-profit accounting follows many of the same principles followed by commercial enterprises. This chapter explores the principal differences and pinpoints the few troublesome areas.

2.1 STEWARDSHIP VERSUS PROFITABILITY

One of the principal differences between not-for-profit and commercial organizations is that they have different reasons for their existence. Simply stated, the ultimate objective of a commercial organization is to make a net profit for its owners by providing some product or service that people will pay for, whereas the ultimate objective of a not-for-profit organization is to meet some socially desirable need or goal of the community or its members.

Like any organization (or individual), a not-for-profit organization should have sufficient resources to carry out its objectives. However, there is no real need or justification for “making a profit”—that is, having an excess of income over expenses for a year or having an excess of assets over liabilities at the end of a year beyond what is needed to provide a reasonable cushion or reserve against a rainy day or provide for future growth plans of the organization. A surplus or profit is only incidental.

Not-for-profit organizations have a responsibility to account for funds that they have received. This responsibility includes accounting for certain specific funds that have been given for use in a particular project as well as a general obligation to employ the organization’s resources effectively. Emphasis, thus, is placed on accountability and stewardship. To the extent that the organization has received gifts restricted for a specific purpose, it may segregate those resources and report separately on their receipt and disposition. This separate accounting for restricted resources is called *fund accounting*, and is discussed in Chapter 4. While financial statements may be prepared by showing the various funds maintained by the organization, most organizations choose not to do so. Instead, activities are categorized and presented based on their level of restriction (unrestricted, temporarily restricted, and permanently restricted). By grouping activities in this manner, overly complex and voluminous reports can be avoided.

The financial statements of commercial organizations are generally easy to understand, relative to those of not-for-profit organizations, because there is only a single set of statements, the terminology and format are usually standardized and familiar, and accounting principles are more clearly defined.

2.2 PRINCIPAL AREAS OF ACCOUNTING DIFFERENCES

There are seven areas where the accounting principles followed by not-for-profit organizations often differ, at least somewhat, from the accounting principles followed by commercial organizations. While the accounting significance of these seven areas should not be minimized, it is also important to note that once the significance of each is understood, the reader will have a good understanding of the major accounting principles followed by not-for-profit organizations. The principal remaining difficulty will then be designing financial statements that reflect these accounting distinctions and are straightforward and easy to understand.

Of the seven areas of differences, only one of them—contributions—is truly unique to not-for-profit organizations, since businesses do not receive gifts. Thus there are no accounting principles addressing how businesses should account for contributions received. (Accounting for contributions made by for-profit organizations is covered in SFAS 116

issued by the Financial Accounting Standards Board (FASB)—see discussion in Chapter 8.)

The other six areas are not the subject of specific detailed accounting rules, except in certain aspects. As for those aspects, the requirements applicable to not-for-profit organizations are not different from the requirements applicable to for-profit organizations, except for accounting for investments. The differences that exist in practice arise mostly from the differing nature of the way not-for-profit organizations operate and the different concerns of readers of the financial statements of those organizations. In fact, practices followed by not-for-profit organizations are very similar to those followed by for-profit organizations.

That leads to the questions of just what is and is not considered a not-for-profit organization for purposes of deciding what accounting standards an organization is subject to. The American Institute of Certified Public Accountants (AICPA), in its audit and accounting guide for not-for-profit organizations, discusses this issue in its Chapter 1.¹ It refers to a definition published earlier by the FASB, which includes the criteria of (1) receiving contributions, (2) not having ownership interests, and (3) having purposes other than making profit. As to most organizations, it is immediately obvious whether they pass or fail this definition. Businesses fail it on all three counts. Most organizations that we think of as not-for-profit—such as colleges, orchestras, charities, churches, hospitals, and foundations—easily pass it.

There are two types of organizations most people think of as being not-for-profit that do not clearly pass this definition: clubs and associations. They do have purposes other than making a profit; and associations do not have ownership interests. However, many clubs do have ownership interests, and both types typically receive little in the way of contributions—they cover their costs from member dues and from sales of goods and services. (Note that “not-for-profit” and “tax-exempt” are not synonymous. Many organizations that are one are also the other; but there are exceptions in both directions.)

Therefore, the question arises as to whether clubs and associations must follow the accounting rules for not-for-profit organizations or the rules for for-profit organizations. The only two accounting areas where there is really any formal difference are investments and functional expenses.

The AICPA’s audit guide for *Not-for-Profit Organizations* resolves this issue by stating that all organizations that were covered by any of the three superseded not-for-profit audit guides (colleges, voluntary health

¹ *Not-for-Profit Organizations—AICPA Audit and Accounting Guide* (New York, American Institute of Certified Public Accountants, 2004).

DISTINCTIONS BETWEEN NOT-FOR-PROFIT AND COMMERCIAL ORGANIZATIONS

and welfare organizations, and SOP 78-10) are also covered by the new guide. Since associations and clubs were specifically listed in SOP 78-10, they are covered by the new guide, and should follow FASB SFAS 124 for valuing marketable investments (see Chapter 8).

In addition, the AICPA's audit guide for *Not-for-Profit Organizations* excludes governmental organizations from coverage. A governmental organization is defined (in paragraph 1.03) as an organization with one or more of the following characteristics:

- Its governing structure is elected by popular vote or appointed (or approved) by governmental officials.
- The organization may be unilaterally dissolved by government with the remaining net assets reverting to the government.
- The organization can enact and enforce a tax levy.
- The organization can directly issue debt, the interest on which is exempt from federal income tax.

This last characteristic may, if it is the only one present, be rebutted.

(a) Cash versus Accrual Accounting

In all but the smallest commercial organizations, the records are almost always recorded on an accrual basis. The accrual basis simply means keeping the organization's records so that in addition to recording transactions resulting from the receipt and disbursement of cash, the organization also records the amounts it owes others, and others owe the organization. Some not-for-profit organizations utilize the cash basis of accounting instead. Cash basis accounting means reflecting only transactions where cash has been involved. No attempt is made to record or accrue unpaid bills owed by the organization or amounts due to the organization. Many small not-for-profit organizations use the cash basis, although most of the medium and larger organizations use the accrual basis.

The accrual basis gives a more accurate picture of an organization's financial condition than the cash basis. The cash basis is generally used only by smaller organizations that require only basic financial information and may not have the accounting resources necessary to compile financial statements prepared on the accrual basis. Everyone has had experience keeping a checkbook. This is a basic example of cash-basis accounting. A nonaccountant can learn to keep a checkbook; but she or he is not likely to comprehend readily how to keep a double-entry set of books on the accrual basis. Furthermore, the cash basis is often used when the nature of the organization's activities is such that there is no material amounts owed to others, or vice versa, and so there is little significant difference between the cash and accrual basis.

(e) Contributions, Pledges, and Noncash Contributions

In commercial or business enterprises, there is no such thing as a "pledge," or a promise to contribute. If the business is legally owed money, that amount is recorded as an account receivable. A pledge to a not-for-profit organization may or may not be legally enforceable, or even if technically enforceable, the organization may (for public relations reasons) have a policy of not taking legal action to attempt to enforce unpaid pledges. Some not-for-profit organizations record pledges because they know from experience that they will collect them. Others do not because they feel they have no legally enforceable claim. A related problem is where and how to report both restricted and unrestricted contributions in the financial statements. Contributions and pledges are discussed in Chapter 8.

Noncash contributions include donations of securities, equipment, supplies, and services of volunteers. Commercial enterprises seldom are recipients of such "income." When and at what values it is appropriate to record such noncash contributions is discussed in Chapter 8.

(f) Accounting for Investments

With the issuance of SFAS 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, not-for-profit organizations have moved closer to the fair market value approach to valuing equity and debt instruments with readily determinable market values that are used by for-profit entities. For-profits are subject to SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*. Organizations that may operate as not-for-profit organizations but do not pass the definition above follow SFAS 115, not SFAS 124. Accounting for investments is further discussed in Chapter 26.

(g) Functional Reporting of Expenses

Accounting literature applicable to not-for-profit organizations has long required some degree of functional reporting of expenses (for example, see the discussion in Chapter 12)—whereas accounting literature applicable to businesses is largely silent on this subject. In practice, however, many businesses use a form of expense reporting that is partly functional. The AICPA's audit guide for *Not-for-Profit Organizations* also requires functional expense reporting for all not-for-profit organizations covered by the guide. Clubs and associations will have to decide on a case-by-case basis whether they believe they pass the definition of not-for-profit. Those that do not pass are not precluded from reporting expenses on a functional basis; and the authors encourage such reporting because they believe it is the most useful to readers of the statements.

2.3 CONCLUSION

2.3 CONCLUSION

The seven areas just discussed are the principal differences in accounting found between not-for-profit and commercial organizations. While each of these can cause real problems for the casual reader if the statements are not carefully prepared, there are only these seven areas, and often not all of these differences will be present in any given organization. Part of the reason for these differences stems from the different objectives in not-for-profit and commercial organizations. In not-for-profit organizations, accountability for program activities and stewardship is the objective. In commercial organizations, the objective is to match revenue and costs to measure profitability. The treasurer familiar with commercial financial statements should have no difficulty preparing not-for-profit financial statements once the nature of each of these seven areas of accounting differences is understood. If the objectives of financial statements are kept in mind, the treasurer should be able to prepare financial statements that meet the "nonaccountant test" for clarity and effectiveness in communicating with readers.

not yet been paid to the government, are a good example of the type of transaction not involving cash that might be recorded. These taxes are just as much an obligation as the salaries.

On a modified cash basis, it is not necessary for the organization to have a complex set of books to record all obligations and receivables. In small- and medium-sized not-for-profit organizations, it is sufficient to keep the records on the cash basis and then, at the end of the month, tally up the unpaid bills and the uncollected receivables and either record these formally in the books through journal entries or record them through a worksheet in the manner described above. Under the cash basis, one of the practical ways some smaller organizations use to record all accrued expenses is to hold the disbursement record "open" for the first four or five days of each month. This allows the bookkeeper to pay last month's bills as they arrive about the first of the month and record them in the prior month's records. While the organization actually pays such amounts in the first few days of the new period, it considers the payment as having been made on the last day of the prior period. This means that the organization does not show accounts payable but a reduced cash balance instead. This is frequently a useful practice for reporting internally to the board because it gives reasonable assurance that all expenditures incurred are recorded in the proper period. In financial statements prepared for external use, such payments subsequent to the end of the period should be shown as accounts payable instead of a decrease in cash.

(a) When Accrual-Basis Reporting Should Be Used

There are several advantages of cash-basis accounting and reporting, but the accrual basis is ordinarily necessary for fair presentation of the financial statements. Unless the organization does not have any significant amounts of unpaid bills or uncollected income at the beginning or end of the period, accrual basis reporting is required to present an accurate picture of the results of operations and of the financial position of the organization. Accrual-basis reporting is also required if an organization is trying to measure the cost of a product or service. It is impossible to know what a particular activity cost during the year if unpaid bills have not been included as an expense in the statement. The same is true where services are provided for a fee, but some fees have not been billed and collected during the period. If a board or its membership is trying to draw conclusions from the statements as to the cost or profitability of a particular service, accrual-basis statements are essential. The same is true when an organization is on a tight budget and budget comparisons are made with actual income and expenses to see how effectively management has kept to the budget. Without including unpaid bills or uncollected income, such

3.5 CONCLUSION

a comparison to budget can be very misleading and useless. GAAP for both commercial and not-for-profit organizations include the use of accrual-basis accounting. Organizations that have their books audited by certified public accountants (CPAs), and who wish the CPA to report that the financial statements are prepared in accordance with GAAP, generally have to either keep their records on the accrual basis, or make the appropriate adjustments at the end of the year to convert to this basis. See Chapter 25 for a discussion of generally accepted accounting principles, independent audits, and auditors' opinions.

3.4 LEGAL REQUIREMENTS

For some organizations that solicit funds from the public, there are legal requirements with respect to using the accrual basis of accounting. In the state of New York, for example, not-for-profit organizations that are required to report to the state must use the accrual basis. However, even in New York the requirement is not that the records be kept on an accrual basis, but only that the organization file reports prepared on an accrual basis. This means the organization could still keep cash-basis records throughout the year, provided it adjusts them to accrual basis for report purposes. Chapter 28 discusses the legal reporting requirements for not-for-profit organizations. If an organization is required to file reports with one or more state agencies, it should examine the instructions accompanying the report very carefully to see what the reporting requirements are.

3.5 CONCLUSION

There are two bases for keeping records—the cash basis and the accrual basis. While it is generally necessary to report financial statements on the accrual basis of accounting to be in conformance with GAAP, some small not-for-profit organizations use the cash basis of accounting, and this can be an acceptable and appropriate basis for such organizations. The chief reason for using the cash basis is its simplicity. For organizations whose financial statements would show significant differences between the accrual and cash basis, the accrual basis should be used. However, for organizations whose financial statements would not be significantly different, the cash basis of presentation may provide significant advantages. It is also possible to keep accounting records on the cash basis and adjust them to the accrual basis for presentation purposes, which allows for simpler recordkeeping while still preparing full accrual statements to provide for more accurate financial performance analysis.

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Fund accounting is peculiar to not-for-profit organizations. Most readers of commercial financial statements are not familiar with this type of accounting. As a consequence, fund accounting more than any other single concept of not-for-profit accounting, tends to confuse the reader. With the implementation of FASB Statement of Financial Accounting Standards No. 117, *Financial Statements of Not-for-Profit Organizations* (SFAS 117), fund accounting is not as commonly used as before, however many organizations still use it for bookkeeping purposes. In some cases financial statements are still prepared showing certain funds of an organization. The purpose of this chapter is to explain this concept as it is still used in practice.

A *fund* is a certain part of an organization, defined in accounting terms. Some organizations have only one fund; some have many. Funds can exist with different characteristics: Some are legally unrestricted, that is, available for any organizational purpose. Some are extremely restricted

because of stipulations placed by donors on the gifts that make up the fund. Usually, all gifts with the same kind of restriction—such as gifts for the purpose of doing research on cancer or gifts restricted for permanent endowment—are grouped together in a separate fund for accounting purposes. In addition, the governing board of an organization may decide to set aside certain available resources into one or more separate funds such as those for investment.

Many people confuse “funds” with “assets” (especially cash), or with what is sometimes called by accountants “fund balance.” The three terms are very different.

- A *fund* is any part of an organization for which separate accounting records are kept.
- *Assets* are resources owned or controlled by the organization. Examples of assets include cash, investments, property, and amounts owed to the organization.
- *Fund balance* is the mathematical amount obtained by subtracting total liabilities from total assets of a particular fund.

As discussed further in Chapter 12, in 1993 the accounting profession issued SFAS 117, which changed the manner in which financial information for not-for-profit organizations is presented in their external financial statements. One benefit of this standard is a reduction in the amount of detail that is required to be shown in financial statements issued to the public. Rather than showing the traditional “funds,” organizations must report their resources as segregated into three “classes” (or groups) of “net assets.”¹ Fund accounting is still a valid tool and will continue to be appropriate for many organizations for keeping their books and for internal reporting to management and the governing board. In addition, the fund-accounting financial records form the basis for preparation of the financial statements used for reporting to the public.

This distinction between internal *accounting* and external financial *reporting* is important to understand. Accounting standards issued by the accounting profession deal only with external financial reporting, not how the internal books are kept. Organizations are free to use any method of recordkeeping they wish, as long as the final result—the financial statements seen by the public—are in the proper form.

While external reports should conform to the rules of generally accepted accounting principles (GAAP), internal reports for management and the governing board should include information and be formatted in

¹ “Net assets” is computed by subtracting liabilities from assets. It is what would be left if all the assets were converted into cash and all the liabilities paid off. This amount is called “fund balance” in the context of a fund accounting system. SFAS 117 describes three classes of net assets: unrestricted, temporarily restricted, permanently restricted. These are further discussed in Chapters 8 and 13.

4.1 FUND ACCOUNTING DEFINED

such a way that they are most useful to the decision-making process of those receiving the reports. For example, reports to the board should facilitate the effective execution of its governance function. The organization's recordkeeping system must allow all for both internal reports and external financial statements to be easily prepared.

Traditional fund accounting has often led to an organization being viewed as a collection of disparate pieces (funds) rather than as a cohesive whole. The new financial reporting model approaches financial reporting from the point of view that an organization is a single entity, controlled by a single governing board, despite the fact that donors may have imposed certain restrictions on how the board may utilize some of the resources at its disposal. Therefore, under the current model, an organization's external financial statements should mirror this point of view and not be fragmented.

This chapter deals with internal recordkeeping and reporting; Chapters 10 to 12 deal with external financial reporting to the public. Fund accounting is also discussed in Chapter 16 of the AICPA's audit guide *Not-for-Profit Organizations*.

4.1 FUND ACCOUNTING DEFINED

Fund accounting is a system of accounting in which separate records are kept for:

- Resources donated to an organization that are restricted by donors or other outside parties to certain specified purposes or use
- Portions of an organization's unrestricted resources that the board has set aside for some specified future use
- All other unrestricted amounts

With appropriate explanations, there is nothing difficult about fund accounting other than mechanics. It reflects an accountability or stewardship concept, used principally by not-for-profit and governmental organizations that are legally responsible for seeing that certain resources are used only for specified purposes or during specified time periods. This need for separate accountability arises whenever a not-for-profit organization receives restricted contributions. For example:

- The Johnstown PTA receives a special contribution of \$15,000, which the donor specifies is to be used only in connection with an educational program on drug abuse.
- The Bethesda Methodist Church decides that they need an addition to the Church, and a building fund drive is established to raise \$200,000. Contributors are told the money will be used only for this building addition.

FUND ACCOUNTING AND INTERNAL FINANCIAL REPORTING

- The Boy Scout Council of Arlington receives a \$250,000 gift from an ex-Boy Scout to be kept as a permanent endowment fund.
- The Kennebunkport Civic League receives a gift specified by the donor as being for use in the following year only.

In each instance, the donor's stipulation has created a legal restriction on the contribution, and by accepting such a restricted gift, the organization has incurred an obligation to follow the donor's instructions. One of the responsibilities of the treasurer is to be sure that controls are established to ensure that restricted funds are used only for the purpose intended. In the listed examples,

- The Johnstown PTA cannot spend its gift for any purpose other than drug abuse education.
- The Bethesda Methodist Church must spend all amounts raised by its fund drive only for the building addition.
- The Arlington Boy Scout Council can never spend the gift itself—only the future investment income earned by the gift is available for use.
- The Kennebunkport Civic League cannot spend the gift this year, nor after the end of next year.

Usually this control is established through the use of fund accounting. Every new treasurer in an organization should review the disbursement procedures to be sure that restricted funds cannot be inadvertently spent in violation of the restriction.

In addition, some organizations, as a matter of convenience, establish by board action additional funds to segregate certain amounts that the board intends to use for specified purposes in the future. An example would be a board-created fund where unrestricted net assets were "designated" to be set aside for use as an "unrestricted investment fund" or "quasi-endowment fund." The important thing to note about these board-designated funds is that they carry no legal restrictions and represent only an internal designation for the convenience of the organization.² By contrast, donor-restricted funds do carry legal restrictions, and the approval of the original donor or a court of law would usually be required should the board of the organization wish to divert these contributions from their stipulated purpose.

² Sometimes an organization will create a board-designated investment fund using resources that a donor has restricted for some operating purpose, but which the board prefers not to spend right away. The resources retain their legal restriction, and take on the additional designation specified by the board that they will be held for investment for some period of time. The investment income generated by the assets is then used for the purpose specified by the donor. The board may at some future time decide to spend the original amount of the gift for the restricted purpose. The term *quasi-endowment—restricted* is used to describe this kind of fund. Colleges and universities are the type of not-for-profit organization that most often use it.

4.2 CATEGORIES OF FUNDS

Internal financial statements or management reports may follow this separate accountability, both for donor-imposed restrictions and for designations imposed by its governing board. Often separate statements are prepared for each “fund.”

Note that fund accounting does not itself require physical segregation of the assets of each fund. For example, separate bank accounts need not be maintained for the cash attributable to each fund. (Although the treasurer *may* do so if this would be considered a convenience, and sometimes a donor of some of the assets may require such a separate account.) Usually, all the organization’s cash may be kept in a single bank or investment account, and the separate accountability maintained through the fund-accounting bookkeeping system. This also saves on bank fees and the time needed to maintain the books and reconcile the monthly bank statements.

4.2 CATEGORIES OF FUNDS

An organization that receives many restricted contributions, each having a different kind of restriction, is faced with the practical problem of having to keep track of and report on many separate funds. While it is possible to keep separate records on any number of restricted funds, such funds are usually grouped by the type of donor restriction. For example, in a college building fund drive, one donor may specify that a gift is to be used for a new chemistry building; another may specify a dormitory. Both represent restricted contributions to a category of fund generally referred to as *building funds*.

In the past, a wide variety of names have been given to various categories of funds. However, four categories or groupings of funds have historically been used most frequently by not-for-profit organizations for reporting purposes. The description or title indicates the general type of restriction on the funds. The following sections describe the four groupings most commonly encountered. Chapter 12 includes a discussion of how the four traditional fund groupings relate to the three classes of net assets defined by SFAS 117.

(a) Current Unrestricted Fund

Several titles are given to the fund that includes the general activities of the organization. It may be known as the *unrestricted fund*, *operating fund*, *general fund*, *current fund*, *current general fund*, or most commonly the *current unrestricted fund*. This fund contains no restricted resources, and the board can use amounts in the fund as it chooses, to carry out the purposes for which the organization exists.

All unrestricted contributions, gifts, and other income should be recorded in this fund. Except for transactions involving one of the other

categories of funds, all transactions of the organization are included in this fund. If the organization never receives restricted gifts or contributions, this fund would show all activity.

(i) **Board-Designated Funds.** Board-designated funds are a subcategory of unrestricted funds. They are established when the board acts to transfer or segregate part of the unrestricted funds for a specific purpose. Remember that the board cannot create legal restrictions, for it can always change its mind later. The board designates certain resources for certain purposes—indeed, this is what it does in the budgeting process. Occasionally, the board may wish to formally (although not legally) segregate the resources it wishes to utilize for a specific purpose, especially when that purpose may extend over a long period of time.

(b) Current Restricted Fund

Various titles are given to the fund that accounts for resources given to an organization to be spent as part of its normal activities but only for specified purposes. It may be known as *current restricted fund*, *fund for specified purposes*, *donor restricted fund*, or just *restricted fund*. For example, the \$15,000 given to the Johnstown PTA for public education on drug abuse would be added to such a fund. In some organizations, such amounts are relatively small, and they are often used in the year received or in the following year.

Many restricted gifts are for a particular purpose that the organization normally carries out as a part of its current activities. However, a contribution may be for a purpose that is not normally part of the organization's regular activities—or, perhaps, for a purpose in the future before the money is needed. Contributions restricted by donors for purposes other than current activities (for example, a contribution to a building fund or an endowment fund) are usually accounted for in a separate fund category.

(c) Restricted Endowment Fund

This title is given to the fund that contains resources donated to the organization with the stipulation by the donor that only the income earned by these assets can be used while the original gift is kept intact, either forever (*permanent endowment*) or for a stated time (*term endowment*). Generally the income itself is not restricted and can be used to carry out the organization's ongoing activities. Yet some endowment gifts also have restrictions on the uses to be made of the income.

If term endowment gifts are received, they must be kept in the endowment fund for a period of time, after which the original amount can be used as desired by the board unless some other purpose was specified by the donor. Another possibility is a gift, the income from which is

paid to the donor until death; then the gift then becomes available for other uses.³

Some donors, while not formally placing restrictions, may express a “preference” that the gift be put in the endowment fund. However, if the actual decision is left to the board, such amounts are legally unrestricted and should be added to the current unrestricted fund. (The board may, if it wishes, then transfer such gifts to an unrestricted, board-designated fund as noted earlier.)

Legally unrestricted gifts should not be added to a restricted endowment fund. All amounts in a restricted endowment fund should bear legal restrictions that the board cannot normally alter without a *cy pres* ruling from a court of law.

(d) Fixed-Asset Fund

Several titles may be given to the fund in which the cost of fixed assets (land, buildings, furniture and fixtures, equipment, etc.) is recorded. This fund may be referred to as the *land, building, and equipment fund*; *fixed-asset fund*; or *plant fund*. Such a fund will usually also include unexpended restricted building fund contributions.

The principal reason for using this fund is that the board wants to separate these assets from the unrestricted fund. The unrestricted fund will then represent more closely the current activity of the organization—that is, the funds available for current program use. Fixed assets such as buildings are not really available in the sense that they cannot be readily converted to cash and expended. Therefore, many boards believe that fixed assets should be placed in a separate fund.

The use of a separate fixed-asset fund is largely a board decision, and there is no reason why a separate fund must be established. Because a separate fixed-asset fund is more likely to create considerable confusion for the reader of the statements without offering any real advantage, we do not recommend the use of a separate fixed-asset fund in external financial statements even though this was the predominant practice. (If a separate fixed-asset fund is not maintained, unexpended gifts restricted by donors for the acquisition or improvement of fixed assets would be included in the current restricted fund until spent for the intended purpose, at which time the amounts would be transferred to the unrestricted fund.) One way to present information about the organization’s equity in its fixed assets is to disclose that amount as a subcategory within the unrestricted class in the net assets section of the balance sheet.

Fixed assets are a necessary part of the resources that are available to the board for achieving the purposes for which its organization was

³ These gifts are variously referred to as “deferred,” “split interest,” “life income,” or “annuity” gifts. See Chapters 8 and 14 for a discussion of these funds.

formed; creating a separate fixed-asset fund may imply to some that fixed assets are not related to the day-to-day operations of the organization.

There is an extended discussion of accounting for fixed assets and depreciation in Chapters 5 and 31.

(e) Other Types of Funds

Other specialized fund groupings may be encountered reflecting either donor restrictions or board decisions regarding the use of unrestricted resources. For example, colleges and universities may have *loan* or *scholarship funds*, *custodian* or *agency funds*, *annuity and life income funds*, and *retirement of indebtedness funds*. Usually the title is descriptive of the nature of these resources and their intended use.

Occasionally a donor will give such a large sum of money, often for endowment purposes, that the board will want to create (or the donor asks the board to create) a separate fund bearing the name of the donor (or some other name specified by the donor), rather than merely burying this separate fund in the financial statements with similar funds. Examples would be the *Howard Geckler Scholarship Fund* or the *Agnes Christiansen Memorial Fund*. The principal reason for this separate reporting is to be able to track and give the donor public recognition for a substantial gift.

4.3 ALTERNATIVE FUND GROUPINGS

(a) Expendable and Nonexpendable

In some cases, statement users may find it useful to see funds classified based on their availability for current expenditure to further the organization's objectives:

- Expendable
 - Current unrestricted funds
 - Current restricted funds
- Nonexpendable
 - Fixed-asset funds
 - Endowment funds

The theory behind this approach is that the board has basically only two kinds of funds: those that are currently expendable for the organization's program and those that are not. The nonexpendable are more in the nature of "capital-type" funds.

(b) Managed Fund Groups

Some organizations prefer to group their funds according to the use made of the resources. These organizations typically have three groups:

FUND ACCOUNTING AND INTERNAL FINANCIAL REPORTING

EXHIBIT 4.1 (CONTINUED)

Typical Set of Income Statements Where Each Fund Is Reported in a Separate Statement

MCLEAN COMMUNITY SERVICE CENTER CURRENT RESTRICTED FUND STATEMENT OF CHANGES IN NET ASSETS FOR THE YEAR ENDED AUGUST 31, 20X1		
Contributions		\$ 24,000
Expenses:		
Athletic awards	\$ 15,000	
Citizenship program	5,000	
Other	<u>3,000</u>	
Total expenses		<u>23,000</u>
Excess of contributions over expenses		1,000
Net assets, beginning of year		<u>10,000</u>
Net assets, end of year		<u>\$ 11,000</u>
MCLEAN COMMUNITY SERVICE CENTER FIXED-ASSET FUND STATEMENT OF CHANGES IN NET ASSETS FOR THE YEAR ENDED AUGUST 31, 20X1		
Net assets, beginning of year		\$ 50,000
Add—Transfer from General Fund		<u>25,000</u>
Net assets, end of year		<u>\$ 75,000</u>
MCLEAN COMMUNITY SERVICE CENTER ENDOWMENT FUND STATEMENT OF INCOME AND CHANGES IN NET ASSETS FOR THE YEAR ENDED AUGUST 31, 20X1		
Income:		
Contributions and gifts		\$ 25,000
Gain on sale of investments		<u>46,000</u>
Total		71,000
Net assets, beginning of year		<u>250,000</u>
Net assets, end of year		<u>\$321,000</u>

The principal advantage of fund accounting is that the activities of each fund are reported separately. Accountability is quite evident because the reader can see exactly what has taken place. This is the stewardship aspect.

The principal disadvantage of fund accounting is that it is difficult to comprehend the total activities of the organization without a careful review of all the statements and perhaps a little bit of pencil pushing. For example, what was the total excess of income over expenses for all funds? To answer

this question it is necessary to add three figures. Be careful to pick out the *right* figures ($\$33,000 + \$1,000 + \$71,000 = \$105,000$). In addition, statements such as these may only be utilized for internal financial reporting; changes would be necessary if the organization were being audited.

One way to simplify fund accounting statements is to show all funds on a single statement in columnar format. In this format, each fund is shown in a separate column side-by-side.

(a) Interfund Borrowing

As was previously noted, one of the problems with having a number of separate funds is that there is sometimes difficulty in keeping all the transactions completely separate. For example, it is possible to have a situation where the current unrestricted fund has a cash shortfall over the summer months and the board authorizes a cash loan from the other funds. In theory one can easily keep track of these borrowings, but it does create one more area where the reader who is not careful or knowledgeable can become confused, as the resulting due to/due from interfund liabilities and receivables may not be clearly presented. Two words of caution with respect to interfund borrowings:

- A fund should not borrow from another fund unless it is clear that the borrowing fund will, within a reasonable time, have the financial resources to repay the amount borrowed. It is not appropriate financial management to finance a deficit operation on an ongoing basis through interfund borrowing.
- Before resources are borrowed from legally restricted funds, advice should be sought from legal counsel as to whether such borrowings are permissible. It would appear entirely inappropriate for an organization to raise funds for a building and then "lend" such amounts to help finance general operations of the organization.

Fund accounting and reporting can become very difficult, not so much because the concepts are difficult but because of the confusion created by so many funds. In addition, it becomes more difficult to see a financial picture of the organization as a whole. It is not enough merely to report the activities of the organization; it is equally important that the statements be effective in communicating what has actually happened. If this is not accomplished, the statements have not served their purpose and the treasurer has failed in a most important responsibility.

4.5 TRANSFERS BETWEEN FUNDS

Not-for-profit organizations following fund-accounting procedures utilize a number of different funds. Some are restricted such as funds for specific purposes; and some are unrestricted such as board-designated funds. The board has the right to transfer assets between unrestricted funds and, in certain circumstances, between restricted and unrestricted funds. For example, if the board has established a board-designated investment fund within the unrestricted fund, it may from time to time transfer funds from the undesignated portion of the current unrestricted fund to this fund. Or, alternatively, it may find at some time that it needs some of the funds previously transferred and will, in turn, transfer some of these funds back to the current unrestricted fund. Another example would be the transfer of unrestricted assets to the fixed-asset fund (if a separate fixed-asset fund is maintained) to pay for fixed assets purchased in whole or part with cash from the unrestricted fund.

The most important aspect regarding transfers is that no transfer should be shown in a manner that suggests the transfer is an expense to the transferring fund or income to the receiving fund. The easiest way to avoid this is to show the transfer in the Statement of Activities immediately before the caption "Change in net assets."

Transfers should not be shown as an expense or as income. This is because only transactions that result in expense or income to the organization *as a whole* are shown in the expense or income sections of a financial statement. A transfer is purely an internal action involving neither. For this reason great care must be taken to avoid a presentation that suggests the transfer is either an income or an expense item.

The most effective way to present a transfer between funds with a minimal risk of misunderstanding is in a columnar statement, with the activity of each fund shown in a separate column, side by side. This is a desirable format because the reader can easily see both sides of the transfer: the amount going out of one fund and the same amount going into the other fund.

Exhibit 4.2 shows this columnar presentation for a Statement of Activities. The board of the Corvallis YMCA decided to transfer \$40,000 from its current unrestricted fund to an unrestricted investment fund. Notice how this is handled in a columnar format. The transfer is shown just before the caption "Change in net assets." There is no inference that the transfer had anything to do with either income or expenses of the current unrestricted fund for the year. Rather, the reader will understand that a portion of the net assets accumulated over prior years was transferred to another board controlled fund.

4.6 ELIMINATION OF FUNDS FOR REPORTING PURPOSES

EXHIBIT 4.2

Reporting a Transfer in a Columnar Format Statement Activities

CORVALIS YMCA STATEMENT OF ACTIVITIES FOR THE YEAR ENDED DECEMBER 31, 20X2 (IN THOUSANDS)			
	Unrestricted		Combined All Funds
	Current Fund	Investment Fund	
Income:			
Membership	\$ 255	\$ —	\$ 255
Community fund	50	—	50
Program activities	372	—	372
Contributions and other income	62	—	62
Investment income	13	—	13
Gain on sale of investments	<u>15</u>	<u>—</u>	<u>15</u>
Total income	<u>767</u>	<u>—</u>	<u>767</u>
Expenses:			
Program	326	—	326
General administration	265	—	265
Property repairs and maintenance	50	—	50
Depreciation	35	—	35
Other	<u>21</u>	<u>—</u>	<u>21</u>
Total expenses	<u>697</u>	<u>—</u>	<u>697</u>
Excess of income over expenses	70	—	70
Transfer between funds	<u>(40)</u>	<u>40</u>	<u>—</u>
Change in net assets	30	40	70
Net assets, beginning of year	<u>425</u>	<u>200</u>	<u>625</u>
Excess of expenses over income	<u>\$ 455</u>	<u>\$ 240</u>	<u>\$ 695</u>

4.6 ELIMINATION OF FUNDS FOR REPORTING PURPOSES

More and more not-for-profit organizations are reevaluating the need to report their financial affairs on a “fund-accounting” basis, even for internal purposes. Instead, they are presenting a consolidated Statement of Activities showing all activity for the year, and a consolidated Statement of Net Assets carefully disclosing in line captions or in footnotes all pertinent information on the restricted funds. This approach gives appropriate recognition that a not-for-profit organization is a single entity and not a series of separate entities called “funds.”

This does not necessarily mean the organization will not keep detailed internal bookkeeping records on a fund-accounting basis. It may do so—or some other tracking mechanism can be utilized to keep from losing track of whether it is complying with donor-imposed restrictions. In either case, for reporting purposes the organization must carefully combine all the activity for the year in a meaningful manner. This is not always easy to

FUND ACCOUNTING AND INTERNAL FINANCIAL REPORTING

do but, if carefully done, adds greatly to the reader's understanding of the organization's overall financial picture.

If an organization wishes, it is still possible to present a reasonably concise Statement of Net Assets showing the traditional funds, while making all the disclosures required by SFAS 117. An example of such a statement follows in Exhibit 4.3. Note that "designations" are shown to clearly show the board's intentions for the future use of unrestricted net assets

EXHIBIT 4.3

Sample Balance Sheet (Showing Funds as Well as Classes of Net Assets)

	Operating	Plant	Endowment	Total All Funds
<i>Assets</i>				
Cash and equivalents	\$ 243	\$ 193	\$ 138	\$ 574
Receivables:				
Tuition	451	—	—	451
Investment income	8	1	87	96
For investments sold	—	—	45	45
Pledges, net	76	17	345	438
Investments, at market	89	23	2,978	3,090
Deferred charges	34	—	—	34
Fixed assets, net	—	387	—	387
Total assets	<u>\$ 901</u>	<u>\$ 621</u>	<u>\$3,593</u>	<u>\$5,115</u>
<i>Liabilities and Net Assets</i>				
Payables and accruals	\$ 187	\$ —	\$ —	\$ 187
Grants payable	32	—	—	32
Payable for investments purchased	—	—	54	54
Deferred tuition income	46	—	—	46
Long-term debt	—	70	—	70
Total liabilities	<u>265</u>	<u>70</u>	<u>54</u>	<u>389</u>
Net Assets:				
Unrestricted:				
Designated for:				
Long-term investment	—	—	2,402	2,402
Plant acquisition	—	115	—	115
Special projects	50	—	—	50
Net equity in plant	—	387	—	387
Undesignated	393	—	—	393
Total unrestricted	<u>443</u>	<u>502</u>	<u>2,402</u>	<u>3,347</u>
Temporarily restricted:				
For specified purposes	127	49	—	176
Until specified periods	66	—	87	153
Total temporarily restricted	<u>193</u>	<u>49</u>	<u>87</u>	<u>329</u>
Permanently restricted	—	—	1,050	1,050
Total net assets	<u>636</u>	<u>551</u>	<u>3,539</u>	<u>4,726</u>
Total liabilities and net assets	<u>\$ 901</u>	<u>\$ 621</u>	<u>\$3,593</u>	<u>\$5,115</u>

4.7 CONCLUSION

While it is theoretically possible to also present the statement of revenues and expenses in this same format, the authors do not recommend this for most organizations, as the resulting statement would be quite complex and difficult to understand.

4.7 CONCLUSION

Fund accounting is simply a commonsense answer to the problem of recording amounts given to an organization for restricted purposes. There is nothing particularly difficult about the concepts involved, but as the number of funds increases, there is considerable risk that the reader of the financial statements will not fully understand the relationship among the funds and therefore will lose sight of the overall financial affairs of the organization. For this reason great care must be taken in preparing the financial statements where fund accounting is involved.

CHAPTER FIVE

Fixed Assets and Depreciation

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Not-for-profit organizations use various kinds of property and equipment in the exercise of their mission. Property and equipment include all long-lived, tangible assets held by not-for-profit organizations except collection items and assets held for investment purposes. Because of their unique nature, collection items are reported differently from other tangible assets. Fixed assets purchased with federal funds are treated differently from fixed assets purchased directly by the organization or received as contributions.

5.1 GENERAL PRINCIPLES—WORKING DEFINITIONS

Property and equipment are recorded by the not-for-profit organization in much the same way as a business enterprise is required to record similar

assets. An asset is typically recorded at its historical cost or fair-market value if donated. Then, over the course of the asset's estimated life, depreciation expense is charged as operating expense and tracked as accumulated depreciation. An organization will present the difference between the original value and the accumulated depreciation as net-fixed assets on the balance sheet. Notes to the financial statement further describe the classes and kinds of fixed assets, the estimated lives in use by the organization, the method of depreciation, and the accumulated depreciation in total or by asset class as of the balance sheet date.

Accounting theory with respect to fixed assets continues to evolve. Intuitively, it seems absurd for an organization to present the cost of an old building on land that has in fact appreciated to many times its value over the course of time. However, the intended purpose of this same building and its use and enjoyment by the organization are independent from the market value until the time comes when the organization changes its purpose and places the asset for sale. Thus, the balance sheet is not intended to be a statement of any organization's true value; rather, it is a combination of a point in time and a period in time. Regular readers of financial reports have come to accept the inherent limitation of accounting for property and equipment, and they will look to the notes on the financial statements for a deeper understanding of the nature and kind of fixed assets. This chapter explores some of the accounting treatments and disclosures that are typical for a not-for-profit organization.

(a) Capitalization of Fixed Assets—Establish a Threshold

The organization will first establish a policy for recording fixed assets. Generally, this policy will provide for the asset to be capitalized if its cost (or fair value at the date of a donation) exceeds a minimum threshold and its useful life is expected to exceed one year. Some organizations have a very low threshold, perhaps as low as \$1,000. Even large not-for-profit organizations may have a comparatively low threshold for capitalization, typically \$5,000, as this amount is generally consistent with tax or other regulatory guidelines. A comprehensive fixed-asset policy may require all assets to be tagged and tracked for insurance and other reporting purposes in addition to being capitalized on the balance sheet.

(b) Capitalization of Fixed Assets—Establish a Reasonable Useful Life

Next the organization will estimate the useful life of the capitalized fixed assets, by class and kind, to provide a ratable system for depreciation over this period. There is considerable flexibility as to the estimated useful life for each class of assets, as there is a considerable difference in the way any individual organization would plan to use the property and

5.2 PROPERTY AND EQUIPMENT—CLASSES AND KINDS OF ASSETS

equipment. As an example, furniture and fixtures may have an estimated useful life for 3–15 years. For leasehold improvements, the useful life is estimated over the life of the lease plus options as appropriate.

Usually, the organization will capitalize fixed assets on the balance sheet in the period in which they were received or put in use, and the organization will record depreciation expense in the statement of activities for each period that the asset is used until the estimated life is expired or the asset is sold or lost.

5.2 PROPERTY AND EQUIPMENT—CLASSES AND KINDS OF ASSETS

Property and equipment commonly held by not-for-profit organizations include the following:

1. *Land.* When land is acquired as part of a parcel that includes a building, the organization should determine the value of the land by objective measure and separate that amount from the value of the building. Land is not subject to depreciation.
2. *Land improvements, buildings, building improvements, equipment, furniture and office equipment, library books, motor vehicles, and similar depreciable assets.* Fixed assets of a similar type and kind should be subject to a consistent depreciation policy. For example, an organization can not arbitrarily change the policy for depreciation of office furniture to a different life each year office furniture is purchased. If there is a reason that a certain grouping of office furniture has a shorter or longer life than general office furniture purchases, the reasons for the difference should be clearly documented.
3. *Leased property and equipment.* These must be capitalized in conformity with accounting rules that consider the life of the lease, the cost of the lease, and the disposition at the end of the lease.¹
4. *Improvements to leased property.* As noted in item 3, such improvements should normally be depreciated (or amortized) over the life of the lease or the useful life of the improvement whichever is less.
5. *Construction in process costs.* Such costs are accumulated on the balance sheet and not depreciated until the project is placed in service. The trigger for placed in service is typically a certificate of occupancy. Accounting rules provide for an organization to capitalize labor, interest costs, and other real costs of the project.²

¹ FASB Statement of Financial Accounting Standards No. 13, *Accounting for Leases*.

² FASB Statement of Financial Accounting Standards No. 34, *Capitalization of Interest Costs*; and FASB Statement of Financial Accounting Standards No. 63, *Capitalization of Interest Cost in Situations Involving Certain Tax-Exempt Borrowings and Certain Gifts and Grants*.

FIXED ASSETS AND DEPRECIATION

6. *Contributions of property and equipment.* These should be recognized at fair value at the date of contribution. If the donor stipulates how or how long the contributed property must be used by the organization, the contribution is reported as restricted support, otherwise the value of the contributed assets are considered unrestricted.
7. *Unconditional promises to give the use of long-lived assets.* Such promises—for example, a building or other facilities for a specified number of periods in which the donor retains legal title to the long-lived asset—may be received in connection with leases or may be similar to leases but have no lease payments. The accounting treatment would provide for the asset to be capitalized at the fair value of property less the stated amount of lease payments, if any.
8. *Computer equipment and costs to increase the functionality of computer equipment or software.* These assets are subject to special accounting rules, but generally they should be capitalized and depreciated.³

Depreciation is generally expensed straight-line over the estimated useful life of the asset. The starting point may be the month the asset is placed in service, or the organization may choose to use a half-year convention for assets placed in service anytime during the first nine months of the fiscal year. The depreciation policy should be defined by a written policy and applied consistently for all depreciable assets.

(a) Disclosures in the Financial Statements

Fixed assets are reported in the financial statements by asset class including land and land improvements, building and building improvements, furniture, machinery and equipment, and construction-in-process. Additional classes may be presented if they are material to the organization. The range of useful lives for each asset class must be disclosed, and accumulated depreciation as of the date of the financial report, in total or by asset class. Other related disclosures include:

- Current year depreciation expense
- Capitalized interest
- Fully depreciated assets in use by the organization
- Commitments related to construction-in-process
- Donated assets, including related depreciation
- Nondepreciating assets, typically land or collections

³ AICPA Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*.

5.3 FIXED ASSETS WHERE TITLE MAY REVERT TO GRANTORS

Some organizations purchase or receive fixed assets under research or similar grants or contract awards in which legal title to the assets remains with the grantor agency. At the completion of the award period, the right to these fixed assets reverts to the grantor agency. Typically the award period closely approximates the useful life of these assets, and the grantor agency seldom asks for their return. The right to reclaim these assets, or to receive the proceeds from the sale of these assets is in the award mainly to protect the grantor agency in the event the grant is prematurely terminated, or the award may simply provide for purchased assets to be used by similarly funded programs.

These kinds of fixed assets are expensed as program expense and are reported on the statement of activities during the period in which they are purchased. This is consistent with the theory of fixed asset accounting and reporting in that the organization does not own the asset. If material, the organization should disclose in notes to the financial statements the value of these assets purchased during the period and the total value retained in custody of the organization. Federal program guidelines may require that not-for-profit organizations receive pre-approval for the purchase of fixed assets and that they identify (tag and track) and inventory fixed assets where title reverts to the grantor agency. Other awards have similar provisions.

5.4 COLLECTIONS

Collections are works of art, historical treasures, or similar assets that are (1) held for public exhibition, education, or research in furtherance of public service rather than financial gain; (2) protected, kept unencumbered, cared for, preserved; and (3) subject to an organizational policy that requires the proceeds of items that are sold to be used to acquire other items for collections.⁴

An organization must adopt a policy for the treatment of collections. The policy is defined by FASB SFAS 116 and may be one of three choices:

1. Capitalize the collection, including all items acquired in prior periods that have not been previously capitalized and all items acquired in future periods.
2. Capitalize only those items acquired after initial adoption of SFAS 116.
3. Capitalize no collections.

⁴ FASB Statement of Financial Accounting Standards No. 116, *Accounting for Contributions Received and Contributions Made*.

An organization may not capitalize part of a collection. The capitalization policy should be clearly defined and is not subject to change.

For those organizations that capitalize collections, items acquired in an exchange transaction should be recognized as assets in the period in which they are acquired and should be measured at cost. Contributed collection items should be recognized as assets and as contributions in the appropriate net asset class, unrestricted, temporarily restricted or permanently restricted, and should be measured at fair value. Fair value can be measured by quoted market price, appraised value, or other techniques.

If an organization does not capitalize collections, no assets should be recognized from the acquisition of collection items. The costs of collection items purchased, proceeds from sale of collection items, and proceeds from insurance recoveries of lost or destroyed collection items should be reported in the statement of activities separately from revenues, expenses, gains, or losses. Additionally, the policy for collections should be clearly described in the notes to the financial statements, particularly with respect to its significance and accounting and stewardship policies. The statement of cash flows should report purchases, sales, and insurance recoveries for unrecognized noncapitalized collection items as investing activities.

For organizations that have a policy to capitalize collections prospectively, as noted above, the line item description on the balance sheet should indicate: "Collections acquired since January 1, 20X1 (Note X)."

5.5 FAIR VALUE MEASUREMENT

An organization will consider the fair value of long-lived assets when circumstances require that an asset be valued for reporting a contribution of a long-lived asset or in the case of impairment. In any case, quoted market values in active markets are the best evidence of fair value and should be used, when available. If quoted market prices are not available, prices for similar assets (groups) or valuation techniques such as the expected present value or traditional present value may be used.

Contributed long-lived assets must be carefully evaluated for the rights and obligations that may attach to the gift. Organizations are strongly encouraged to have a comprehensive gift policy that defines the nature and kind of long-lived assets that will be accepted, and the process, including board committee approval, that will be required before the gift and related asset will be received.

Sometimes organizations receive noncash gifts or "gifts-in-kind" as agency transactions. In an agency transaction, the organization does not have the right to the use or enjoyment of the asset, and accordingly the

5.6 CONTRIBUTIONS RESTRICTED FOR PURCHASE OF FIXED ASSETS

asset should not be recorded with fixed assets as described in this chapter. Noncash fixed assets intended for use by the organization should be recognized as contributions when received (or unconditionally promised) from the donor. Gifts in kind that can be used or sold should be measured at fair value. When determining fair value, the organization should consider the quality and quantity of the gifts including the applicable discount for purchase of similar quantity. If the gifts have no value, as might be the case for a gift of furniture or equipment that cannot be used internally or sold externally, the gift should not be recognized. The value recognized for contributed property and equipment should include all costs incurred by the organization to place the assets in use. Examples of such costs include the freight and installation of contributed equipment and cataloging costs for contributed library books.

Contributed long-lived assets may trigger a significant tax benefit to the donor depending upon the valuation of the asset. For this reason, the organization should be circumspect when recording fixed assets that are valued by the donor.

5.6 CONTRIBUTIONS RESTRICTED FOR PURCHASE OF FIXED ASSETS

Many nonprofit organizations solicit funds for the express purpose of building or improving physical property. Contributions so received are typically recorded as temporarily restricted support (if the building or physical property is incomplete) until such time the building is placed in service when these temporarily restricted contributions are released from restriction. However, the organization may define its accounting policy to afford better matching of contributions and related depreciation expense.

Gifts of long-lived assets received without stipulations about how long the donated asset must be used are reported as restricted support if it is the organization's accounting policy to imply a time restriction that expires over the useful life of the donated assets. When the organization adopts such a policy, contributions restricted for the purchase of fixed assets are released from restriction over the estimated useful life of the asset. In this way the organization will achieve a "matching" of depreciation expense against unrestricted revenue. Organizations that adopt a policy of implying time restrictions shall imply a time restriction on long-lived assets acquired with gifts of cash or other assets restricted for those acquisitions. In the absence of that policy and other donor-imposed restrictions on the use of the asset, gifts of long-lived assets shall be reported as unrestricted support. The organization is required to disclose its accounting policy on this matter.

the temporarily restricted net assets) for the specified purpose. Then as these funds are expended for the restricted purpose, the funds are “released” to unrestricted net assets.

Another option available to the entity is to adopt a policy whereby, if funds are received and spent in the same fiscal period, then the receipt of the funds can be recorded directly into unrestricted net assets. If this policy is adopted, then the restricted endowment income earned and spent in the same fiscal period can be recorded as unrestricted. Of course, if this policy is adopted, it should be disclosed in the footnotes to the financial statements and followed consistently.

At some point, organizations will encounter instances in which a donor will provide an endowment gift (permanently restricted) in which the income earned is required to be added to the original gift until a specific level of funds is achieved. This situation usually arises during the times of capital campaigns. An example is where a college establishes a named endowment at the \$100,000 level, but a donor only gives gifts of \$80,000. The donor may indicate that income and appreciation be added to the original gift value until the \$100,000 level is achieved and then the income, as determined by the organization’s endowment policy and applicable laws, will be available for the specific purpose of the endowment fund.

(d) Gains or Losses on Unrestricted Net Assets

Gains or losses (both realized and unrealized) on board-designated and other unrestricted investment net assets are likewise unrestricted. For this reason, gains or losses on such unrestricted net assets should always be recorded directly in the unrestricted net assets.

(e) Gains or Losses on Endowment Net Assets

The FASB reporting standard in SFAS 117 requires the organization to determine which portion of the gains is legally restricted, either by explicit donor restrictions or by applicable laws to which the organization is subject. If the income from the endowment fund is restricted, then the gains are similarly restricted and would be recorded in temporarily or permanently restricted net assets. All gains not so restricted will be reported directly in unrestricted net assets rather than in the restricted net assets. In many ways, gains on investments are income in the same sense that interest and dividends are income, except where by law or donor restriction they are required to be added to principal. As such, the reader has a right to clearly see the amount of such gains.

(f) Underwater Funds

Donors can stipulate that their gifts be invested in perpetuity or for a specified term. Some donors may require that a portion of income, gains,

6.1 ACCOUNTING PRINCIPLES

Descriptions such as “Endowment Spending,” “Endowment Gains Used in Operations,” and “Endowment Gains Applied Towards Authorized Spending Rate” are examples of appropriate descriptions. Captions such as “Endowment Income” or “Investment Income from Endowment” would not be appropriate because the reader could be misled into thinking that these were all earnings that are generated in the current year when, in fact, the amounts include some prior years income or gains.

However, in no circumstance can an organization spend amounts that it has never earned. In other words, if an organization has not accumulated unspent investment returns from previous years, it cannot in the current year report a spending formula amount in excess of actual investment yield for the current year.

In situations in which the spending formula amount exceeds the total current year’s return, it is important to identify the portion of spending formula amount that is coming from prior years accumulated gains.³

(i) Disclosure of Underwater Endowment Funds in an Organization’s External Financial Statements

The authors believe the following would be considered best disclosure practice for underwater endowment funds (assuming such amounts are not insignificant) in an organization’s external financial statements.

- Disclosure of the total underwater fund deficiency that exists as of the date of the statement of financial position, as well as a related description of the nature of the deficiency and how it has been accounted for by the organization. In addition, the disclosure of the endowment spending policy should be clarified to describe the organization’s policy related to expenditure from or funding for underwater endowment funds.
- Depending on the extent of the underwater funds, additional detail may be provided describing the nature of significant underwater funds (e.g., purpose, value) and how the position of such funds have affected the endowment distribution in the current year.
- For organizations that provide a “Management Discussion and Analysis” with the financial statements and related footnotes, a discussion of how the organization’s liquidity and operating needs could be affected by underwater funds in the following years may be appropriate. The need for such a discussion would depend on the severity of the underwater fund situation.

³ For more information, see paragraph 106 of SFAS 124.

(j) Investments Carried at Cost

Where an organization carries certain investments at cost rather than at market, gains can be recorded only when they were realized. On the other hand, if the market value of an investment is less than cost, consideration has to be given to writing down the carrying value to the market value.

Where it appears necessary to write down part of the carrying value of the investments, the provision for decline should appear in the statement of activities as part of “unrealized gain or loss.” In subsequent periods, any increase in the fair market value would not be recognized until such time as the asset was sold and the gain realized.

(k) Presentation of Gains or Losses in the Financial Statements

The presentation of gains or losses in the statement of activities can vary depending on whether such gains or losses are considered unrestricted or restricted (temporarily or permanently), and whether the organization makes a distinction between capital type transactions and other types of transactions.

(i) Unrestricted Realized Gains or Losses. Unrestricted realized gains or losses can be shown in the unrestricted revenue and additions section of the statement or in a separate unrestricted section of the statement as shown in the following example. Alternatively, investment income, excluding gains or losses, can be shown in the operating income section, with gains or losses shown in the non-operating income section. If this is done, a footnote should show the total return.

STATEMENT OF INCOME, EXPENSES, AND CHANGES IN NET ASSETS (IN PART)		
Operating income (in total)	\$ 125,000	
Expenses (in total)	<u>(150,000)</u>	
Excess of expenses over operating income		\$(25,000)
Add—Nonoperating income:		
Contributions	20,000	
Interest and dividends	10,000	
Capital gains	<u>25,000</u>	
Total nonoperating income		<u>55,000</u>
Excess of income over expenses		<u>\$ 30,000</u>

(ii) Restricted Realized Gains or Losses. Restricted realized gains or losses can be presented in the financial statements in the same manner as unrestricted realized gains, discussed in the previous subsection, except in the appropriate (temporarily or permanently) restricted net asset column.

6.1 ACCOUNTING PRINCIPLES

beneficiaries. The amount of the benefit to each beneficiary often will be a function of the fair value of the donated assets over the term of the agreement. When the reporting not-for-profit organization directly receives the donated assets (or is trustee over a trust containing the donated assets), the AICPA Audit and Accounting Guide, *Not-for-Profit Organizations*, requires that a liability be recognized for the obligation to make future payments to the other beneficiaries of the trust based on the present value of the future expected payments to the beneficiaries. Although the liability may reflect the fair value of the obligation initially, it will not reflect fair value in future periods because the same AICPA Audit and Accounting Guide indicates that the discount rate used in remeasuring the liability each period should not be revised to reflect current interest rates. Because the liability is not measured at fair value, the potential for an embedded derivative exists.

In April 2002, the FASB cleared Derivatives Implementation Group (DIG) Issue B35, *Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from an Irrevocable Split-Interest Agreement*. Issue B35 states that the obligation recognized under a split-interest agreement should be analyzed to determine whether there is an embedded derivative. If so, the embedded derivative must be separated from its host contract and accounted for separately if certain circumstances are met. In situations where the obligation to make payments to other beneficiaries ceases upon the death of the beneficiary(ies), the split-interest agreement is considered to be life-contingent and thus is excluded from Issue B35 under the exception provided in paragraph 10(c) of SFAS 133 for insurance arrangements. However, under fixed-period arrangements (i.e., those where the payments are made for a specified number of years), if the payments vary based on the investment return from the contributed assets, bifurcation of an embedded derivative will be required. This issue is complex, and so we suggest that you read the FASB's guidance in its entirety, including the examples, on the FASB website, <http://www.fasb.org>. You may also need to seek the advice of knowledgeable accounting professionals.

(m) Securities Lending

Many not-for-profit organizations that hold large endowment portfolios will lend securities to brokers for a fee in order to enhance their overall return on the investment portfolio. There are specific accounting rules dealing with securities lending.

In September 2000, the FASB issued SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, a replacement of SFAS 125. SFAS 140 changes the accounting for certain securitizations and

INVESTMENT INCOME, GAINS AND LOSSES, AND ENDOWMENT FUNDS

other transfers of financial assets and collateral. It also requires certain disclosures.

SFAS 140 affects securities pledged in a securities lending transaction. When an organization participates in a securities-lending transaction, it no longer has access to the loaned securities. As such, the not-for-profit organization should segregate the loaned securities as a separate line item on its statement of financial position. If the value of loaned securities is not material, disclosure of the amount in the footnotes may be sufficient. In addition, if the securities lending transaction involves the receipt of cash collateral, a not-for-profit organization is required to record both the collateral received and the obligation to return the collateral received on the statement of financial position (i.e., cash received and obligation to repay). As illustrated in the statement that follows, the organization is not permitted to net the transaction on the statement of financial position. If, however, the securities lending transactions include, for example, the posting of a letter of credit by the borrower instead of cash collateral, the receipt of the letter should be disclosed in the footnotes but is not recorded on the statement of financial position. Many organizations are not aware if they have a lending arrangement with their custodian, thus it is advised to review the existing agreement(s) or to confirm the absence of such an arrangement.

STATEMENT OF FINANCIAL POSITION	
ASSETS	
Cash	\$162,000
Securities pledged	100,000
Investments at market	250,000
Other assets	60,000
Total assets	<u>\$572,000</u>
LIABILITIES AND NET ASSETS	
Cash collateral held under securities	
lending agreement	\$102,000
Other liabilities	335,000
Net assets	<u>135,000</u>
Total liabilities and net assets	<u>\$572,000</u>

In this example statement, the organization has loaned \$100,000 of securities (“securities pledged”) and have received (and recorded) \$102,000 of cash as collateral (included in “cash” and “cash collateral” balances).

6.2 TOTAL RETURN CONCEPT

To improve the management of their endowment and similar investments, many organizations utilize the “total return” concept. This is utilized by the

6.2 TOTAL RETURN CONCEPT

organization and its board for establishing the objectives of their investment portfolio and will become one of the benchmarks used to measure the investment portfolio's performance. The total return concept takes into account traditional investment yield (dividends and interest) as well as any gains or losses (both unrealized and realized). This "return" is used to determine what the investment portfolio actually earned over the period. This concept allows the organization to take a broader approach to investing and to not be focused on interest or dividends.

Organizations that follow a total return policy will also use this concept when determining how much to spend from the endowment investments in a year ("spending rule"). This practice allows the organization to spend from the interest and dividends as well as from gains (both realized and unrealized). This approach would appear to comply with the requirements of the Uniform Management of Institutional Funds Act (UMIFA). Many states have adopted their own version of UMIFA. Please check with your particular state's requirements. The laws generally allow that a prudent amount of gains of endowment funds can be spent so long as the spending of these gains (realized and unrealized) does not reduce the value of the endowment fund below its historical gift value.⁴ Under the total return concept, a spending rate (for example, five percent of the defined endowment market value) may be fulfilled by a combination of dividends and interest as well as a portion of net realized gains. Any total return above the spending rate will be reinvested in the investment portfolio and available for future periods.

In the following example, the benefits of utilizing a total return policy are shown in statement form. If an organization's \$1 million endowment fund is invested in five-percent bonds, income would be \$50,000 a year. If, instead, it were invested in common stocks that pay two percent in dividends, but can be expected to double in value every ten years, annual income would be \$20,000. If the doubling assumption is correct, over the 10-year period, the organization will realize far more from the common stocks than from the bonds.

	<u>Common Stocks</u>		<u>Bonds</u>
Interest/dividends over 10 years	\$ 200,000		\$500,000
Increase in value over 10 years	<u>1,000,000</u>	or	<u>—</u>
	<u>\$1,200,000</u>		<u>\$500,000</u>
Average per year	<u>\$ 120,000</u>		<u>\$ 50,000</u>

⁴ If there are questions as to how to apply a state's rules or if a state has not adopted its own UMIFA rules, consult legal counsel.

INVESTMENT INCOME, GAINS AND LOSSES, AND ENDOWMENT FUNDS

Under SFAS 117 (discussed in more detail in Chapter 12), organizations have a great deal of flexibility in how they present the sequence of items in the financial statements. When a spending rate formula is in use, a common approach for presenting gains is to present that portion of gains considered available for operations under the formula presented above the subtotal from operations—that is, the “Excess of income over expenses” of (\$15,000) in Exhibit 6.1—and then to place the balance of gains for the year under the operating excess or deficit. Using this approach, it is possible in a year when the stock market performed poorly and gains were less than required to make up the spending rate amount, to have a negative amount in place of the \$25,000 number in the unrestricted column just above the change in net assets. The amount reported in the first section (\$5,000 in Exhibit 6.1) would still be the same.

(a) Inflation Index to Protect Principal

It should be noted that the discussion so far has not touched on the budgeting considerations that an organization’s board may consider in establishing the amounts to be transferred from the endowment fund to unrestricted net assets. The most common approach is the “spending rate” approach described in the previous section, in which the board decides on the amount to be spent in total and then, after deducting actual dividends and interest, transfers the balance. It is referred to as the spending rate because often it is arrived at, in part at least, by determining what income could be achieved if emphasis were placed on current income rather than on growth.

EXHIBIT 6.1

Example of a Way to Present Capital Gains on Endowment Investments

	Unrestricted Fund	Endowment Fund
Revenue:		
Program income	\$100,000	
Dividend income	20,000	
Endowment gains applied towards authorized spending rate	<u>5,000</u>	
Total revenue	125,000	
Expenses	<u>(140,000)</u>	
Excess of income over expenses	(15,000)	
Endowment gains in excess of spending rate	<u>25,000</u>	\$ 5,000
Change in net assets	10,000	5,000
Net assets, beginning of year	<u>50,000</u>	<u>1,000,000</u>
Net assets, end of year	<u>\$ 60,000</u>	<u>\$1,005,000</u>

6.2 TOTAL RETURN CONCEPT

(i) Inflation Protection Approach. Some individuals believe this spending rate approach is backward. The more appropriate approach is for the board to first establish the rate at which the endowment fund must be increased to protect it from inflation. Transfers to the unrestricted fund should then be made only to the extent that gains exceed the amount, which has to be added to principal to protect it from inflation. There is a significant difference between the spending rate approach and this inflation protection approach. The spending rate approach may or may not protect the principal against inflation, depending on the assumptions used in arriving at the spending rate. Yet the first concern of the board should be to protect the principal against inflation. Only if there are gains in excess of this requirement should transfers be made to unrestricted net assets. Exhibit 6.2 shows how an inflation index could be used to determine the amount to be transferred. Assuming inflation of five percent a year, again our original principal of \$1 million, two percent dividends, and realized gains of \$50,000, \$40,000, and \$120,000 in each of three years, the amount that would be transferred in each of three years would be calculated as shown in Exhibit 6.2. In this illustration, a constant inflation rate of five percent has been assumed. In actual practice, the rate would vary and the board would, of course, peg its rate to the appropriate government index. The advantage of this approach is that all income—dividends and gains—is transferred except that portion that must be retained as an inflation adjustment to protect the value of the endowment fund. This means that the full impact of the board’s investment decisions will be felt, whether conservative or speculative. Income does fluctuate because of the magnitude and timing of realized capital gains. Notice in Exhibit 6.2 that only \$7,500 of income is available in 20X2. A refinement advocated in

EXHIBIT 6.2

Example Showing How the Amount of the Transfer Would Be Calculated under the Total Return Approach Using an Inflation Protection Approach

	20X1	20X2	20X3
Principal at beginning of year, adjusted for inflation	\$1,000,000	\$1,050,000	\$1,102,500
Add inflation factor of, say, 5%	<u>50,000</u>	<u>52,500</u>	<u>55,125</u>
Principal end of year as adjusted for inflation	<u>\$1,050,000</u>	<u>\$1,102,500</u>	<u>\$1,157,625</u>
Dividends	\$ 20,000	\$ 20,000	\$ 20,000
Realized gains	<u>50,000</u>	<u>40,000</u>	<u>120,000</u>
Total	70,000	60,000	140,000
Less amount retained as an adjustment for inflation	<u>(50,000)</u>	<u>(52,500)</u>	<u>(55,125)</u>
Balance, for current operations	<u>\$ 20,000</u>	<u>\$ 7,500</u>	<u>\$ 84,875</u>

earlier editions of this book and used by many institutions (and even required by some state laws) is to provide that the amount of the transfer should be averaged over a three-year period. This would have the effect of dampening large changes due to the timing of the realized gains.

(b) Transferring Realized Gains

Implicit in the above discussion is the assumption that at least part of the realized gains on funds donated to an organization for endowment purposes are, in fact, legally available for unrestricted use by the organization. Is this a valid assumption? There used to be a tendency to assume that the law required endowment funds and the realized gains on the sales of endowment fund investments to be inseparable and sacrosanct. There is now authoritative support, as discussed earlier, for the view that the gains on endowment funds may also be considered unrestricted under appropriate circumstances. In 1969, in a widely publicized report to the Ford Foundation entitled “The Law and the Lore of Endowment Funds,” W. L. Cary and C. B. Bright concluded:

If the managers of endowment funds wish to seek long-term appreciation in their investments, the need of their institutions for current yield should not dissuade them. We find no authoritative support in the law for the widely held view that the realized gains of endowment funds can never be spent. Prudence would call for the retention of sufficient gains to maintain purchasing power in the face of inflation and to guard against potential losses, but subject to the standards which prudence dictates, the expenditure of gains should lie within the discretion of the institution’s directors.

Subsequent to Cary and Bright’s report, most states have adopted legislation that specifically permits most not-for-profit organizations to include capital gains in spendable income to the extent the board deems “prudent.” In fact, the model uniform law (UMIFA) provides that not only realized gains may be considered spendable income but also unrealized gains. Institutions must follow applicable state laws in this regard.

Some attorneys have raised questions about the proper reporting of endowment gains not subject to a donor-imposed restriction as to use, and which (1) are available under state law for appropriation by the governing board of an organization, but (2) have not yet been so appropriated. These attorneys have stated that because the gains cannot yet be spent by the organization’s management, the gains should be reported in a restricted class of net assets until the governing board votes to appropriate them, at which time they would be reclassified to the unrestricted net assets.

The accounting profession disagrees with that approach, and believes such unappropriated and otherwise unrestricted gains should nevertheless be reported in unrestricted net assets, with disclosure of the need for

the board to vote to appropriate the gains before they can be spent. However, in several states, which have applicable law or regulation on this subject, usually requiring such gains to be temporarily restricted, such laws/regulations must be followed.

There is another important factor to consider. Many colleges and universities for investment management purposes combine two types of endowment funds—board-designated investment funds and true donor-restricted endowments—into a single fund (or investment pool). There is a great deal of difference between the two. In the first, the limitation is internally and voluntarily created, whereas in the other the restriction is donor imposed and cannot be changed by the organization.

There would appear to be no question that the board may transfer to the operating fund not only the realized gains but also the principal of board-designated investments. After all, the board's designation was voluntary and it could, therefore, reverse its designation and transfer such funds to the operating fund. Board-designated investment funds constitute a substantial portion of the endowment funds of many large educational institutions.

As of 1999, this act has been passed in some form in 40 states and the District of Columbia. Because the text of the act differs between states, organizations should have their attorney consult the exact text as it applies to them before acting in accordance with it. In states that have not passed the uniform act, there is likely to be other state law governing gains on restricted endowments. If this is done in the external financial statements, the model shown in Exhibit 4.3 should be followed so that readers can see clearly how much is unrestricted and how much is donor-restricted.

CHAPTER SEVEN

**Affiliated Organizations,
Pass-Through Transactions, and
Mergers**

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Not-for-profit organizations are often associated with other organizations, either not-for-profit or for-profit. The association may result from many different types of relationships. In the not-for-profit world, true “ownership” of one entity by another rarely exists, although sometimes a not-for-profit will own a for-profit business that it either established or had donated to it. Affiliated organizations are more often related by agreements of various sorts, but the level of control embodied in such agreements is usually far short of ownership. For example, the “Friends of the Warsaw Museum” may exist primarily to support the Warsaw Museum, but it is likely a legally independent organization with its own governing board, and only informal ties to its “parent.” The museum may ask, but the Friends may choose its own time and method to respond. Further the museum may have no way to legally compel the Friends to do its bidding if the Friends resists.

The issue for donors is, “If I give to the Friends, am I not really just supporting the museum? Or if I am assessing the financial condition of the museum, is it not reasonable to include the resources of the Friends in the calculation? Even though the Friends is legally separate, and even though the Friends does not have to turn its assets over to the museum, isn’t it reasonable to assume that if the Museum got into bad financial trouble, the Friends would help?”

There are three areas of interest resulting from such relationships.

1. How should transactions between related entities be recorded?
2. Under what circumstances should financial information of related entities be combined for reporting purposes?
3. How should a merger of two organizations be accounted for?

7.1 TYPES OF RELATIONSHIPS OFTEN FOUND

(a) The Fundraising Affiliate of a Parent Organization

These are often named something like “The Friends of the [Museum],” “The [Symphony] Guild,” “The [University] Foundation,” and so on. They are found most often with cultural organizations such as museums, performing arts, and the like, and with health care and educational institutions. College alumni associations may perform this function for the college. Public universities usually use such an affiliate to raise funds that are not included in budgetary numbers submitted to the state legislature (which, if the affiliate did not exist or were combined, might cause a reduction in the governmental appropriation to the college). Hospitals often do the same, with their purpose being to keep the assets out of the

7.1 TYPES OF RELATIONSHIPS OFTEN FOUND

base used to calculate Medicare/Medicaid reimbursement rates, or to protect them from malpractice claims. Some colleges also have affiliates set up to raise money for a particular college activity—often the athletic department (in which case they are often referred to as “booster clubs”). This allows the funded activity more financial and operating flexibility than if it were limited to what it would be allocated under the organization’s regular budgetary process and allowed under standard operating policies.

A traditional federated fundraising organization such as United Way or a community arts fund also performs this kind of function. However, the question of consolidation rarely arises with such groups because they are usually completely independent of the groups for which they raise money. (The question of when a fundraiser is merely acting as an agent for another organization is germane to all of these kinds of organizations, controlled and noncontrolled, but that is a different issue, discussed in Section 7.2(a) of this chapter.)

(b) The Asset-Holding Affiliate

Organizations that are in the fortunate position of having more assets than are immediately needed for activities, or that have large endowment funds, hope to avoid having to answer embarrassing questions from prospective and previous donors about the organization’s real need for gifts, or questions from employees as to why salaries are not larger, by placing the assets into a separate legal entity. Two other reasons sometimes cited for such an arrangement are that management of the investment portfolio is more efficient, and that the assets are—or at least are believed to be—protected against possible lawsuits resulting from program activities of the parent organization (especially in areas such as health care, child care, etc.).

A variation on this scenario occurs when a donor establishes a separate legal entity (a trust, foundation, or a fund within a community or private foundation) and stipulates that the income from the fund is to go to a specified organization, usually in perpetuity. The supported organization may or may not have any authority over the investment management of the fund, or over the amounts and timing of income distributions to it, or access to any of the principal of the fund.

Another similar situation involves the more common deferred giving arrangements, such as gift annuities, pooled-income funds, or charitable remainder trusts, which always terminate at some specified or determinable time (often upon the death of the donor or other life income beneficiary). The assets that fund such arrangements are sometimes managed by the charity, sometimes by a third-party trustee.

(c) The Program Activity Affiliate

Some organizations set up legally separate affiliates to carry out certain program functions within the general area of the organization's activities. A university might have a research foundation specifically to work in a particular area of research. Funding of such organizations sometimes comes wholly from the main organization; sometimes funding is partly or entirely from sources specific to the affiliate. Other examples include a university publishing company or study center (which can be geographically separated from the main campus such as Harvard's Villa i Tatti, an art study center in Florence, Italy); a hospital testing laboratory; a cemetery affiliated with a church; a broadcasting station affiliated with a university or with a religious organization; and an overseas mission, university, hospital, convent, orphanage, monastery, or charitable organization affiliated with a religious denomination.

A variation on this theme is the affiliate that conducts "program" activities that are peripheral to those of the parent entity. Examples include those commonly referred to as "auxiliary activities" of a university (such as food service, recreational activities, parking facilities) or activities that support the operations of a hospital (such as a laundry, or an office building in which physicians affiliated with the hospital have their private offices). Other examples include pension funds, captive insurance companies, gift shops, welfare benefit plans, and investment or management companies.

Another variation is the "organization" that is legally part of the parent entity but is operated almost as if it were separate. Examples include guilds, circles, and similar church groups, committees set up to carry on certain activities such as annual fairs, dinner-dances, or other fundraising events. These often have separate bank accounts and "governing" boards that act very much like those of legally separate organizations.

There are also organizations that are legally separate from the "parent" but are connected by informal relationships stemming from a mandatory organizational affiliation of their members. Examples include on- and off-campus student organizations at a college, such as fraternities, sororities, cultural organizations (drama club, glee club, etc.), student-edited publications, community service organizations, honor societies, academic and athletic clubs, and alumni associations. Such affiliated entities are often supported financially by the parent in ways such as having their administrative expenses paid by the parent. A variation on this theme is the corporate foundation, a not-for-profit controlled and funded by a for-profit. In addition to making contributions to their foundation, most parent companies pay directly all or most of its administrative expenses.

(d) Affiliates of a Common Parent

These include the major national charities and service organizations, many of them medically or youth oriented (cancer, heart, lung, United Way, scouts, etc.). This is also found with some professional and trade associations such as the various medical, dental, legal, accounting, labor, and similar associations, and with national fraternal and civic organizations (Greek letter fraternities and sororities, Rotary, Lions, Kiwanis, etc.). Other examples include the various campuses of a state university system (New York and California are two of the largest). In some cases, the state and local “affiliates” have little or no legal relationship with the national organization (AICPA is one example), while in other cases the national closely controls the affiliates (Arthritis Foundation is an example).

Most religious denominations are also in this category as to the relationship between the national organization and individual churches, parishes, synagogues, mosques and the like. In many denominations there are also intermediate-level entities such as dioceses (Roman Catholic and Episcopal), synods (Lutheran), or conferences (Methodist). The degree of control of the local entities by the national varies considerably. An additional complicating factor with religious organizations is the existence in some denominations of two different sets of governing rules: theological rules (sometimes referred to as canon law) and secular administrative rules based on civil law.

7.2 DEFINITION OF THE REPORTING ENTITY

There are two issues here but they involve the same concepts. The issues are:

1. Gifts to a related organization, such as a fundraising affiliate, that are later passed through to another organization (the one for which the affiliate raises money) or held indefinitely by the recipient organization with the income being remitted to the supported entity, and transfers by a not-for-profit organization to an affiliate to be held for the benefit of the transferring organization
2. When the financial data of affiliated entities should be combined with that of a central or parent organization for purposes of presenting the central organization’s financial statements

Of course, if the data are combined, the question of pass-through gifts need not be addressed since the end result is the same regardless of which entity records gifts initially.

(a) Pass-Through Gifts and Assets Held for the Benefit of Another Organization

The question is, should amounts received (gifts or other transfers) be recorded by the affiliate as its own revenue, followed by gift or grant expense when the money is passed on to the parent organization? Or should the receipts be recorded by the recipient as an amount held on behalf of the parent? Gifts made in this way are often called pass-through gifts since they pass through one entity to another entity.

Although FASB SFAS 116 states (in paragraphs 4 and 52 through 54) that gifts to an organization that is only acting as an agent or intermediary for another organization should not be reported as gifts by the agent, it gave little guidance for distinguishing agents from nonagents in practice. The determination depends partly on the degree of control over the use of the gift, and active involvement in soliciting, processing, and distributing the gift by the first recipient organization. If it has little control and little active involvement, it is likely an agent and should record the gift as an amount held for the other organization. Appendix 7–A, at the end of this chapter, is a checklist to help organizations make this distinction in practice.

A related question is how to account for transfers of assets by a not-for-profit organization to an affiliated organization to be held for the benefit of the transferor. Are such transfers revenue of the transferee, or are they something else?

In 1999, FASB SFAS 136, *Transfers of Assets to a Not for-Profit Organization or Charitable Trust that Raises or Holds Contributions for Others* was issued and provides definitive guidance for accounting for both kinds of such transfers. A summary of its principal provisions follows.

- *Paragraphs 3, 4.* Applies to transactions in which one organization (resource provider or donor) transfers assets to another organization (recipient) for the benefit of a third organization (beneficiary), including cases where the first and the third organizations are the same organization.
- *Paragraphs 8–18.* Tenor of requirements is that the recipient can report the receipt of the assets as revenue or other increase in net assets if it is financially interrelated with either the resource provider or beneficiary, or if it has discretion as to the disposition of the assets, but it cannot report revenue if it has no discretion over the ultimate disposition of the assets, or if it is not assured of a requirement to return the assets to the resource provider. (See the flowchart in Appendix 7–B, for details.)
- *Paragraph 109* illustrates some possible methods of presenting the revenue section of the statement of activities under SFAS 136. For

7.2 DEFINITION OF THE REPORTING ENTITY

example, it is permitted for a federated fundraiser to report gross receipts as the first line in the revenue section, followed by an off-setting amount for the pass-through gifts that are not reported as revenue. This might appear as follows:

Proceeds of fund-raising campaign	\$ 100,000
Less—Donor-designated amounts included above	(40,000)
Contribution revenue	<u>\$ 60,000</u>

In this way, readers are informed of the total proceeds from a fund-raising campaign, even though not all of these proceeds qualify under SFAS 136 as revenue of the federated fund-raiser. The most significant effect, compared with present practice, will be on how federated fund-raisers (e.g., United Way) report donor-designated contributions (heretofore reported as revenue; will be now reported as a liability).

In 2003, the AICPA issued a Technical Practice Aid (TPA), 6140.12, Nondiscretionary Assistance Programs. TPAs are nonauthoritative questions and answers. The TPA on nondiscretionary assistance programs deals with not-for-profit organizations that receive assets, such as food, food vouchers, and public transportation vouchers. The organization would distribute them on behalf of the resource provider (donor) in exchange for a fee for performing that service. The question posed was, should the recipient not-for-profit organizations report receipts and disbursements of assets under such programs (other than any fees for performing the service) as revenues and expenses?

The AICPA responded that a recipient organization that receives non-financial assets—such as food vouchers or public transportation vouchers that are denominated in either dollar values or in nonfinancial terms, such as pounds of food or bus rides, but that will not be settled in cash—is permitted, but not required, to recognize its liability and those assets, provided that the organization reports consistently from period to period and discloses its accounting policy.

(b) Combined Financial Statements

The concept underlying the combining of financial data of affiliates is to present to the financial statement reader information that portrays the complete financial picture of a group of entities that effectively function as one entity.

A key determinant of whether consolidation of affiliates is appropriate is the degree of control exercised by one entity over another. Since the normal method of measuring such control—ownership of voting stock—does not usually apply in the not-for-profit environment, other factors

must be used. At the end of this chapter, Appendix 7–C lists the factors the authors consider relevant for this purpose.

In the business setting, the determination of when a group of entities is really just a single entity is normally made by assessing the extent to which the “parent” entity has a controlling financial interest in the other entities in the group. In other words, can the parent use for its own benefit the financial resources of the others without obtaining permission from any party outside the parent? When one company owns another company, such permission would be automatic; if the management of the affiliate resisted, the parent would exercise its authority to replace management.

Previously existing accounting literature included only limited guidance for assessing the need for a not-for-profit organization to combine financial data of affiliates. The basic rules for businesses are in FASB Accounting Research Bulletin No. 51, *Consolidated Financial Statements*; AICPA Accounting Principles Board Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*; and SFAS 94, *Consolidation of All Majority-Owned Subsidiaries*. While, strictly speaking, these rules are generally viewed as not applying to not-for-profits, the concepts embodied therein and the related background discussions are helpful to someone considering the issue. Considerable judgment is called for, however, in each case to decide whether sufficient control exists to require consolidation.

(i) AICPA SOP 94-3. In 1994, the AICPA issued Statement of Position No. 94-3, which discusses when a not-for-profit organization should combine the financial statements of affiliated organizations with its financial statements. Briefly, the requirements of the SOP are as follows:

- When a not-for-profit owns a majority of the voting equity interest in a for-profit entity, the not-for-profit must consolidate the for-profit into its financial statements, regardless of whether the activities of the for-profit are at all related to those of the not-for-profit.
- If the not-for-profit owns less than a majority interest in a for-profit but still has significant influence over the for-profit, it must report the for-profit under the equity method of accounting, except that the not-for-profit may report its investment in the for-profit at market value if that is its policy for reporting such investments. If the not-for-profit does not have significant influence over the for-profit, it should value its investment in accordance with the rules applicable to that kind of not-for-profit organization (see Chapter 7 and Chapters 13 through 18).

7.3 MERGERS OF NOT-FOR-PROFIT ORGANIZATIONS

- When a not-for-profit organization has a relationship with another not-for-profit in which the parent both exercises control over (through majority ownership or voting interest) and has an economic interest in the affiliate, it must consolidate the affiliate, unless control is likely to be temporary. Consolidation is optional if the control is through other than majority ownership/voting interest.
- If the not-for-profit has either control *or* an economic interest but not both, disclosure of the relationship and significant financial information is required.

“Economic interest” is generally defined as one of four kinds of relationships: an affiliate that raises gifts for the parent, an affiliate that holds assets for the parent, an affiliate that performs significant functions for the parent, or an affiliate that is committed to provide resources to or guarantees the debt of the parent.

(ii) **FASB FIN 46R.** In January 2003, the FASB issued Interpretation (FIN) 46, *Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51*, and amended it by issuing FIN 46R in December 2003. FIN 46R addresses consolidation by business enterprises of variable interest entities (called “special-purpose entities” or SPEs). In the “Scope” section of FIN 46R, it reads:

Not-for-profit organizations as defined in paragraph 168 of FASB Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, are not subject to this Interpretation, except that they may be related parties for purposes of applying paragraphs 16 and 17 of this Interpretation. In addition, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of this Interpretation, that not-for-profit entity shall be subject to this Interpretation.

7.3 MERGERS OF NOT-FOR-PROFIT ORGANIZATIONS

When two (or more) organizations merge to form a new combined organization, somehow the financial information of the partners must be combined to reflect the new entity. Historically, accountants have used two different methods to report such mergers: the “purchase” and the “pooling” methods. Under the purchase method, one organization is designated as the acquiring organization; in the business world, this is the organization that has bought the other organization. The accounting treatment is as if the purchaser had bought the various assets and liabilities of the purchasee; values are assigned to each, based on their market value at the date of the merger, and the purchase price is allocated to each. The effect is to revalue many assets and liabilities to current values. (The actual process can get very complex, but details are not needed here.) Under the pooling method, the assets, liabilities, revenues, expenses, and

net assets of the two organizations are simply added together as if the organizations had been combined all along; previously reported values are not changed.

Many not-for-profit mergers are accounted for by the pooling method as that best represents the essence of what happens: Two organizations simply “get together” and become one organization; and no money changes hands. It is possible to apply purchase accounting to a not-for-profit merger if one thinks of the transaction as a contribution of the net assets of one organization to the other organization. If that is the essence of what has happened, then the transaction would be accounted for by revaluing the various assets and liabilities of the “contributed” organization to their current values and recording them as assets and liabilities of the surviving organization at the new values. This is the same as the accounting for non-cash contributions generally (see the discussion in Chapter 8).

(a) SFAS 141 and 142

In June 2001, the FASB issued SFAS 141, *Business Combinations*, as well as SFAS 142, *Goodwill and Other Intangible Assets*. If a not-for-profit organization is acquired by a for-profit organization, the transaction is included in the scope of SFAS 141. All other transactions involving not-for-profit organizations—that is, mergers of two or more not-for-profit organizations or the acquisition of a for-profit entity by a not-for-profit organization—are excluded from the scope of SFAS 141. They will be addressed in the FASB’s project, *Combinations of Not-for-Profit Organizations*. In the meantime, the excluded transactions will continue to be governed by the AICPA’s *Accounting Principles Bulletin (APB) 16—Business Combinations*.

Not-for-profit organizations are included in the scope of SFAS 142, *Goodwill and Other Intangible Assets*. However, the effective date will be deferred for those entities until the standard on not-for-profit combinations is issued and effective. As a result, not-for-profit organizations should continue to follow the guidance in the AICPA’s *Accounting Principles Bulletin (APB) 16—Intangible Assets* with respect to accounting for intangible assets.

(b) FASB-Proposed Exposure Draft—Combinations of Not-for-Profit Organizations

In November 1999, the FASB affirmed its earlier decision to undertake a project on combinations of not-for-profit (NFP) organizations that was separate from its business combinations project and consequently develop guidance on the accounting and reporting for combinations of NFP organizations.

7.3 MERGERS OF NOT-FOR-PROFIT ORGANIZATIONS

The FASB decided to consider combinations of not-for-profit organizations separately from for-profit enterprises for the following reasons:

- There is diversity among not-for-profit organizations in how they currently account for combinations between not-for-profit organizations.
- Guidance is needed as SFAS 141 eliminated the pooling-of-interests method.
- During the 1990s, the not-for-profit health care industry underwent significant consolidation. Many expect that other segments of the NFP sector will similarly consolidate over the coming years. Therefore, FASB believes that its forthcoming guidance will be timely.

The FASB has been deliberating issues associated with NFP combinations concurrent with its deliberations on business combinations. Although its deliberations on NFP combinations is still ongoing, its initial phase of the business combinations project was completed in June 2001 and resulted in the issuance of FASB SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets* discussed already in this chapter.

The following summarizes the tentative conclusions reached by the FASB to date with respect to the approach and scope of the project:

- The project will be conducted following an approach that presumes that SFAS 141 should apply to combinations of NFP organizations unless a circumstance unique to those combinations is identified that would justify a different accounting treatment. That approach is being referred to as the “differences-based” approach.
- The definition of NFP in SFAS 116, *Accounting for Contributions Received and Contributions Made*, is being carried over. Further, an NFP combination is tentatively defined as any event that results in the initial inclusion of a *combined set of assets and activities* in an NFP organization’s consolidated financial statements. The FASB decided to use a term such as *combined set of assets and activities* to differentiate acquisitions of a group of assets from combinations of an integrated set of assets and activities that are within the scope of this project.
- The scope of this project includes (1) combinations between two or more NFP organizations; (2) the acquisition of a for-profit business enterprise by an NFP organization; (3) acquisitions of net assets that are not separate entities; and (4) all initial consolidation events. (The acquisition of an NFP organization by a business enterprise is within the scope of SFAS 141). Included in the scope are those combinations in which no combining entity dominates the process of selecting a voting majority of the combined entity’s governing board (transactions which are sometimes referred to as

mergers of equals where no entity controls the organization post-combination). Excluded from the scope are:

- The formation of a joint venture
- The acquisition of noncontrolling interests
- A transfer of net assets or exchange of equity interests between entities under common control

The Board reached tentative conclusions regarding the method of accounting for NFP business combinations for the following types of combinations:

- Combinations of two NFP organizations in which neither cash nor other assets are exchanged as consideration
- Combinations of two or more NFP organizations or the acquisition of a business enterprise by a NFP organization that include the exchange of cash or other assets as consideration

Additional tentative conclusions reached include:

- The types of factors to consider when identifying the acquiring organization in a combination between NFP organizations (factors similar to the guidance provided in paragraph 17 of SFAS 141)
- Continuing to apply SFAS 116 to account for the measurement and recognition of collections acquired as part of a combination
- Utilizing the criteria set forth in SFAS 141 when separately recognizing intangible assets in combinations of NFP organizations
- Accounting for the initial and subsequent recognition of goodwill in combinations in which the NFP is the acquiring organization and the acquired enterprise will continue to be operated as a business enterprise. (In those situations, the Board concluded that goodwill should be recognized and accounted for subsequent to acquisition in accordance with SFAS 142.)
- Presentation and display issues in the statement of activities and statement of cash flows relating to acquisition transactions
- Requiring NFPs to provide disclosures (1) in accordance with SFAS 141 (as modified to apply to the NFP sector) and (2) that ultimately result from the Business Combinations: Purchase Method Procedures Project
- Disclosing the fair value of collection items acquired in a reciprocal combination and then written-off in the same period. (However, the disclosure would not be required if the FASB decides at a later date to require an immediate write-off of goodwill.)

7.3 MERGERS OF NOT-FOR-PROFIT ORGANIZATIONS

- Applying the following “two-path” method of accounting for goodwill subsequent to acquisition:
 - Reporting units primarily supported by fees or other charges to third parties for goods and services should test goodwill for impairment using the fair value method required by SFAS 142.
 - Reporting units not primarily supported by fees or other charges to third parties should test goodwill for impairment using a trigger-based approach that writes-off goodwill in its entirety if certain triggering events occur. Furthermore, NFPs would disclose the reasons goodwill arose in the transaction and the triggering events that would result in a write-off of goodwill.

The proposed statement also would (1) be effective upon issuance; (2) apply prospectively to all combinations initiated after the effective date; (c) preclude adjustments of amounts recognized in combinations occurring before the issuance date regardless of whether the combination was originally accounted for by the purchase or pooling-of-interests methods; and (d) include transition provisions for intangible assets and negative goodwill consistent with the guidance in paragraphs 61 and 62 of SFAS 141.

An exposure draft is planned for the first quarter of 2005, shortly after it issues its exposure draft for the Business Combinations: Purchase Method Procedures project.

APPENDIX 7–A

Factors to Be Considered in Deciding Whether a Pass-Through Gift Is Truly Revenue and Expense to a Pass-Through Entity

Following is a list of factors that may be helpful to auditors in assessing the appropriateness of the client’s decision and to not-for-profit organizations in deciding whether assets received by them are contributions within the meaning of FASB SFAS 116 and 136, or are transfers in which the entity is acting as an agent, trustee, or intermediary (see also Appendix 7–B, following). No one factor is usually determinative by itself; all relevant factors should be considered together.

A = Original noncharitable donor (individual or business)

B = Initial charitable recipient/donor or pass-through entity (sometimes there is more than one charity in the chain)

C = Ultimate charitable or individual recipient

* = Factors considered to be generally more significant

Factors 11 through 14 in the left column may be indicative that B is merely a facilitator.

Factors whose presence indicate recording by B as revenue and expense may not be appropriate

Factors whose presence indicate recording by B as revenue and expense may be appropriate

General Factors—Relevant to All Gifts:

- | | |
|---|---|
| <p>1. B has solicited the gift from A under the specific pretense of passing it on to C.*</p> | <p>B Has solicited the gift ostensibly for B’s own activities.</p> |
| <p>2. A has restricted the gift by specifying that it must be passed on to C, and B does not have variance power.*</p> | <p>A has not restricted the gift in this manner, or B has explicit variance power (see Par. 12 of SFAS 136).</p> |
| <p>3. B is controlled by A or by C.</p> | <p>A or C do not control B.</p> |
| <p>4. Two or more of A, B, and C are under common control, have overlapping boards or management, and share facilities or professional advisors.*</p> | <p>Factor not present.</p> |
| <p>5. Even without the intermediation of B, A would still easily be able to make the gift to C.</p> | <p>Without such intermediation, A would not be able to make a gift to C (A is unaware of existence of C or of C’s needs, geographic separation, etc.).*</p> |
| <p>6. The stated program activities of B and C are similar.</p> | <p>The program activities are not particularly similar.</p> |

APPENDIX 7-A

Factors whose presence indicate recording by B as revenue and expense may not be appropriate	Factors whose presence indicate recording by B as revenue and expense may be appropriate
7. B does not ever obtain legal title to the assets composing the gift.*	B does at some time obtain legal title to the assets.
8. A and/or other entities under common control are major sources of support for B.	Factor not present.
9. C and/or other entities under common control are major destinations for B's charitable resources, and B and C are <i>not</i> financially interrelated. (If B and C were financially interrelated, Par. 13 of SFAS 136 might apply.)	Factor not present.
9a. Both factors 8 and 9 are present.*	One but not both present.
10. The "chain" from A to C consists of several Bs.	The chain consists of only one or very few Bs.
11. Gifts passed from A to B are frequently in exactly the same dollar amount (or very close) as gifts subsequently passed from B to C.*	Factor not present.
12. Times elapsed between receipt and disbursement of particular amounts by B are short (less than a month).	Times elapsed are relatively long or variable.
13. B makes pledges to C, payment of which is contingent on receipt of gifts from A.	Factor not present.
14. B was created only shortly prior to receiving the gift, and/or B appears to have been created specifically for the sole purpose of passing gifts from A on to C.*	Factor not present.
<i>Factors Especially Relevant to Gifts-in-Kind:</i>	
15. B never takes physical possession of the gift at an owned or rented facility.	B does have physical possession of the items at some time, at a facility normally owned or rented by it.
16. The nature of the items is not consistent with the program service activities of B as stated in its Form 1023, 990, organizing documents, fundraising appeals, and annual report.*	The nature is consistent with B's stated program activities.
17. The gift was not solicited by B.	B specifically solicited the particular items from A.
18. The quantity of items is large in relation to the foreseeable needs of B or its donees.	Factor not present.
19. Factor not present.	Members of the board or staff of B have specific technical or professional expertise about the items, and actively participate in deliberations about where to obtain the items and how best to use them.*
20. A appears to be the only source from which B considers acquiring the item. Same for B/C.	B has several potential or actual sources for the item. Same for C.

(continued)

AFFILIATED ORGANIZATIONS, PASS-THROUGH TRANSACTIONS, AND MERGERS

Factors whose presence indicate recording by B as revenue and expense may not be appropriate	Factors whose presence indicate recording by B as revenue and expense may be appropriate
21. B receives numerous types of items dissimilar in their purpose or use.	Factor not present.
22. B receives items from A and passes them on to C in essentially the same form.	B “adds value” to the items by sorting, repackaging, cleaning, repairing, or testing them.*
23. B <i>and</i> either or both of A and C have little in the way of program services other than distribution of gifts in kind to other charities.	Either B or <i>both</i> A and C have significant program services other than distribution of gifts in kind.
24. The value assigned to the items by A or B appears to be inflated.	Factor not present.
25. There is a consistent pattern of transfers of items along the same “chain” (A to B to C, etc.).	Factor not present.
26. Factor not present.	B incurs significant expenses (freight, insurance, storage, etc.) in handling the items.

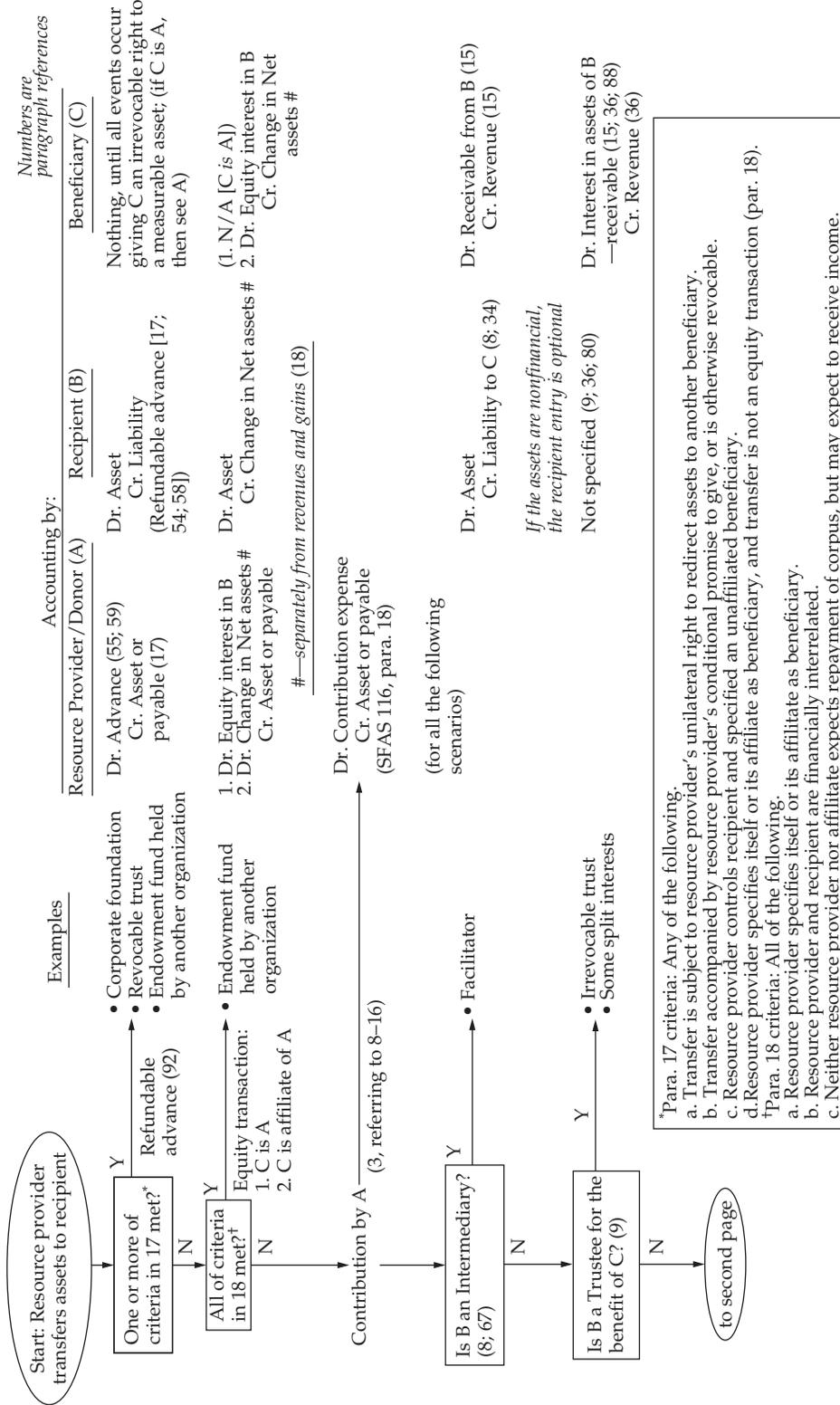
APPENDIX 7–B

SFAS 136—Transfers of Assets to a Not-for-Profit Organization or Charitable Trust that Raises or Holds Contributions of Others

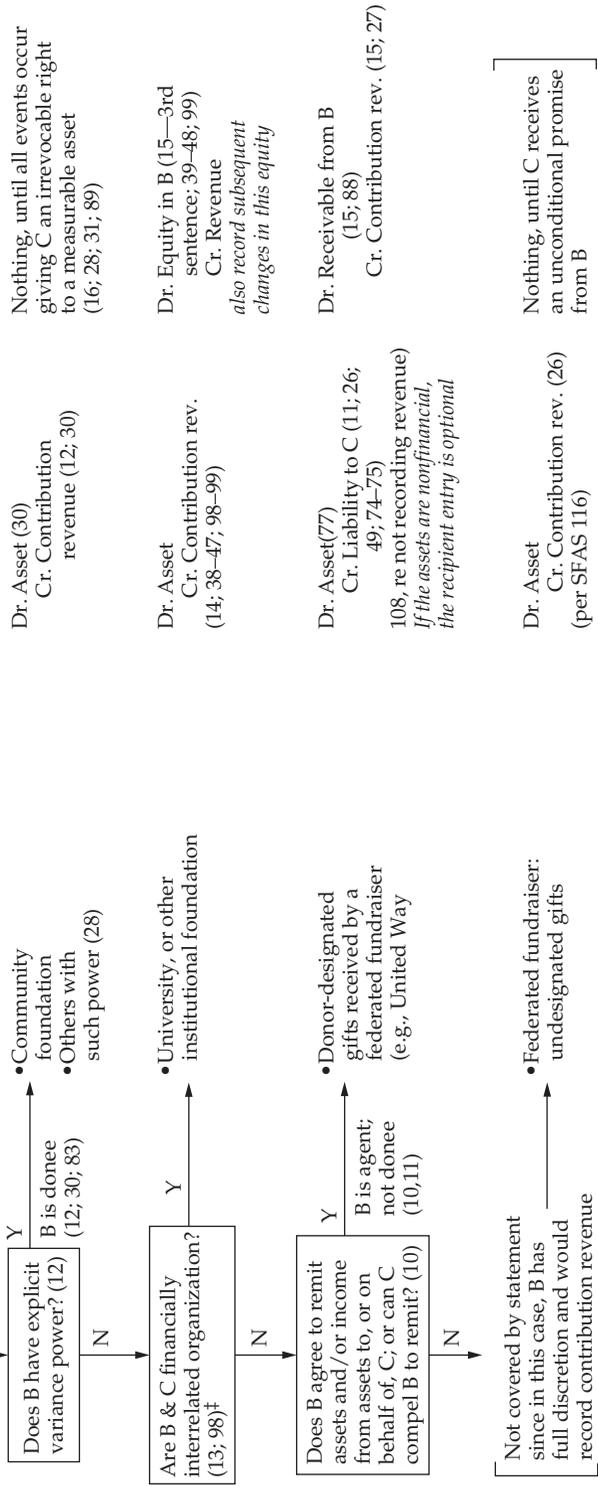
SFAS 136—OTHER PROVISIONS

- *Paragraphs 3, 4.* Applies to transactions in which one organization (resource provider or donor) transfers assets to another organization (recipient) for the benefit of a third organization (beneficiary), including cases where the first and the third organizations are the same organization.
- *Paragraph 6.* Applies to transfers of all kinds of assets (see paragraph 5 of SFAS 116).
- *Paragraph 7.* Supersedes, but carries forward, FASB FIN 42 (variance power).
- *Paragraphs 8–18.* Tenor of requirements is that the recipient can report the receipt of the assets as revenue or other increase in net assets if it is financially interrelated with either the resource provider or beneficiary, or if it has discretion as to the disposition of the assets; but it cannot report revenue if it has no discretion over the ultimate disposition of the assets or if it is not assured of not having to return the assets to the resource provider. (See flowchart that follows for details.)
- *Paragraphs 19, 20.* Disclosures required: When the resource provider and beneficiary are the same or affiliated organizations, the resource provider shall disclose information about the terms of the transfer and about the beneficiary organization. If a not-for profit organization discloses a ratio of fundraising expenses to amounts raised, it shall also disclose how it computes that ratio.
- *Paragraphs 21, 22.* Effective for fiscal periods beginning after December 15, 1999; early application is encouraged. (Except paragraph 12, carried forward from FASB FIN 42, is already effective.) Adoption may be either retroactive or prospective (per AICPA APB 20).

Disposition of Assets Flowchart and Examples



from first page



†Para. 13 definition of “financially interrelated”: Both of the following.
 a. One organization has ability to influence operating and financial decisions of the other, such as: by being affiliates; having considerable governing board representation; having the charter or bylaws of one limiting its activities to those that benefit the other; having a formal agreement between them providing for influence in policymaking.
 b. One has an ongoing economic interest in the net assets of the other, which is a residual interest that changes as a result of the activities of the other (as contrasted with a fixed receivable) (102).
 Also consider whether consolidation may be required [100].

AFFILIATED ORGANIZATIONS, PASS-THROUGH TRANSACTIONS, AND MERGERS

Paragraph 109 illustrates some possible methods of presenting the revenue section of the statement of activities under SFAS 136.

The most significant effect, compared with present practice, will be on how federated fundraisers (e.g., United Way) report donor-designated contributions (currently reported as revenue; will be a liability in the future).

APPENDIX 7–C

Factors Related to Control that May Indicate that an Affiliated Organization (A) Should Be Combined with the Reporting Organization (R), if Other Criteria for Combination Are Met (Per AICPA SOP 94-3)

SOP 94-3 defines control as “the direct or indirect ability to determine the direction of management and policies through ownership, contract, or otherwise.” Following is a list of factors, which may be helpful to auditors in assessing the appropriateness of the client’s decision, and not-for-profit organizations, in deciding whether to combine financial statements of affiliated organizations. Many of these factors are not absolutely determinative by themselves, but must be considered in conjunction with other factors.

Factors whose presence indicate control	Factors whose presence indicate lack of control
<i>Organization Relationship</i>	
<p>1. A is clearly described as controlled by, for the benefit of, or an affiliate of R in some of the following.</p> <ul style="list-style-type: none"> —Articles/charter/by-laws —Operating/affiliation agreement —Fundraising material/membership brochure —Annual report —Grant proposals —Application for tax-exempt status 	<p>A is described as independent of R, or no formal relationship is indicated.</p>
<i>Governance</i>	
<p>2. A’s board has considerable overlap in membership with R; common officers.</p> <p>3. A’s board members and/or officers are appointed by R, or are subject to approval of R’s board, officers, or members.</p> <p>4. Major decisions of A’s board, officers or staff are subject to review, approval, or ratification by R.</p>	<p>Little or no overlap.</p> <p>A’s board is self-perpetuating with no input from R.</p> <p>A’s decisions are made autonomously; or even if in theory subject to such control, R has in fact never or rarely exercised control and does not intend to do so.</p>
<i>Financial</i>	
<p>5. A’s budget is subject to review or approval by R.</p> <p>6. Some or all of A’s disbursements are subject to approval or countersignature by R.</p>	<p>Budget not subject to R’s approval.</p> <p>Checks may be issued without R’s approval.</p>

(continued)

AFFILIATED ORGANIZATIONS, PASS-THROUGH TRANSACTIONS, AND MERGERS

Factors whose presence indicate control	Factors whose presence indicate lack of control
<p>7. A's excess of revenue over expenses or net assets or portions thereof are subject to being transferred to R at R's request, or are automatically transferred.</p> <p>8. A's activities are largely financed by grants, loans, or transfers from R, or from other sources determined by R's board.</p> <p>9. A's bylaws indicate that its resources are intended to be used for activities similar to those of R.</p> <p>10. A's fundraising appeals give donors the impression that gifts will be used to further R's programs.</p>	<p>Although some of A's financial resources may be transferred to R, this is done only at the discretion of A's board.</p> <p>A's activities are financed from sources determined by A's board.</p> <p>A's bylaws limit uses of resources to purposes that do not include R's activities.</p> <p>Appeals give the impression that funds will be used by A.</p>
<i>Operating</i>	
<p>11. A shares with R many of the following operating functions.</p> <ul style="list-style-type: none"> —Personnel/payroll —Purchasing —Professional services —Fundraising —Accounting, treasury —Office space <p>12. Decisions about A's program or other activities are made by R or are subject to R's review or approval.</p> <p>13. A's activities are almost exclusively for the benefit of R's members.</p>	<p>Few operating functions are shared, or reimbursement of costs is on a strictly arms-length basis with formal contracts.</p> <p>A's decisions are made autonomously.</p> <p>Activities benefit persons unaffiliated with R.</p>
<i>Other</i>	
<p>14. A is exempt under IRC Section 501(c) (3) and R is exempt under some other subsection of 501(c), and A's purpose for existence appears to be to solicit tax-deductible contributions to further R's interest.</p>	<p>A's purposes appear to include significant activities apart from those of R.</p>

CHAPTER EIGHT

Contributions, Pledges, and Noncash Contributions

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So far we have not discussed the general problems of recording and reporting the principal resource most not-for-profit organizations depend on: contributions. An organization can receive contributions with a wide range of restrictions attached. First these contributions must be *recorded* correctly in the right fund internally; then they must be *reported externally* in such a way that the financial statement reader is fully aware of their receipt and any restrictions on them. In addition, there has been considerable controversy surrounding the timing of the recording of different types of gifts as income. Some contributions are made in the form of pledges (the FASB refers to these as “promises to give”) that will be paid off over a period of time or at some future date; the main accounting questions are whether such pledges should be recorded as assets prior to their collection, and when they should be recognized as income. Also, an organization can receive a variety of noncash contributions ranging from marketable securities, buildings, and equipment to contributed services of volunteers and the use of fixed assets. All of these types of contributions present accounting and reporting problems for the organization.

Support for a not-for-profit organization can be received in many different forms. Each of the types of contributions will be discussed in a separate section of this chapter. Contributions are also discussed in Chapter 5 of the audit guide for *Not-for-Profit Organizations*. SFAS 116, *Accounting for Contributions Received and Contributions Made* sets forth the guidance for accounting contributions. The details of the requirements of this statement are discussed throughout this chapter. In brief, it says that all contributions, whether unrestricted or restricted, and in whatever form—cash, gifts-in-kind, securities, pledges, or other forms—are revenue in full immediately upon receipt of the gift or an unconditional pledge. The revenue is reported in the class of net assets (discussed in Chapter 14) appropriate to any donor-imposed restriction on the gift (unrestricted, if there is no donor-imposed restriction). It also contains guidance on accounting for donated services of volunteers, and an exception to the normal rule when dealing with museum collection objects.

8.1 EXPENDABLE CURRENT SUPPORT

(a) Unrestricted Contributions

This section discusses simple unrestricted cash gifts. Unrestricted gifts in other forms, such as pledges, gifts of securities, and gifts of equipment and supplies, are discussed in later sections. The general principles discussed here apply to all unrestricted gifts, in whatever form received.

(i) Accounting for Unrestricted Contributions. All unrestricted contributions should be reported in the unrestricted class of net assets in a Statement of Activities (which includes revenues, expenditures, and other charges in net assets). It is *not acceptable* to report unrestricted gifts in a restricted class of net assets.

(ii) Bargain Purchases. Organizations are sometimes permitted to purchase goods or services at a reduced price that is granted by the seller in recognition of the organization's charitable or educational status. In such cases, the seller has effectively made a gift to the buyer. This gift should be recorded as such if the amount is significant. For example, if a charity buys a widget for \$50 that normally sells for \$80, the purchase should be recorded at \$80, with the \$30 difference being reported as a contribution. It is important to record only true gifts in this way. If a lower price is really a normal discount available to any buyer who requests it, then there is no contribution. Discounts that should not be accounted for as contributions include, for example, quantity discounts, normal trade discounts, promotional discounts, special offers, or lower rates (say, for professional services) to reflect the seller's desire to utilize underused staff, or sale prices to move slow-moving items off the shelves.

(iii) Presentation in the Statement of Activities. The presentation of unrestricted contributions within the Statement of Activities can be handled in one of several ways. For smaller organizations and for organizations where fees for services rendered are not a significant factor, contributions are usually reported in the top section of the statement along with all other sources of income:

<hr/>	
Income:	
Contributions	\$ 50,000
Other income	<u>10,000</u>
Total	60,000
Expenses (in total)	<u>(55,000)</u>
Change in net assets	<u><u>\$ 5,000</u></u>
<hr/>	

CONTRIBUTIONS, PLEDGES, AND NONCASH CONTRIBUTIONS

For some other organizations, it may be more appropriate to separate contributions from service fee income in order to arrive at an excess or deficit before contributions are added. The following is a simplified example of this type of presentation.

Service fees	\$ 150,000
Less expenses	<u>(175,000)</u>
Excess of expenses over service fees before contributions	(25,000)
Contributions	<u>40,000</u>
Change in net assets	<u><u>\$ 15,000</u></u>

Note that in both examples contributions are shown above the change in net assets for the period so the reader can see the net results of all unrestricted activities.

Sequence of Items in the Statement of Income. As also discussed in Sections 14.3(e) and 14.3(h) of this chapter, SFAS 117 is quite flexible about the sequence of items in a statement of income, expenses, and changes in net assets. Organizations can choose whether to separate revenue and expense items into “operating” and “nonoperating” groups, with subtotals for each, and can, within certain limits, choose the sequence in which items are presented. So, for example, an organization might choose to present all unrestricted contributions in one section, or it might choose to have one section showing what it considers operating contributions, and another section including nonoperating contributions. Nonoperating contributions might be things such as unrestricted bequests or nonrecurring foundation grants, as distinguished from the proceeds of the organization’s regular annual fundraising campaign. Appendix 8–B also may be helpful here. It is also possible for an organization to present one statement showing all activity in the unrestricted class of net assets, the bottom line (“Change in Unrestricted Net Assets”) of which is then carried forward into another statement showing the activity in all three net asset classes. This presentation is illustrated in Appendix C (Format C) of SFAS 117.

(b) Temporarily Restricted Contributions

Temporarily restricted contributions are contributions that can be used to meet the current expenses of the organization, although restricted to use for some specific purpose, or during or after some specified time. An example of the former would be a gift “for cancer research” (a “purpose restriction”), and of the latter, a gift “for your 20X0 activities” (a “time restriction”). In practice, the distinction between temporarily restricted gifts and unrestricted gifts is not always clear. In many cases, the language used by the donor leaves doubt as to whether there really is a

restriction on the gift. Appendix 8–A contains a checklist to help readers make this distinction in practice.

The principal accounting problem relates to the question of what constitutes “income” or “support” to the organization. Is a gift that can only be used for a specific project or after a specified time “income” to the organization at the time the gift is received? Or does this restricted gift represent an amount that should be looked on as being held in a form of escrow until it is expended for the restricted purpose (cancer research in the above example) or the specified time has arrived (20X0 in the above example)? If it is looked on as something other than income, what is it—deferred income or part of a restricted net asset balance?

If a temporarily restricted gift is considered income or support in the period received—whether expended or not—the accounting is fairly straightforward. It would be essentially the same as for unrestricted gifts, described earlier, except that the gift is reported in the temporarily restricted class rather than in the unrestricted class of net assets. The question of how to account for temporarily restricted contributions has now been settled by the issuance of SFAS 116.

Let’s look at an example: The Johnstown Eye Foundation received a contribution of \$50,000 to be used for salary costs of the staff of a mobile eye clinic that visits elementary schools to test children’s vision in the greater Johnstown area. In the first year, \$40,000 was expended for this purpose. In addition to the mobile clinic contribution, the Johnstown Eye Foundation had other unrestricted contributions and income of \$320,000 and expenses of \$315,000.

The accounting would be to report the temporarily restricted gift of \$50,000 as income in total in the year received, and then reflect the unspent amount of \$10,000 as temporarily restricted net assets at the end of the year (Exhibit 8.1). This is the method historically used by voluntary health and welfare organizations, and which is called for by SFAS 116.

(i) Accounting for Temporarily Restricted Contributions: Report as Income in Full in the Year Received. The approach required by SFAS 116 is to report a temporarily restricted gift as income or support in full in the year received, in the temporarily restricted class of net assets. In this approach, gifts are recognized as income as received and expenses are recognized as incurred. The unspent income is reflected as part of temporarily restricted net assets. Exhibit 8.1 shows the Statement of Activities and the Balance Sheet for the Johnstown Eye Foundation, following this approach. The reader can clearly see that the Johnstown Eye Foundation received gifts of \$50,000 and spent \$40,000 and that the organization had unspent temporarily restricted gifts of \$25,000 from previous years. The implication of this presentation is that the \$50,000 is income at the time received, and that while there may be restrictions on the use of the amount, the board

CONTRIBUTIONS, PLEDGES, AND NONCASH CONTRIBUTIONS

EXHIBIT 8.1

Example of a Set of Financial Statements in Which Current Restricted Income Is Reported as Income in Total in the Year Received, in the Temporarily Restricted Class

THE JOHNSTOWN EYE FOUNDATION			
STATEMENT OF			
ACTIVITIES			
FOR THE YEAR ENDED JUNE 30, 20X1			
	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Total</u>
Income:			
Restricted contributions		\$50,000	\$ 50,000
Other income	\$320,000		320,000
Net assets released from restrictions	<u>40,000</u>	<u>(40,000)</u>	<u>—</u>
	<u>360,000</u>	<u>10,000</u>	<u>370,000</u>
Less—Expenses	<u>(355,000)</u>	<u>—</u>	<u>(355,000)</u>
Change in net assets	5,000	10,000	15,000
Net assets, beginning of year	<u>100,000</u>	<u>25,000</u>	<u>125,000</u>
Net assets, end of year	<u>\$105,000</u>	<u>\$35,000</u>	<u>\$140,000</u>
 BALANCE SHEET JUNE 30, 20X1			
			<u>Total</u>
Cash			\$ 78,000
Other assets			<u>85,000</u>
Total			<u>\$163,000</u>
Accounts payable			\$ 23,000
Net assets:			
Unrestricted			105,000
Temporarily restricted			<u>35,000</u>
Total net assets			<u>140,000</u>
Total			<u>\$163,000</u>

truly considers the \$50,000 as resources of the Johnstown Eye Foundation, reportable as such. Observe, however, that in this approach a temporarily restricted gift received on the last day of the reporting period will also be reflected as income, and this would increase the change in net assets reported for the entire period. However, the organization is merely reporting what has happened and to report the gift otherwise is to obscure its receipt. The approach shown in Exhibit 8.1 is one way not-for-profit organizations present activity in the temporarily restricted net assets. However, organizations also have the choice that restricted gifts received and expended in the same period may be recognized as “unrestricted” if this is disclosed in their accounting policies.

8.1 EXPENDABLE CURRENT SUPPORT

(ii) **Grants for Specific Projects.** Many organizations receive grants from third parties to accomplish specific projects or activities. These grants differ from other current restricted gifts principally in the degree of accountability the recipient organization has in reporting back to the granting organization on the use of such monies. In some instances, the organization receives a grant to conduct a specific research project, the results of which are turned over to the grantor. The arrangement is similar to a private contractor's performance on a commercial for-profit basis. In that case, the "grant" is essentially a purchase of services. It would be accounted for in accordance with normal commercial accounting principles, which call for the revenue to be recognized as the work under the contract is performed.¹ In other instances, the organization receives a grant for a specific project, and while the grantee must specifically account for the expensing of the grant in detail and may have to return any unexpended amounts, the grant is to further the programs of the grantee rather than for the benefit of the grantor. This kind of grant is really a gift, not a purchase. The line between ordinary temporarily restricted gifts and true "grants" for specific projects is not important for accounting purposes because the method of reporting revenue is now the same for both. What can get fuzzy is the distinction between grants and purchase of services contracts. Most donors of temporarily restricted gifts are explicit as to how their gifts are to be used, and often the organization will initiate a report back to the donors on the use of their gifts. However, restricted gifts and grants usually do not have the degree of specificity that is attached to purchase contracts. Appendix 8-B contains a checklist to help readers distinguish between gifts and purchase contracts in practice. Paragraphs 5.13 to 5.14 of the audit guide for *Not-for-Profit Organizations* also discuss this subject.

Prepayment versus Cost-Reimbursement. Grants and contracts can be structured in either of two forms: In one, the payor remits the amount up front and the payee then spends that money; in the other, the payee must spend its own money from other sources and is reimbursed by the payor.

In the case of a purchase contract, amounts remitted to the organization in advance of their expenditure should be treated as deferred income until such time as expenditures are made which can be charged against the contract. At that time, income should be recognized to the extent earned. Where qualifying expenditures have been made but the grantor has not yet made payment, a receivable should be set up to reflect the grantor's obligation.

In the case of a true grant (gift), advance payments must be recognized as revenue immediately upon receipt, as is the case with all contributions

¹ Purchase of service contracts are explicitly excluded from coverage by paragraph 3 of SFAS 116.

under SFAS 116. Reimbursement grants are recognized as revenue as reimbursements become due—that is, as money is spent which the grantor will reimburse. This is the same method as is used under cost-reimbursement purchase contracts. Recording the entire amount of the grant as a receivable at the time awarded, offset by deferred grant income on the liability side of the Balance Sheet is not appropriate under SFAS 116. If the entire grant amount qualifies as an unconditional pledge (see Section 8.3(b)), then that amount must be recorded as revenue, not deferred revenue. On the other hand, receivables under a purchase contract are created only when qualifying expenditures have been made.

(c) Investment Securities

Frequently an organization will receive contributions that are in the form of investment securities: stocks and bonds. These contributions should be recorded in the same manner as cash gifts. One problem usually encountered is difficulty in determining a reasonable basis for valuation in the case of closely-held stock with no objective market value.

The value recorded should be the fair market value at the date received. Marketable stocks and bonds present no serious valuation problem. They should be recorded at their market value on the date of receipt or, if sold shortly thereafter, at the amount of proceeds actually received. However, the “shortly thereafter” refers to a sale within a few days or perhaps a week after receipt. Where the organization deliberately holds the securities for a period of time before sale, the securities should be recorded at their fair market value on the date of receipt. This will result in a gain or loss being recorded when the securities are subsequently sold (unless the market price remains unchanged).

For securities without a published market value, the services of an appraiser may be required to determine the fair value of the gift. See Chapter 6 for discussion of reporting investments in the financial statements.

8.2 GIFTS-IN-KIND

(a) Fixed Assets (Land, Buildings, and Equipment) and Supplies

Contributions of fixed assets can be accounted for in one of two ways. SFAS 116 permits such gifts to be reported as either unrestricted or temporarily restricted income at the time received. If the gift is initially reported as temporarily restricted, the restriction is deemed to expire ratably over the useful life of the asset—that is, in proportion to depreciation for depreciable assets. The expiration is reported as a reclassification from the temporarily restricted to the unrestricted class of net assets. This method of reporting is illustrated in Exhibit 8.2. Nondepreciable assets

8.2 GIFTS-IN-KIND

EXHIBIT 8.2

Example of a Statement of Income, Expenses, and Changes in Net Assets in Which a Value Is Reported for Contributed Services of Volunteers

THE KANAB COMMUNITY SERVICE ORGANIZATION STATEMENT OF ACTIVITIES FOR THE YEAR ENDED JUNE 30, 20X1			
Income:			
Service fees	\$200,000		
Contributions	50,000		
Value of contributed services	<u>75,000</u>		
Total income			<u>\$325,000</u>
Expenses:			
Program services:			
Assistance to the elderly	100,000		
Assistance to the poor	100,000		
Assistance to youth	<u>50,000</u>		
Total program			250,000
Supporting services:			
Administration	40,000		
Fundraising	<u>10,000</u>		
Total supporting			<u>50,000</u>
Total expenses			<u>300,000</u>
Change in net assets			25,000
Net assets, beginning of year			<u>100,000</u>
Net assets, end of year			<u>\$125,000</u>

such as land would remain in the temporarily restricted class indefinitely—until disposed of. (Recognizing the gift as income in proportion to depreciation recognized on the asset is not in conformity with generally accepted accounting principles.) Supplies and equipment should be recorded at the amount which the organization would normally have to pay for similar items. A value for used office equipment and the like can usually be obtained from a dealer in such items. The valuation of donated real estate is more difficult, and it is usually necessary to get an outside appraisal to determine the value.

(b) Museum Collections

SFAS 116 provides a choice to capitalize or not capitalize donated (and purchased) museum collection objects, if certain criteria are met and certain disclosures are made. Owners of such objects do not have to record them, although they may if they wish. This subject is discussed further in Chapter 7 of *Not-for-Profit Organizations*.

(c) Contributed Services of Volunteers

Many organizations depend almost entirely on volunteers to carry out their programs, and sometimes supporting functions. Should such organizations place a value on these contributed services and record them as “contributions” in their financial statements?

(i) Criteria for Recording. The answer is yes, under certain circumstances. These circumstances exist only when *either* of the following conditions is satisfied.

1. The services create or enhance nonfinancial assets.
2. The services:
 - a. Require specialized skills
 - b. Are provided by persons possessing those skills
 - c. Would typically have to be purchased if not provided by donation

If neither criterion is met, SFAS 116 precludes recording a value for the services, although disclosure in a footnote is encouraged.

Creating or Enhancing Nonfinancial Assets. The first criterion is fairly straightforward. It covers volunteers constructing or making major improvements to buildings or equipment. It would also cover things like building sets or making costumes for a theater or opera company, and writing computer programs, since the resulting assets could be capitalized on the Balance Sheet. The criterion says “nonfinancial” assets so as *not* to cover volunteer fundraisers who, it could be argued, are “creating” assets by soliciting gifts.

Specialized Skills. The second criterion has three parts, all of which must be met for recording to be appropriate. The first part deals with the nature of the services themselves. The intent is deliberately to limit the types of services that must be recorded, thus reducing the burden of tracking and valuing large numbers of volunteers doing purely routine work, the aggregate financial value of which would usually be fairly small. SFAS 116 gives very little guidance about how to identify, in practice, those skills that would be considered “specialized,” as opposed to nonspecialized. There is a list of skills that are considered specialized, but it merely recites a list of obvious professions such as doctors, lawyers, teachers, carpenters. What is lacking is an operational definition of specialized that can be applied to all types of services. Appendix 8–C contains a checklist to help readers make this distinction in practice. The second part of the criterion will usually cause no problems in practice, as persons practicing the types of skills contemplated should normally possess the skills (if not, why are they performing the services?).

Would Otherwise Purchase. The third part of the criterion will be the most difficult of all to consider, as it calls for a pure judgment by management. Would the organization purchase the services or would it not?

Probably the most important requirement is that the services being performed are an essential part of the organization's program. The key test is whether the organization would hire someone to perform these services if volunteers were not available. This is a difficult criterion to meet. Many organizations have volunteers involved in peripheral areas which, while important to the organization, are not of such significance that paid staff would be hired in the absence of volunteers. But this is the acid test: If the volunteers suddenly quit, would the organization hire replacements? Appendix 8-D contains a checklist to help readers assess this criterion.

(ii) Basis on Which to Value Services. An additional criterion that is not explicitly stated in SFAS 116 in connection with donated services is that there must be an objective basis on which to value these services. It is usually not difficult to determine a reasonable value for volunteer services where the volunteers are performing professional or clerical services. By definition, the services to be recorded are only those for which the organization would in fact hire paid staff if volunteers were not available. This suggests that the organization should be able to establish a reasonable estimate of what costs would be involved if employees had to be hired. In establishing such rates, it is not necessary to establish individual rates for each volunteer. Instead, the volunteers can be grouped into general categories and a rate established for each category. Some organizations are successful in getting local businesses to donate one of their executives on a full- or part-time basis for an extended period of time. In many instances, the amount paid by the local business to the loaned executive is far greater than the organization would have to pay for hired staff performing the same function. The rate to be used in establishing a value should be the lower rate. This also helps to get around the awkwardness of trying to discern actual compensation. An organization may wish not to record a value unless the services are significant in amount. There is a cost to keep the records necessary to meet the reporting requirements and unless the resulting amounts are significant it is wasteful for the organization to record them.

(iii) Accounting Treatment. The dollar value assigned to contributed services should be reflected as income in the section of the financial statements where other unrestricted contributions are shown. In most instances, it is appropriate to disclose the amount of such services as a separate line. On the expense side, the value of contributed services

should be allocated to program and supporting service categories based on the nature of the work performed. The amounts allocated to each category are not normally disclosed separately. If volunteers were used for constructing fixed assets, the amounts would be capitalized rather than being charged to an expense category. Unless some of the amounts are capitalized, the recording of contributed services will not affect the change in net assets, since the income and expense exactly offset each other. Exhibit 8.2 shows a simplified example of reporting for contributed services.

The footnotes to the financial statements should disclose the nature of contributed services and the valuation techniques followed.

(iv) Costs of Soliciting Contributed Services. In March 2000, the AICPA's Accounting Standards Team released a nonauthoritative question and answer (Q&A), which is commonly referred to as a Technical Practice Aid (TPA). TPA 6140.11 pertains to the costs of soliciting contributed services and time. The questions posed to the AICPA were: Should those costs be reported as fundraising? Are there circumstances in which the services or time do not meet the recognition criteria in paragraph 9 of SFAS 116, *Accounting for Contributions Received and Contributions Made*? If so, should they be reported in the functional category to which the solicited services or time pertain?

The TPA states that the costs of soliciting contributed services should be reported as fundraising, regardless of whether those services meet the recognition criteria in paragraph 9 of SFAS 116. The costs of soliciting contributed services that will be used in program functions should be reported as fundraising, even if the services do not meet the recognition criteria in SFAS 116. Similarly, the costs associated with soliciting management and general services should be reported as fundraising, even if the management and general services do not meet the recognition criteria.

In the basis for conclusions of SFAS 116, certain contributed services are prohibited from being recognized for practical reasons. Nonetheless, these services are contributions, regardless of whether they are recognized. Therefore, soliciting contributions meets the definition of fundraising in FASB SFAS 117 and *Not-for-Profit Organizations*.

(d) Use of Facilities

Occasionally a not-for-profit organization will be given use of a building or other facilities either at no cost or at a substantially reduced cost. A value should be reflected for such a facility in the financial statements, both as income and as expense. The value to be used should be the fair market value of facilities which the organization would otherwise rent if the contributed facilities were not available. This means that if very

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expensive facilities are donated, the valuation to be used should be the lower value of the facilities which the organization would otherwise have rented. Implicit in this rule is the ability to determine an objective basis for valuing the facilities. If an organization is given the use of facilities that are unique in design and have no alternative purpose, it may be impossible to determine what they would have to pay to rent comparable facilities. This often occurs with museums that occupy elaborate government-owned buildings.

Where a donor indicates that the organization can unconditionally use such rent-free facilities for more than a one-year period, the organization should reflect the arrangement as a pledge, and record the present value of the contribution in the same way as other pledges.

(e) Services Provided by Other Organizations

Some not-for-profit organizations are the beneficiaries of services provided at no cost by other organizations, often organizations with which the reporting organization is affiliated in some way. An example is a corporate foundation that occupies office space belonging to the company, uses office equipment belonging to the company, and has its functions performed by personnel on the company payroll, for which no charge is made by the company to the foundation. In separate financial statements of the foundation, the value of the “free” services should be reported as both a contribution and an expense. The expense would be reported in the categories appropriate to the nature and purpose of the services provided.

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(a) Endowment Gifts

Donor-restricted endowment contributions should be reported as revenue upon receipt in a restricted class of net assets: temporary in the case of a term endowment gift, otherwise permanent. There are different approaches for reporting endowment gifts in a Statement of Income and Expenses. Usually a multicolumn presentation is followed to separate unrestricted from restricted income, as shown here. Gifts of term endowment are later reclassified to the unrestricted class when the term of the endowment expires. If upon expiration of the endowment restriction, the gift is still restricted—such as for some operating purpose—it would not be reclassified until money was spent for that purpose. If upon expiration of the term endowment restriction, the gift becomes permanently restricted, it should be recorded in that class initially.

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	Unrestricted	Permanently Restricted	Total
Support and Revenue:			
Contributions	\$125,000	\$50,000	\$ 175,000
Other	<u>200,000</u>	<u>—</u>	<u>200,000</u>
Total	325,000	50,000	375,000
Less—Expenses (in total)	<u>(310,000)</u>	<u>—</u>	<u>(310,000)</u>
Change in net assets	<u>\$ 15,000</u>	<u>\$50,000</u>	<u>\$ 65,000</u>

(b) Pledges (Promises to Give)

A pledge is a promise to contribute to an organization.² Typically, fundraising organizations solicit pledges because a donor either does not want to or is not able to make a contribution in cash in the amount desired by the organization at the time solicited. In giving, as with consumer purchases, the “installment plan” is a way of life. Organizations find donors are more generous when the payments being contributed are smaller and spread out over a period of time. A pledge may or may not be legally enforceable. The point is largely moot because few organizations would think of trying to legally enforce a pledge. The unfavorable publicity that would result would only hurt future fundraising. The only relevant criteria are: Will the pledge be collected and are pledges material in amount? If these criteria are satisfied, then there are two accounting questions: Should a pledge be recorded as an asset at the time the pledge is received? If the answer is “yes,” the next question is: When should the pledge be recognized as income?

(i) Recording as an Asset. For many organizations, a significant portion of their income is received by pledge. The timing of the collection of pledges is only partially under the control of the organization. Yet over the years most organizations find they can predict with reasonable accuracy the collectible portion of pledges, even when a sizable percentage will not be collected. Accounting literature requires that unconditional pledges the organization expects to collect be recorded as assets and an allowance established for the portion that is estimated to be uncollectible.

(ii) Conditions versus Restrictions. The requirement in SFAS 116 is to record *unconditional* pledges as assets. Unconditional means without conditions. What is meant by conditions? FASB defines a condition as “a future and uncertain event” that must occur for a pledge to become binding on the pledgor. There are two elements to this definition: future and uncertain. Future means it has not happened yet; this is fairly clear.

² SFAS 116 uses the phrase “promise to give” to refer to what is more commonly called a pledge.

Uncertain is, however, more subject to interpretation. How uncertain? This will be a matter of judgment in many cases.

If a donor pledges to give to a charity “if the sun rises tomorrow,” that is not an uncertain event; the sun will rise tomorrow, at a known time. If a donor pledges to give \$10,000 to the Red Cross “if there’s an earthquake in California,” that is very uncertain (a geologist will say the eventual probability of an earthquake happening is 100 percent, but the timing is completely uncertain). This latter pledge would be conditional upon an earthquake occurring. Once an earthquake occurs, then the donor’s pledge is unconditional (the condition has been removed) and the pledge would be recorded by the Red Cross.

Another example of a condition is a matching pledge (also known as a challenge grant). A donor pledges to give an amount to a charity if the charity raises a matching amount from other sources. (The “match” need not be one for one; it can be in any ratio the donor specifies.) In this case, the charity is not entitled to receive the donor’s gift until it has met the required match. Once it does, it will notify the donor that the pledge is now due.

A third type of donor stipulation sounds like a condition, but it may or may not actually be one. A donor pledges to contribute to a symphony orchestra “if they will perform my favorite piece of music [specified by name].” Yes, this is an uncertain future event, since the piece of music has not yet been performed, but how uncertain is it? If the orchestra might very well have played the piece anyway, then the “condition” is really trivial, and the event would not be considered uncertain. However, if the piece were one that the orchestra would be very unlikely to perform without the incentive represented by the pledge in question, then the event would be considered uncertain, and the pledge conditional. In this case, the condition is fulfilled when the orchestra formally places the music on its schedule and so informs the donor.

Note that the concept of a condition is quite different from that of a restriction. Conditions deal with events that must occur before a charity is entitled to receive a gift. Restrictions limit how the charity can use the gift after receipt. Unconditional pledges can be either unrestricted or restricted; so can conditional pledges. Donor stipulations attached to a gift or pledge must be read carefully to discern which type of situation is being dealt with. For example, “I pledge \$20,000 *if* you play my favorite music” is conditional but unrestricted (the donor has not said the gift must be used to pay for the performance). Whereas “I pledge \$20,000 *for* [the cost of] playing my favorite piece of music” is restricted, but unconditional. In the latter case, the donor has said the pledge will be paid, but can only be used for that performance. The difference in wording is small, but the accounting implications are great. The conditional pledge

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is not recorded at all until the condition is met; the unconditional restricted pledge is recorded as revenue (in the temporarily restricted class) upon receipt of notification of the pledge. Appendix 8–E contains a checklist to help readers determine whether an unconditional pledge actually exists. Appendix 8–F contains a checklist to help distinguish conditions from restrictions. Exhibit 8.3 summarizes the accounting for contributions, depending whether they are restricted or conditional. Readers have noticed several areas where judgment is required to determine the proper accounting for current items. Exhibit 8.4 presents this thought process graphically.

(iii) Discounted to Present Value. SFAS 116 requires recipients (and donors) of pledges payable beyond the current accounting period to discount the pledges to their present value, using an appropriate rate of interest. Thus, the ability to receive \$1,000 two years later is really only equivalent to receiving about \$900 (assuming about a five percent rate of interest) now, because the \$900 could be invested and earn \$100 of interest over the two years. The higher the interest rate used, the lower will be the present value of the pledge, since the lower amount would earn more interest at the higher rate and still be worth the full \$1,000 two years hence. The appropriate rate of interest to use in discounting pledges is a risk-free rate of return. Additional guidance is in SFAS 116 and APB 21.

EXHIBIT 8.3

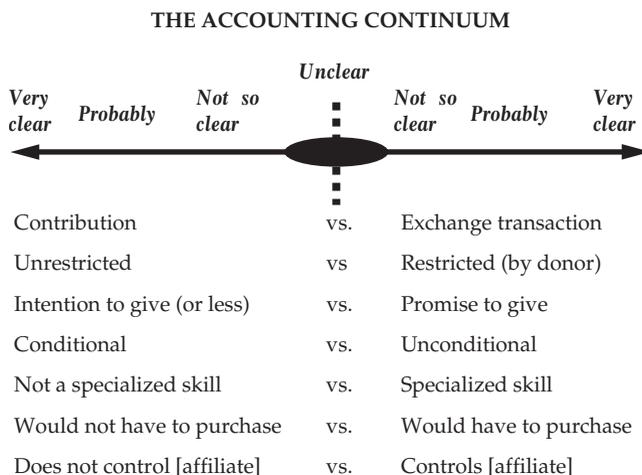
Restrictions versus Conditions

CONDITIONAL AND RESTRICTED CONTRIBUTIONS		
REVENUE RECOGNITION		
Gift is: →	Unrestricted	Restricted (expendable)
Unconditional	When assets transferred or promised	When assets transferred or promised
	Unrestricted class	Temporarily restricted class*
Conditional	When condition is substantially met	When condition is substantially met
	Unrestricted class	Temporarily restricted class*

*Reclassified to unrestricted when restriction is met or expires

EXHIBIT 8.4

Accounting Judgments



As the time passes between the initial recording of a discounted pledge and its eventual collection, the present value increases since the time left before payment is shorter. Therefore, the discount element must be gradually “accreted” up to par (collection) value. This accretion should be recorded each year until the due date for the pledge arrives. The accretion is recorded as contribution income. (This treatment differs from that specified in APB. 21 for business debts for which the accretion is recorded as interest income.)

(iv) Pledges for Extended Periods. There is one limitation to the general rule that pledges be recorded as assets. Occasionally, donors will indicate that they will make an open ended pledge of support for an extended period of time. For example, if a donor promises to pay \$5,000 a year for 20 years, would it be appropriate to record as an asset the full 20 years’ pledge? In most cases, no; this would distort the financial statements. Most organizations follow the practice of not recording pledges for future years’ support beyond a fairly short period. They feel that long-term open-ended pledges are inherently conditional upon the donor’s continued willingness to continue making payments, and thus are harder to collect. These arguments have validity, and organizations should consider very carefully the likelihood of collection before recording pledges for support in future periods beyond, say, five years.

(v) **Allowance for Uncollectible Pledges.** Not all pledges will be collected. People lose interest in an organization; their personal financial circumstances may change; they may move out of town. This is as true for charities as for businesses, but businesses will usually sue to collect unpaid debts; charities usually will not. Thus another important question is how large the allowance for uncollectible pledges should be. Most organizations have past experience to help answer this question. If over the years, 10 percent of pledges are not collected, then unless the economic climate changes, 10 percent is probably the right figure to use. Care must be taken, however, because while an organization's past experience may have been good, times do change—as many organizations have discovered to their sorrow. An organization should also consider their past experience with a particular donor, particularly with large pledges.

Another factor to consider is the purpose for which the pledge will be used. Some people will hesitate to default on a pledge for a worthwhile current year's project but may be less conscientious about a pledge for a building fund or a long-term project. SFAS 116 is silent about how to present the allowance in the financial statements. There is no question about the presentation in the balance sheet: It is an offset to the receivable amount. Thus, if the organization has outstanding pledges totaling \$75,000, and it estimates that 10 percent of that amount will be uncollectible, the allowance of \$7,500 is deducted from the \$75,000 and the net amount of \$67,500 is shown.

What is not clear in SFAS 116 is how to present the reduction in the amount recorded in the statement of income and expenses to reflect the fact that not all of the recorded revenue will actually ever become available to the organization. One obvious possibility is to reduce the reported revenue amount by the uncollectible percentage. Another is to report the full amount of the pledges as revenue and the uncollectible amount as an expense. Because expenses are deducted from revenue, either method of reporting results in the same net excess of revenue over expenses for the year. The audit guide for *Not-for-Profit Organizations* states the initial establishment of the allowance is deducted from revenue. Any increases subsequently required are reported as expenses or losses. However, according to a recent AICPA TPA, bad debt losses may not be netted against contribution revenues because losses are only permitted to be netted with gains, not revenue. Another point to keep in mind in setting up an allowance is that a pledgor who defaults on an installment once is likely to do so again. If the default brings no notice from the organization, the pledgor assumes the contribution is not really needed, and it will be easier to skip the next payment. So once a donor becomes delinquent on even a single installment, a 100 percent allowance for that total pledge, not just for the delinquent portion, should be considered. In addition, the organization should

review the amount of allowance needed for other nondelinquent pledges; once there are signs of delinquency, the overall collection assumptions may be in doubt. If so, the organization should be conservative and set up additional allowances.

(vi) Recognition as Income. The second, related question is: When should a pledge be recognized as income? The answer is easy: immediately upon receipt of an unconditional pledge. This is the same rule that applies to all kinds of gifts under SFAS 116. Conditional pledges are not recorded until the condition is met, at which time they are effectively unconditional pledges. Footnote disclosure of unrecorded conditional pledges should be made.

Under SFAS 116, all pledges are considered implicitly time-restricted, by virtue of their being unavailable for use until collected. Additionally, time-restricted gifts, including all pledges, are reported in the temporarily restricted class of net assets. They are then reclassified to the unrestricted class when the specified time arrives. This means that even a pledge not payable for five years, or a pledge payable in many installments is recorded as revenue in full (less the discount to present value) in the temporarily restricted class in the year the pledge is first received. Sometimes a charity may not want to have to record a large pledge as immediate revenue; it may feel that its balance sheet is already healthy and recording more income would turn off other donors. If a pledge is unconditional, there is no choice: The pledge must be recorded. One way to mitigate this problem is to ask the donor to make the pledge conditional; then it is not recorded until some later time when the condition is met. Of course, there is a risk that the donor may not be as likely ever to pay a conditional pledge as one that is understood to be absolutely binding, so not-for-profit organizations should consider carefully before requesting that a pledge be made conditional.

SFAS 116 requires that donors follow the same rules for recognition of the expense of making a gift as recipients do for the income—that is, immediately upon payment or of making an unconditional pledge. Sometimes a charity will find a donor reluctant to make a large unconditional pledge, but willing to make a conditional pledge. Fundraisers should be aware of the effect of the accounting principles in SFAS 116 on donors' giving habits, as well as on recipients' balance sheets.

(c) Bequests

A bequest is a special kind of pledge. It is the ultimate conditional pledge: a very uncertain future event must occur for it to become payable. Accordingly, bequests should never be recorded before the donor dies—not because death is uncertain, but because a person can always

change a will, and the charity may get nothing. (There is a special case: the pledge payable upon death. This is not really a bequest, it is just an ordinary pledge, and should be recorded as such if it is unconditional.) After a person dies, the beneficiary organization is informed that it is named in the will, but this notification may occur long before the estate is probated and distribution made. Should such a bequest be recorded at the time the organization first learns of the bequest or at the time of receipt? The question is one of sufficiency of assets in the estate to fulfill the bequest. Since there is often uncertainty about what other amounts may have to be paid to settle debts, taxes, other bequests, claims of disinherited relatives, and so on, a conservative, and recommended, approach is not to record anything until the probate court has accounted for the estate and the amount available for distribution can be accurately estimated. At that time, the amount should be recorded in the same manner as other gifts.

Thus, if an organization is informed that it will receive a bequest of a specific amount, say \$10,000, it should record this \$10,000 as an asset. If instead the organization is informed that it will receive 10 percent of the estate, the total of which is not known, nothing would be recorded yet although footnote disclosure would likely be necessary if the amount could be sizeable. Still a third possibility exists if the organization is told that while the final amount of the 10 percent bequest is not known, it will be at least some stated amount. In that instance, the minimum amount would be recorded and footnote disclosure made of the contingent interest.

(d) Split-Interest Gifts

Many not-for-profit organizations conduct deferred giving programs under which the ultimate receipt of all the benefits of a gift is deferred until some later date or event. These are often referred to as planned giving or estate planning, and by some organizations as stewardship programs. Such programs are designed to encourage giving through various arrangements which normally provide certain reciprocal benefits to the donor or other beneficiaries (life tenants) for a stated term or lifetime.

Because of complex legal implications involved in properly administering and accounting for these agreements, due care must be taken to understand and comply with federal and state laws, as well as with the specific provisions of the documents governing such transactions. For example, annuity programs are normally subject to approval and regulation by the insurance commissioner of the state in which the annuitant resides. Also, certain revocable loan (debt) instruments are subject to state securities regulations. Trusts provide binding legal and fiduciary obligations and, if specific requirements are met, may qualify the grantor for a

more advantageous charitable contribution deduction. Therefore, a committee should be established by the board (or an existing committee designated) to whom to assign the responsibility to establish policy and to monitor compliance with the aforementioned requirements in the administration of such giving programs. Management must also take the responsibility to establish and monitor internal controls over this area; auditors must review controls and test for proper recording of transactions.

Care should also be taken to ensure that all costs as well as benefits are considered in planning such programs, and that the programs meet the objectives of the board before they are implemented and before any such gifts are accepted. It is often difficult to measure the economic benefits of a deferred giving program because of its long-range nature; the ultimate benefit to the organization may not be known until many years in the future.

The term *split-interest gifts* is used to refer to irrevocable trusts and similar arrangements (also referred to as deferred gifts) where the interest in the gift is split between the donor (or another person specified by the donor) and the charity. These arrangements can be divided into two fundamentally different types of arrangements: lead interests and remainder interests. Lead interests are those in which the benefit to the charity “leads” or precedes the benefit to the donor (or other person designated by the donor). To put this into the terminology commonly used by trust lawyers, the charity is the “life tenant,” and someone else is the “remainderman.” The reverse situation is that of the “remainder” interest, where the donor (or the donor’s designee) is the life tenant and the charity is the remainderman—that is, the entity to which the assets become available upon termination (often called the *maturity*) of the trust or other arrangement. There may or may not be further restrictions on the charity’s use of the assets and/or the income therefrom after this maturity.

Under both types of arrangements the donor makes an initial lump-sum payment into a fund. The amount is invested, and the income during the term of the arrangement is paid to the life tenant. In some cases, the arrangement is established as a trust under the trust laws of the applicable state. In other cases, no separate trust is involved; rather, the assets are held by the charity as part of its general assets. In some cases involving trusts, the charity is the trustee; in other cases, a third party is the trustee. Typical third-party trustees include banks and trust companies or other charities such as community foundations. Some arrangements are perpetual—that is, the charity never gains access to the corpus of the gift—while others have a defined term of existence that will end either upon the occurrence of a specified event such as the death of the donor (or other specified person) or after the passage of a specified amount of time.

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To summarize to this point, the various defining criteria applicable to these arrangements are that:

- The charity's interest may be a lead interest or a remainder interest.
- The arrangement may be in the form of a trust or it may not.
- The assets may be held by the charity or held by a third party.
- The arrangement may be perpetual or it may have a defined term.
- Upon termination of the interest of the life tenant, the corpus may be unrestricted or restricted.

Split-interest gifts are discussed in detail in Chapter 6 of *Not-for-Profit Organizations*.

(i) **Lead Interests.** There are two kinds of such arrangements as normally conceived.³ These are:

1. Charitable lead trust
2. Perpetual trust held by a third party

In both of these cases, the charity receives periodic payments representing distributions of income, but never gains unrestricted use of the assets which produce the income. In the first case, the payment stream is for a limited time; in case two, the payment stream is perpetual. A charitable lead trust is always for a defined term, and usually held by the charity. At the termination of the trust, the corpus (principal of the gift) reverts to the donor or to another person specified by the donor (may be the donor's estate). Income during the term of the trust is paid to the charity; the income may be unrestricted or restricted. In effect, this arrangement amounts to an unconditional pledge, for a specified period, of the income from a specified amount of assets. The current value of the pledge is the discounted present value of the estimated stream of income over the term of the trust. Although the charity manages the assets during the term of the trust, it has no remainder interest in the assets. A perpetual trust held by a third party is the same as the lead trust, except that the charity does not manage the assets, and the term of the trust is perpetual. Again the charity receives the income earned by the assets, but never gains the use of the corpus. In effect there is no remainderman. This arrangement is also a pledge of income, but in this case the current value of the pledge is the discounted present value of a perpetual stream of income from the assets. Assuming a perfect market for investment securities, that amount will equal the current quoted market value of the assets of the trust or, if there is no quoted market value, then the "fair

³ It is also possible to consider both a simple pledge and a permanent endowment fund as forms of lead interests. In both cases, the charity receives periodic payments, but never gains unrestricted use of the assets which generate the income to make the payments. A pledge is for a limited time; an endowment fund pays forever.

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value,” which is normally determined based on discounted future cash flows from the assets.

Some may argue that since the charity does not and never will have day-to-day control over the corpus of this type of trust, it should only record assets and income as the periodic distributions are received from the trustee. This argument is overcome by the requirement in SFAS 116 that long-term unconditional pledges be recorded in full (discounted) when the pledge is initially received by the pledgee. Since SFAS 116 requires that the charity immediately record the full (discounted) amount of a traditional pledge, when all the charity has is a promise of future gifts, with the pledgor retaining control over the means to generate the gifts, then the charity surely must record immediately the entire amount (discounted) of a “pledge” where the assets that will generate the periodic payments are held in trust by a third party, and receipt of the payments by the charity is virtually assured. Thus, assuming a trust with assets \$1,000,000, earning five percent (\$50,000) per year, the charity will record \$1,000,000 as revenue (in the permanently restricted class) in the year the trust is established. The charity will also record the \$50,000 it receives each year, as investment income. This will have the effect of making the charity look better off financially than it did in the past. Fundraisers must be prepared to respond to the donor’s concerns over this apparent wealth. Recording the trust in this way is appropriate, however, since the arrangement is essentially equivalent to a gift directly to the charity of \$1,000,000 of permanent endowment. In both cases the charity will receive \$50,000 of spendable income forever, but has no ability to use the principal of the gift.

A variation of this type of arrangement is a trust held by a third party in which the third party has discretion as to when and/or to whom to pay the periodic income. Since in this case the charity is not assured in advance of receiving any determinable amount, no amounts should be recorded by the charity until distributions are received from the trustee; these amounts are then recorded as contributions.

(ii) Remainder Interests. There are four types of these arrangements. These are:

1. Charitable remainder annuity trust
2. Charitable remainder unitrust
3. Charitable gift annuity
4. Pooled income fund (also referred to as a life income fund)

These arrangements are always for a limited term, usually the life of the donor and/or another person or persons specified by the donor (often the donor’s spouse). The donor or the donor’s designee is the life

tenant; the charity is the remainderman. Again, in the case of a trust, the charity may or may not be the trustee; in the case of a charitable gift annuity, the charity usually is the holder of the assets. Upon termination of the arrangement, the corpus usually becomes available to the charity; the donor may or may not have placed further temporary or permanent restrictions on the corpus and/or the future income earned by the corpus. In many states, the acceptance of these types of gifts is regulated by the state government—often the department of insurance—since, from the perspective of the donor, these arrangements are partly insurance contracts, essentially similar to a commercial annuity.

A *charitable remainder annuity trust* (CRAT) and *charitable remainder unitrust* (CRUT) differ only in the stipulated method of calculating the payments to the life tenant. An annuity trust pays a stated dollar amount that remains fixed over the life of the trust; a unitrust pays a stated percentage of the then current value of the trust assets. Thus, the dollar amount of the payments will vary with changes in market value of the corpus. Accounting for the two types is the same except for the method of calculation of the amount of the present value of the life interest payable to the life tenant(s). In both cases, if current investment income is insufficient to cover the stipulated payments, corpus may have to be invaded to do so; however, the liability to the life tenant is limited to the assets of the trust.

A *charitable gift annuity* (CGA) differs from a CRAT only in that there is no trust; the assets are usually held among the general assets of the charity (some charities choose to set aside a pool of assets in a separate fund to cover annuity liabilities), and the annuity liability is a general liability of the charity, limited only by the charity's total assets. A *pooled income fund* (PIF, also sometimes called a life income fund) is actually a creation of the Internal Revenue Code (IRC) § 642(c)(5), which, together with IRC § 170, allows an income tax deduction to donors to such funds. (The amount of the deduction depends on the age[s] of the life tenant[s] and the value of the life interest and is less than that allowed for a simple charitable deduction directly to a charity, to reflect the value the life tenant will be receiving in return for the gift.) The fund is usually managed by the charity. Many donors contribute to such a fund, which pools the gifts and invests the assets. During the period of each life tenant's interest in the fund, the life tenant is paid the actual income earned by that person's share of the corpus. (To this extent, these funds function essentially as mutual funds.) Upon termination of a life interest, the share of the corpus attributable to that life tenant becomes available to the charity.

(iii) **Accounting for Split-Interest Gifts.** The essence of these arrangements is that they are pledges. In some cases, the pledge is of a stream of payments to the charity during the life of the arrangement (lead interests).

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In other cases, the pledge is of the value of the remainder interest. Calculation of the value of a lead interest is usually straightforward, as the term and the payments are well defined. Calculation of remainder interests is more complicated, since life expectancies are usually involved and the services of an actuary will likely be needed.

SFAS 116 gives very little guidance specific to split-interests, however, *Not-for-Profit Organizations* includes more definitive guidance in Chapter 6, which should be consulted for details including discount rates to be used in the valuation calculation. Additionally, certain split interest agreements may contain embedded derivatives if they are established as annuities for a period certain. See Section 8(l) of this chapter for more information.

(iv) Other Deferred Gifts: Life Insurance. Donors may use whole-life insurance policies in various ways to make gifts to an organization. The simplest is to name the organization the beneficiary of a policy where the ownership is retained by the donor, and to pledge to continue the premium payments. The present value of this pledge, which should be recorded in the usual way, is the face value of the policy discounted from the actuarially expected payment date, less any allowance for uncollectible pledges that is considered appropriate. Other forms of life insurance gifts involve transferring ownership of a policy to the organization. If the policy is fully paid up, the value is equivalent to the face value, discounted as in the preceding paragraph. The *cash surrender value* (CSV) will approximate this amount. If the policy requires premiums still to be paid, either the donor may pledge to pay them or the donor may indicate that any future premiums are the responsibility of the organization. If the donor promises to pay the premiums, the value of the pledge is the same discounted value as above. If the organization is to pay the premiums, the initial value is the CSV at the date of gift. As future premiums are paid, the CSV increases.

APPENDIX 8–A

Checklist: Factors to Be Considered in Deciding Whether a Particular Gift (for Operating Purposes) Should Be Classified as Purpose-Restricted or Not

The following list of factors is to be considered by:

- *Not-for-profit organizations*, in deciding how to classify operating gifts
- *Auditors*, in assessing the appropriateness of the client’s decision

In some cases, no one of these factors will be determinative by itself; all applicable factors should be considered together. These factors are intended to facilitate consideration of the appropriate classification of operating gifts that may be purpose-restricted. This list is not intended to deal with how to account for gifts, nor with questions regarding time-restricted gifts or nonoperating gifts, although some factors may be helpful in those areas.

Factors whose presence in the grant document, donor’s transmittal letter, or other gift instrument, or in the appeal by the recipient, would indicate the gift is purpose-restricted	Factors whose presence would indicate the gift may not be purpose-restricted
<ol style="list-style-type: none"> 1. The purpose of the gift is very specifically set forth.¹ (This factor, if judged to be present, would normally be considered determinative.) 2. The donor expects a detailed report of how the gift was used. 3. Refund to the donor of any unspent amount is specifically called for. 4. The recipient would likely not have conducted the activity at all, or to the same extent, in the absence of the gift. 5. The donor specifies that the gift can only be used to expand existing activity. 6. The terms of the gift are set forth in a formal written document. 7. The activities funded by the gift are similar to the activities funded by previous gifts from the same donor, where the previous gifts were clearly restricted. 8. The expressed intention of the recipient in soliciting the gift was to solicit restricted gifts. 	<p>The purpose is described in general or vague terms.</p> <p>No special reporting to the donor is expected.</p> <p>No mention is made of the disposition of any unspent amount.</p> <p>The recipient would likely have conducted the activity anyway.</p> <p>Factor not present.</p> <p>The terms are set forth only orally or informally.</p> <p>The solicitation was silent as to the use of the gift or described the use in general terms.</p>

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Factors whose presence in the grant document, donor’s transmittal letter, or other gift instrument, or in the appeal by the recipient, would indicate the gift is purpose-restricted	Factors whose presence would indicate the gift may not be purpose-restricted
<p>9. In describing the purpose of the gift, solicitation or the gift instrument includes words such as:</p> <ul style="list-style-type: none"> restricted must; will only expect certain promise; agree 	<p>These documents include words such as:</p> <ul style="list-style-type: none"> general; operating should any; if intend; hope several plan
<p>10. Based on the overall tone of the language describing the gift, it can reasonably be inferred that the donor’s expectation is that the gift is restricted. (See other factors.)</p>	<p>The overall tone does not lead to such an inference.</p>
<p>11. For management control and reporting purposes, the recipient is divided into operating units to conduct different programs;² the gift is explicitly directed to one of those units.</p>	<p>Factor not present.</p>
<p>12. The terms of the gift include non-programmatic “compliance” -type requirements (often found with government grants).³</p>	<p>Factor not present.</p>

¹ The purpose may be described in various ways. Examples include:

- Geographic location (e.g., a city, neighborhood, etc.)
- Population to be served or otherwise benefit (e.g., the visually handicapped, children)
- Anticipated outcome of the activity (e.g., reduction in teenage pregnancy, performance of a certain opera)
- Precise use of the particular gift (e.g., to pay the salary of a suicide counselor, to repair a bloodmobile)

² Examples include:

- An organization serving handicapped children runs a daycare center and a summer camp.
- A university has a law school and a medical school.
- A symphony orchestra has a separate department that operates a youth orchestra.

³ Examples include compliance with regulations governing:

- Purchasing and hiring
- Affirmative action and civil rights
- Lobbying and political activity
- Drug-free workplace
- Cash management
- Allowable costs and overhead rates
- Subgrants
- Fixed assets
- Audits and financial reports

APPENDIX 8–B

Checklist: Factors to Be Considered in Distinguishing Contracts for the Purchase of Goods or Services from Restricted Grants

The following is a list of factors that may be helpful to:

- *Not-for-profit organizations*, in deciding how to account for the receipt of payments that might be considered as being either for the purchase of goods or services from the organization, or as restricted-purpose gifts or grants to the organization (as contemplated in paragraph. 3 of SFAS 116)
- *Auditors*, in assessing the reasonableness of the client’s decision

Additional discussion of this distinction can be found in the instructions to IRS Form 990, lines 1a–c; and in IRS Regulation 1.509(a)–3(g). No one of these factors is normally determinative by itself; all relevant factors should be considered together.

Factors whose presence would indicate the payment is for the purchase of goods or services	Factors which would indicate the payment is a gift
<i>Factors related to the agreement between the payor and the payee</i>	
1. The expressed intent is for the payee to provide goods/services to the payor, or to other specifically identified recipients, as determined by the payor.	The expressed intent is to make a gift to the payee to advance the programs of the payee.
2. There is a specified time and/or place for delivery of goods/services to the payor, or other recipient.	Time and/or place of delivery of any goods/services is largely at the discretion of the payee.
3. There are provisions for economic penalties, beyond the amount of the payment, against the payee for failure to meet the terms of the agreement.	Any penalties are expressed in terms of required delivery of goods/services, or are limited to return of unspent amounts.
4. The amount of the payment per unit is computed in a way that explicitly provides for a “profit” margin for the payee.	The payment is stated as a flat amount, or a fixed amount per unit based only on the cost (including overhead) of providing the goods/service.
5. The total amount of the payment is based only on the quantity of items delivered.	The payment is based on a line-item budget request, including an allowance for actual administrative costs.
6. The tenor of the agreement is that the payor receives approximately equivalent value in return for the payment.	The payor does not receive approximately equivalent value.
<i>Factors related to the goods/services (items) covered by the payment</i>	
7. The items are closely related to commercial activity regularly engaged in by the payor.	The items are related to the payee’s program services.

APPENDIX 8-B

Factors whose presence would indicate the payment is for the purchase of goods or services	Factors which would indicate the payment is a gift
<p>8. There is substantial benefit to the payor itself from the items.</p>	<p>The items are normally used to provide goods/services considered of social benefit to society as a whole, or to some defined segment thereof (e.g., children, persons having a disease, students) which might not otherwise have ready access to the items.</p>
<p>9. If the payor is a governmental unit, the items are things the government itself has explicitly undertaken to provide to its citizens; the government has arranged for another organization to be the actual service provider.</p>	<p>The government is in the role of subsidizing provision of services to the public by a non-governmental organization.</p>
<p>10. The benefits resulting from the items are to be made available only to the payor, or to persons or entities designated by the payor.</p>	<p>The items, or the results of the activities funded by the payment, are to be made available to the general public, or to any person who requests and is qualified to receive them. Determination of specific recipients is made by the payee.</p>
<p>11. The items are to be delivered to the payor, or to other persons or entities closely connected with the payor.</p>	<p>Delivery is to be made to persons or entities not closely connected to the payor.</p>
<p>12. Revenue from sale of the items is considered unrelated business income (IRC Sec. 512) to the payee.</p>	<p>Revenue is “related” income to the payee.</p>
<p>13. In the case of sponsored research, the payor determines the plan of research and the desired outcome, and retains proprietary rights to the results.</p>	<p>The research plan is determined by the payee; desired outcomes are expressed only in general terms (e.g., to find a cure for a disease), and the rights to the results remain with payee or are considered in the public domain.</p>
<p>14. The payment supports applied research.</p>	<p>The payment supports basic research.</p>

APPENDIX 8–C

Checklist: Factors to Be Considered in Assessing Whether Contributed Services Are Considered to Require Specialized Skills (per Paragraph 9 of SFAS 116, “Accounting for Contributions Received ...”)

The following is a list of factors that may be helpful to:

- *Recipients of contributed services of volunteers*, in assessing whether the skills utilized by the volunteers in the performance of their services are considered to be “specialized” within the meaning of Paragraph 9 of SFAS 116
- *Auditors*, in assessing the appropriateness of the client’s judgment

This list of factors is not intended to be used in determining how to value or account for such services. In some cases, no single factor is necessarily determinative by itself; all relevant factors should be considered together.

FACTORS WHOSE PRESENCE IS OFTEN INDICATIVE THAT SKILLS ARE “SPECIALIZED”

1. Persons who regularly hold themselves out to the public as qualified practitioners of such skills are required by law or by professional ethical standards to possess a license or other professional certification, or specified academic credentials. Alternatively, if possession of such license/certification/credentials is optional, the person performing the services does possess such formal certification.
2. Practitioners of such skills are required, by law or professional ethics, to have obtained a specified amount of technical pre-job or on-the-job training, to obtain specified amounts of continuing professional education, a specified amount of practical work experience, or to complete a defined period of apprenticeship in the particular type of work.
3. Proper practice of the skills requires the individual to possess specific artistic or creative talent and/or a body of technical knowledge not generally possessed by members of the public at large.
4. Practice of the skills requires the use of technical tools or equipment. The ability to properly use such tools or equipment requires training or experience not generally possessed by members of the public at large.
5. There is a union or professional association whose membership consists specifically of practitioners of the skills, as opposed to such groups whose members consist of persons who work in a broad industry, a type of company, or a department of a company.

APPENDIX 8-C

Admission to membership in such organization requires demonstrating one or more of the factors 1, 2, or 3, above. (Whether or not the person whose skills are being considered actually belongs to such organization is not a factor in assessing whether the skills are considered to be specialized; it may be relevant in assessing whether the person possesses the skills.)

6. Practitioners of such skills are generally regarded by the public as being members of a particular "profession."
7. There is a formal disciplinary procedure administered by a government or by a professional association, to which practitioners of such skills are subject, as a condition of offering their skills to the public for pay.
8. Practice of the skills by persons who do so in their regular work is ordinarily done in an environment in which there is regular formal review or approval of work done by supervisory personnel or by professional peers.

APPENDIX 8–D

Checklist: Factors to Be Considered in Determining Whether or Not an Organization Would Typically Need to Purchase Services if Not Provided by Donation

The following is a list of factors that may be helpful to:

- *Not-for-profit organizations*, in deciding whether or not contributed services meet the third part of the criterion in paragraph 9b of SFAS 116
- *Auditors*, in assessing the reasonableness of the client’s decision

No one of these factors is normally determinative by itself; all relevant factors and the strength of their presence should be considered together.

Factors whose presence would indicate the services would typically need to be purchased	Factors whose presence would indicate the services would typically not need to be purchased
<ol style="list-style-type: none"> 1. The activities in which the volunteers are involved are an integral part of the reporting organization’s ongoing program services (as stated in its IRS Form 1023/4, fundraising material, and annual report), or of management or fundraising activities that are essential to the functioning of the organization’s programs. 2. Volunteer work makes up a significant portion of the total effort expended in the program activity in which the volunteers are used. 3. The program activity in which the volunteers function is a significant part of the overall program activities of the organization. 4. The reporting organization has an objective basis for assigning a value to the services. 5. The organization has formal agreements with third parties to provide the program services that are conducted by the volunteers. 6. The reporting organization assigns volunteers to specific duties. 7. The volunteers are subject to ongoing supervision and review of their work by the reporting organization. 	<p>The activities are not part of the reporting organization’s program, or of important management or fundraising activities, or are relatively incidental to those activities; the services primarily benefit the program activities of another organization.</p> <p>Volunteer work is a relatively small part of the total effort of the program.</p> <p>The program activity is relatively insignificant in relation to the organization’s overall program activities.</p> <p>No objective basis is readily available.</p> <p>Factor not present.</p> <p>Assignment of specific duties to volunteers is done by persons or entities other than the reporting organization, or the volunteers largely determine for themselves what is to be done within broad guidelines.</p> <p>The activities of the volunteers are conducted at geographic locations distant from the organization, or factor otherwise not present.</p>

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Factors whose presence would indicate the services would typically need to be purchased	Factors whose presence would indicate the services would typically not need to be purchased
<p>8. The organization actively recruits volunteers for specific tasks.</p>	<p>Volunteers are accepted but not actively recruited, or, if recruited, specific tasks are not mentioned in the recruiting materials.</p>
<p>9. If the work of the volunteers consists of creating or enhancing nonfinancial assets, the assets will be owned and/or used primarily by or under the control of the reporting organization after the volunteer work is completed. If the assets are subsequently given away by the organization to charitable beneficiaries, the organization decides who is to receive the assets.</p>	<p>The assets will immediately be owned or used primarily by other persons or organizations.</p>
<p>10. If there <i>were</i> to be a net increase in net assets resulting from the recording of a value for the services (even though in practice, there usually is not), the increase would better meet the criteria for presentation as revenue, rather than a gain, as set forth in SFAC No. 6, paragraphs 78–79, 82–88, and 111–113.</p>	<p>The net increase would better meet the criteria of a gain, rather than revenue.</p>
<p>11. Management represents to the auditor that it would hire paid staff to perform the services if volunteers were not available.*</p>	<p>Management represents that it would not hire paid staff, or it is obvious from the financial condition of the organization that it is unlikely that financial resources would be available to pay for the services.</p>
<p><i>Factors particularly relevant in situations where the volunteer services are provided directly to charitable or other beneficiaries of the reporting organization's program services (e.g., Legal Aid society), rather than to the organization itself</i></p>	
<p>12. The reporting organization assumes responsibility for the volunteers with regard to workers' compensation and liability insurance, errors or omissions in the work, satisfactory completion of the work.</p>	<p>The organization has explicitly disclaimed such responsibility.</p>
<p>13. The reporting organization maintains ongoing involvement with the activities of the volunteers.</p>	<p>The organization functions mainly as a clearinghouse for putting volunteers in touch with persons or other organizations needing help, but has little ongoing involvement.</p>

*Auditors are reminded that management representations alone, do not normally constitute sufficient competent evidential matter to support audit assertions; however, they may be considered in conjunction with other evidence.

APPENDIX 8–E

Checklist: Factors to Be Considered in Assessing Whether a Donor Has Made a Bona Fide Pledge to a Donee

The following is a list of factors that may be helpful to:

- *Donees*, in assessing whether a pledge (unconditional promise to give—as contemplated in paragraphs 5–7, 22, and 23 of SFAS 116) has, in fact, been made
- *Auditors*, in assessing the appropriateness of the client’s judgment

This list of factors is not intended to be used in deciding on proper accounting (for either the pledge asset or the related revenue/net assets) or to assess collectibility, although some of the factors may be relevant to those decisions as well. In many cases, no single factor is necessarily determinative by itself; all relevant factors should be considered together.

Factors whose presence may indicate a bona fide pledge was made	Factors whose presence may indicate a bona fide pledge was not made
<i>Factors related to the solicitation process</i>	
<ol style="list-style-type: none"> 1. There is evidence that the recipient explicitly solicited formal pledges. 2. Public announcement¹ of the pledge has been made (by donor or donee). 3. Partial payment on the pledge has been made (or full payment after Balance Sheet date). 	<p>The “pledge” was unsolicited, or the solicitation did not refer to pledges.</p> <p>No public announcement has been made.</p> <p>No payments have yet been made, or payments have been irregular, late, or less than scheduled amounts.</p>
<i>Factors related to the “pledge” itself</i>	
<ol style="list-style-type: none"> 4. There is written evidence created by the donor that clearly supports the existence of an unconditional promise to give. (This factor, if present, would normally be considered determinative.) 5. The evidence includes words such as: <ul style="list-style-type: none"> promise agree will binding; legal 6. The pledge appears to be legally enforceable. (Consult an attorney if necessary.) (Note also factor 13.) 7. There is a clearly defined payment schedule, stated in terms of either calendar dates or the occurrence of specified events whose occurrence is reasonably probable. 	<p>There is no written evidence,² the only written evidence was prepared by the donee, or written evidence is unclear.</p> <p>There is written evidence, but it includes such words as:</p> <ul style="list-style-type: none"> intend; plan hope may; if expected <p>Legal enforceability is questionable, or explicitly denied.</p> <p>A payment schedule is not clearly defined, or events are relatively unlikely to occur.</p>

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Factors whose presence may indicate a bona fide pledge was made	Factors whose presence may indicate a bona fide pledge was not made
<p>8. The calendar dates or events comprising the payment schedule will (are expected to) occur within a relatively short time³ after the Balance Sheet date (or in the case of events, have already occurred).</p> <p>9. The amount of the pledge is clearly specified or readily computable.</p> <p>10. The donor has clearly specified a particular purpose for the gift—e.g., endowment, fixed assets, loan fund, retire long-term debt, specific program service. The purpose is consistent with ongoing donee activities.</p>	<p>The time (period) of payment contemplated by the donor is relatively far in the future.</p> <p>The amount is not clear or readily computable.</p> <p>The purpose is vaguely stated or not specified, or is inconsistent with donee activities.</p>

Factors relating to the donor

11. There is no reason to question the donor's ability or intent to fulfill the pledge.	Collectibility of the gift is questionable.
12. The donor has a history of making and fulfilling pledges to the donee of similar or larger amounts.	Factor not present.

Factors relating to the donee

13. The donee has indicated that it would take legal action to enforce collection if necessary, or has a history of doing so.	It is unlikely (based on donee's past practices) or uncertain whether the donee would enforce the "pledge."
14. The donee has already taken specific action in reliance on the pledge or publicly ¹ announced that it intends to do so. ⁴	No specific action has been taken or is contemplated.

¹ The announcement would not necessarily have to be made to the general public; announcement in media circulated among the constituency of either the donor or donee would suffice. Examples include newsletters, fundraising reports, annual reports, a campus newspaper, and so on. In the case of announcements by the donee, there should be a reasonable presumption that the donor is aware of the announcement and has not indicated any disagreement with it.

² Oral pledges can be considered bona fide under some circumstances. In the case of oral pledges, much greater weight will have to be given to other factors if the existence of a bona fide pledge is to be asserted. Also, the auditor will have to carefully consider what audit evidence can be relied on.

³ What constitutes a relatively short time has to be determined in each case. The longer the time contemplated, the more weight will have to be given to other factors (especially 5, 6, 11, and 13) in assessing the existence of a pledge. In most circumstances, periods longer than 3 to 5 years would likely be judged relatively long.

⁴ Types of specific action contemplated include:

- Commencing acquisition, construction, or lease of capital assets or signing binding contracts to do so
- Making public announcement of the commencement or expansion of operating programs used by the public (e.g., the opening of a new clinic, starting a new concert series, a special museum exhibit)
- Indicating to another funder that the pledge will be used to match part of a challenge grant from that funder
- Soliciting other pledges or loans for the same purpose by explicitly indicating that "x has already pledged"
- Committing proceeds of the pledge in other ways such as awarding scholarships, making pledges to other charities, hiring new staff, etc (where such uses are consistent with either the donee's stated purposes in soliciting the pledge or the donor's indicated use of the pledge)
- Forbearing from soliciting other available major gifts (e.g., not submitting an application for a foundation grant) because, with the pledge in question, funding for the purpose is considered complete
- Using pledge as collateral for a loan

APPENDIX 8–F

Checklist: Factors to Be Considered in Deciding Whether a Gift or Pledge Subject to Donor Stipulations Is Conditional or Restricted (as Discussed in SFAS 116, Paragraphs 7, 22–23, 57–71, and 75–81)

Donors place many different kinds of stipulations on pledges and other gifts. Some stipulations create legal *restrictions* that limit the way in which the donee may use the gift. Other stipulations create *conditions* which must be fulfilled before a donee is entitled to receive (or keep) a gift.

In SFAS 116, the FASB defines a condition as an uncertain future event that must occur before a promise based on that event becomes binding on the promisor. In some cases, it is not immediately clear whether a particular stipulation creates a condition or a restriction. (Some gifts are both conditional and restricted.) Accounting for the two forms of gift is quite different, so it is important that the nature of a stipulation be properly identified so that the gift is properly categorized. Following is a list of factors to be considered by:

- *Recipients (and donors) of gifts*, in deciding whether a pledge or other gift that includes donor stipulations is conditional or restricted
- *Auditors*, in assessing the appropriateness of the client’s decision

In many cases, no one of these factors will be determinative by itself; all applicable factors should be considered together.

Factors whose presence in the communication from the donor or the donee-prepared pledge card would indicate the gift may be conditional

Factors whose presence in the grant document, donor’s transmittal letter, or other gift instrument, or in the appeal by the recipient would indicate the gift may be restricted

Factors related to the terms of the gift/pledge

1. The document uses words such as:
 If*
 Subject to*
 When
 Revocable*
2. Neither the ultimate amount nor the timing of payment of the gift are clearly determinable in advance of payment.
3. The pledge is stated to extend for a very long period of time (over, say, 10 years) or is open-ended. (Often found with pledges to support a needy child overseas, or a missionary in the field.)

- The document uses words such as:
- Must
 - For
 - Purpose
 - Irrevocable
- At least one of the amount and/or timing are clearly specified.
- The time is short and/or specific as to its end.

APPENDIX 8-F

Factors whose presence in the communication from the donor or the donee-prepared pledge card would indicate the gift may be conditional	Factors whose presence in the grant document, donor's transmittal letter, or other gift instrument, or in the appeal by the recipient would indicate the gift may be restricted
<p>4. The donor stipulations in the document refer to <i>outcomes</i> expected as a result of the activity (with the implication that if the outcomes are not achieved, the donor will expect the gift to be refunded, or will cancel future installments of a multi-period pledge)^{1a*} (Such gifts are likely also restricted.)</p> <p>5. There is an explicit requirement that amounts not expensed by a specified date must be returned to the donor.</p> <p>6. The gift is in the form of a pledge.</p> <p>7. Payment of amounts pledged will be made only on a cost-reimbursement basis.(D)</p> <p>8. The gift has an explicit matching requirement (D), or additional funding beyond that already available will be required to complete the activity.</p>	<p>The donor stipulations focus on the <i>activities</i> to be conducted. Although hoped-for outcomes may be implicit or explicit, there is not an implication that achievement of particular outcomes is a requirement.^{1b*}</p> <p>There is no such refund provision, or any refund is required only if money is left after completion of the specified activities.</p> <p>The gift is a transfer of cash or other noncash assets.</p> <p>Payment of the gift will be made up-front, or according to a payment schedule, without the necessity for the donee to have yet incurred specific expenses.</p> <p>Factor not present.</p>
<i>Factors relating to the circumstances surrounding the gift</i>	
<p>9. The action or event described in the donor's stipulations is largely outside the control of the management or governing board of the donee.^{2a*}</p> <p>10. The activity contemplated by the gift is one which the donee has not yet decided to do, and it is not yet certain whether the activity will actually be conducted.*</p> <p>11. There is a lower probability that the donor stipulations will eventually be met.</p> <p>12. The activities to be conducted with the gift money are similar to activities normally conducted on a for-profit basis by the donee or by other organizations.</p> <p>13. As to any tangible or intangible outcomes which are to be produced as a result of the activities, these products will be under the control of the donor. (In such cases, the payment may not be a gift at all; rather, it may be a payment for goods or services.)</p>	<p>The action or event is largely within the donee's control.^{2b*}</p> <p>The donee is already conducting the activity, or it is fairly certain that the activity will be conducted.*</p> <p>There is a higher probability.</p> <p>The activities are not similar.</p> <p>Any outcomes will be under the control of the donee.</p>

D: Presence of this factor would normally be considered determinative. Absence of the factor is not necessarily determinative.

* Factors which would generally be considered more important.

(continued)

CONTRIBUTIONS, PLEDGES, AND NONCASH CONTRIBUTIONS

(continued)

^{1a} Examples of outcomes contemplated by this factor include:

- Successful creation of a new vaccine
- Production of a new television program
- Commissioning a new musical composition
- Establishing a named professorship
- Reduction in the teenage pregnancy rate in a community
- Construction of a new building
- Mounting a new museum exhibit

^{1b} Examples of activities contemplated by this factor include (but see Factor 10†):

- Conduct of scientific or medical research
- Broadcasting a specified television program
- Performing a particular piece of music
- Paying the salary of a named professor
- Counseling teenagers judged at risk of becoming pregnant
- Operating a certain facility
- Providing disaster relief

^{2a} Examples of events contemplated by this factor include:

- Actions of uncontrolled third parties, e.g.:
- Other donors making contributions to enable the donee to meet a matching requirement of this gift
- A government granting approval to conduct an activity (e.g., awarding a building or land use permit, or a permit to operate a medical facility)
- An owner of other property required for the activity making the property available to the organization (by sale or lease)
- Natural and manmade disasters
- Future action of this donor (such as agreeing to renew a multi-period pledge in subsequent periods)
- The future willingness and ability of a donor of personal services to continue to provide those services (see SFAS No. 116, par. 70, third sentence)

(Events outside of the donee's control, but which are virtually assured of happening anyway at a known time and place—e.g., astronomical or normal meteorological events—and the mere passage of time, are not conditions.)

^{2b} Examples of events contemplated by this factor include (but see Factor 10†):

- Eventual use of the gift for the specified purpose (e.g., those listed in Note 1b above) or retention of the gift as restricted endowment
- Naming a building for a specified person
- Filing with the donor routine performance reports on the activities being conducted

† There is a presumption here that the right column of Factor 10 applies.

CHAPTER NINE

Accounting Issues Relating to Fundraising¹

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Accounting is important to fundraising for a variety of reasons. First, the results of fundraising—gifts—are reported in donees’ (and sometimes in donors’) financial reports. Second, those reports are used by many donors to help decide on whether and how much to give, as well as by regulators and evaluation agencies to assess the performance of donees. Third, federal tax rules restrict to some extent what donors and donees can do.

Donors as well as donees should always be aware of the accounting, reporting, and tax rules affecting their activities. Donees will raise more money if they consider donors’ concerns. Donors will have their gifts used more effectively if they structure the gifts with donees’ constraints in mind. Both groups will more greatly benefit society if tax rules are observed.

¹ Adapted with permission from “Accounting Issues Relating to Fundraising” in *Financial Practices for Effective Fundraising*, J. M. Greenfield (ed.), pp. 27–48 (San Francisco: Jossey-Bass, 1994). Copyright © 1994 by Jossey-Bass, Inc., updated to 1999.

9.1 ACCOUNTING FOR GIFTS

The accounting issues related to gifts are whether to record certain types, when to record the asset and the revenue, how to record gifts, and how to show them in the financial statements. These issues are discussed here under the topics of pledges, revenue, restricted gifts, split interest gifts, noncash gifts, donor tax deductions, pass-through gifts, and donor accounting. Relevant tax rules are noted. SFAS 116 and 117 provide accounting guidance for gifts and certain other matters related to not-for-profit entities discussed in Chapter 8.

(a) Pledges

A pledge is a promise to give in the future. The pledge may be unconditional (that is, dependent only on the passage of time to become due) or conditional (that is, dependent on some future event or events, other than the passage of time, to become binding on the donor). Examples of conditions are raising of a specified “matching” amount, occurrence of a natural disaster such as an earthquake, and approval by a regulatory agency for a donee to proceed with some program activity. Conditional pledges are not recorded by either the donor or donee until the condition is met. Footnote disclosure of such pledges should be made. Unconditional pledges are recorded as assets (liabilities by the donor) when evidence of a binding promise is given the donee. The assets are recorded by the donee at their estimated realizable value, which is net of an allowance for estimated uncollectible pledges. The amount of the allowance is normally based on historical experience. Pledges payable over a long period should be discounted to reflect the time value of money, with accretion of the discount being recorded as contributions income.

SFAS 116 requires all donors to record unconditional pledges payable as liabilities at their present value—the same rule as for donees, except applied backwards. The recording of the donee’s revenue (expense to donors) is discussed below.

There are two related judgments that must be made in deciding whether or when to record a pledge: Is there really a pledge at all (versus a vague intention to give)? If so, are there any conditions to be fulfilled before the pledge becomes binding on the donor? These judgments must be made on a case-by-case basis; there are no formal rules. Some of the factors that should be considered in determining whether a pledge exists include whether the pledge is explicitly binding; whether the donee has announced the pledge publicly and the donor has not disagreed; whether partial payment has been made; the language used in the pledge document; whether the donee has made commitments based on reliance on the pledge; and how specific the pledge is in terms of amount, payment

schedule, or use of the gift. As for conditionality, one should consider the exact language of the pledge, how explicitly the condition is defined, the likelihood of the event occurring and within what time period, and the extent to which occurrence can be facilitated by action of the donee.

Because recording (or not recording) pledges can make a considerable difference in the apparent financial condition of the donee (and maybe the donor), fundraisers will find that sometimes management will very much want (or not want) to record some pledges. Especially with major fund drives and with very large single pledges, as soon as plans are made or evidence of the pledge becomes apparent, the fundraiser is well advised to discuss with management of the donee, and with the donor, whether either has concerns about the way the pledge is to be accounted for. The fundraiser should be familiar with the different methods of accounting and the factors used in deciding which method is proper so that all alternatives can be discussed. For example, maybe both the donor and donee do not wish to record the pledge until a later period. In that case, if both agree, the language of the pledge can be written to make the pledge nonbinding or to include a condition that will not be met until the later period. Of course, there will be times in any fundraiser's career when one party wants to record the pledge and the other does not. Since the rules are the same for both, one of them will have to be flexible; maybe some inducement by one will convince the other. The fundraiser may be able to close the deal by facilitating such negotiation.

(b) Revenue and Restricted Gifts

Even more important than when pledges are recorded as assets is when all gifts, including pledges, are recorded as revenue. This is because readers of financial statements usually pay more attention to the relationships among revenues, expenses, net assets than they do to noncash assets. The question of when and how revenue should be recorded is challenging. The determining factors are whether the gift is explicitly restricted by the donor, what kind of restriction exists, and whether the gift is in the form of a pledge. SFAS 116 specifies that explicitly time restricted gifts ("for your 200X program") and gifts restricted for a particular operating purpose ("for cancer research") are temporarily restricted revenue when received or unconditionally promised; unrestricted and permanent endowment gifts are revenue in the unrestricted and permanently restricted classes, respectively, when received. Practices relating to split-interest (deferred) gifts are complex and varied and are discussed in Chapter 8.

The standard—that all unconditional gifts (including pledges) are revenue when the gift or pledge is first received (a prepayment of a conditional pledge is still revenue only when the condition is met)—has the effect that many not-for-profits record some of their revenue sooner than

if they had recognized revenue to the extent of expenses. This means usually higher revenue, larger change in net assets, and larger net assets. These organizations appear to be in better financial condition than previously and thus sometimes present fundraisers with the additional challenge of convincing prospective donors that new gifts are truly needed. Fundraisers need to be adept at pointing out to donors that parts of the resources of the donee are legally restricted or not yet available for use.

The standards call for only three “classes” of net assets:

- *Unrestricted*, or resources with no donor-imposed restrictions
- *Temporarily restricted*, or resources with a donor-imposed restriction that lapses with the passage of time or is fulfilled by action of the donee
- *Permanently restricted*, or resources with a donor imposed restriction that never lapses or is never fulfilled

Included in unrestricted net assets are all board-designated funds (quasi-endowment, for special projects, or other purposes) and property, plant, and equipment purchased with unrestricted resources. Temporarily restricted net assets include operating restricted funds, term endowments, annuity and life income (split-interest) funds, unspent gifts restricted for acquisition of fixed assets, and fixed assets donated or acquired with funds restricted for that purpose. Pledges payable in a future period are considered implicitly time-restricted until that period. Permanently restricted net assets include permanent endowment and revolving loan funds.

Fundraisers soliciting unrestricted gifts will call donors’ attention to the financial data for the unrestricted class, and similarly for other types of gifts. A donee may have a large endowment or other restricted balance but still be genuinely in need of unrestricted gifts because the restricted resources are not available except for specific purposes. Fundraisers should not, however, attempt to gloss over quasi-endowment funds and mislead donors into believing that these cannot be spent. Quasi-endowments are legally unrestricted and thus can be spent at any time with approval of the board of the organization. Some boards may wish to pretend that they cannot use quasi endowments, but since that is not the case, there is a risk of losing credibility with donors. The main conceptual issue involved with classifying revenue is that of determining whether there is truly a donor-imposed restriction on a gift. This, too, is often a matter of judgment and may call for an interpretation of the donor’s intent by the donor or by an attorney. Some of the factors to be considered include the exact language used by the donor, whether refund of unspent amounts is called for, the presence of nonprogrammatic “compliance” requirements, and the donee’s intent in soliciting the gift. (See Appendix 8–A in the previous chapter.)

9.1 ACCOUNTING FOR GIFTS

As with pledges, the fundraiser may be able to work with the donor to structure a gift so that accounting for it does not have adverse side effects for the donee. (In this case, the method of recording by the donee does not affect the accounting by the donor.) For example, a charity may receive support from a federated fundraising organization whose policy is to deduct any unrestricted surplus as of year's end from the following year's allocation. An unexpected unrestricted gift received just before year's end can result in a surplus; the gift in effect ends up being turned over to the other funder next year. However, if approached with a proposal to restrict the gift to some specific anticipated need of the donee, the donor may be willing to comply, thereby retaining the gift for the charity. Fundraisers must always be up-to-date on the entire fundraising and financial picture of an organization, and alert for opportunities to plan gifts to achieve maximum benefit for both parties.

(i) Program Expenses. Another accounting issue of concern to fundraisers is when and how program expenses paid with restricted gifts are reported and how these expenses are "matched" in the financial statements with that revenue. When restricted resources are available for a particular activity, and money is spent to conduct that activity, it is presumed that the restricted resources were used, even though the entity may also have unrestricted resources available and may even have specifically used money identified as unrestricted. In the latter case, the restricted resources that remain are then considered unrestricted, by virtue of the donor's restriction having been fulfilled.

An additional aspect of reporting program expenses is where they are shown in the statement of revenue and expenses. The requirement in SFAS 117 is to report all expenses as unrestricted, with restricted resources being released (transferred) to the unrestricted class to match the expenses incurred. Fundraisers have to be prepared to explain to donors how the donee reports the use of their gifts: At first, it may look like no restricted gifts have been used. Since all expenses are in the unrestricted class, the restricted class shows no expenses, which some donors will question. Also in computing the ratio of program expenses to contributions (an indicator used by some to evaluate a donee's performance), fundraisers must take the program expense number from the unrestricted class but add together unrestricted and restricted gifts to obtain the denominator of the ratio.

(c) Split-Interest Gifts

This category refers to the several types of gift arrangements involving "split" interests—that is, both the donor and the donee receive benefits, at least for a while. The task of accounting for the five stages in the life of

a split-interest gift (initial receipt; periodic income; periodic payments to life tenant; periodic actuarial revaluation of remainder interest, if applicable; and final distribution of corpus) is not well defined in accounting literature. Further, accounting for different types of gifts varies with the exact gift arrangement, and sometimes with different types of organizations. Hence, a wide variety of methods is used in practice.

A more complete discussion of all of the accounting issues for these gifts is in Chapter 8, but fundraisers should be aware of which methods are used by an organization. If a type of gift not previously received by an organization appears in prospect, the fundraiser should discuss the proposed accounting with the organization's chief financial officer and, maybe, its independent auditor so that appropriate information can be communicated to the donor if requested. Further, because tax attributes of these gifts are complex, and significant to the donor, the fundraiser should be certain that donors are receiving adequate professional advice prior to making these gifts.

Briefly, the accounting issues are as follows.

- Is the initial receipt of the gift recorded as revenue, deferred revenue, or an addition to net assets?
- Is the initial amount discounted to present value?
- What discount rate should be used and should the rate be adjusted?
- Are the annual income and the payments to the life tenant recorded as revenue and expense of the donee?
- How is any actuarial adjustment presented?
- How is the final distribution presented in the donee's financial statements?

The answers to these questions are relevant in determining how to assess the performance of the organization in soliciting and managing these gifts.

(d) Noncash Gifts and Donor Tax Deductions

This section discusses issues related to the recording of gifts that are not in the form of cash or marketable securities. These gifts include gifts of assets (real estate, equipment, supplies, collectibles, and nonmarketable investments), donated services of volunteers, and the use of property. The two questions here are: Should the gift be recorded at all and, if so, at what amount?

Generally, gifts of assets are recorded at their estimated fair value, which is theoretically the amount the donee would have had to pay on the open market to acquire items of similar utility. Fair value can be

determined by an appraisal, reference to sellers' catalogues or price lists, recent purchase prices of similar items, or other sources. Items sold shortly after receipt are usually recorded at the selling price. (In certain circumstances, sale of an asset by the donee can affect the allowable tax deduction by the donor.) Certain assets are not always recorded: gifts of emergency supplies to disaster relief agencies (because of the logistical problems of counting, valuing, and tracking large quantities of diverse and difficult-to-value items such as used clothing under disaster conditions) and museum collection objects (because of the difficulty in determining meaningful values for many items, and the unique status of such objects—usually retained indefinitely and not directly income producing; see also the next section, Section 9.1(e), on pass-through gifts).

Fundraisers soliciting such gifts should be aware of what the donee's policies are about accounting for them, in case donors inquire. Sometimes the donor will ask what value the donee is placing on a gift. Usually the donor is looking for support for the tax deduction to be taken. While a donee may choose to satisfy a donor's pure curiosity, the donee should, under no circumstances, assume the role of an appraiser for the donor. In fact, for gifts valued over \$5,000, the tax code forbids a donee from appraising such gifts. It is the donor's responsibility to obtain an independent appraisal for tax purposes. The donee does not wish to become involved in a possible later dispute between the donor and the Internal Revenue Service (IRS) over the proper value of the property.

For noncash gifts over \$500, the donor must complete IRS Form 8283 and attach it to the tax return. If the gift is over \$5,000, the donee will be asked to sign the form; this signature merely acknowledges receipt of the items and in no way attests to their value. Further, if the donor does not appear to be aware of the requirement to file Form 8283, the donee should advise the donor of this. Both of these pieces of advice will likely avoid later donor unhappiness, which, were it to occur, would certainly reduce the likelihood of future gifts. Finally, if the donee sells an item within two years of receipt, the donee must advise the IRS (and the donor), on Form 8282, of the amount received from the sale. Donees are well advised to warn donors of this requirement. The donee does not want a donor who overvalues the amount of a deduction to blame the donee for a personal tax audit that is triggered by a report of a later sale of the item for a much lower amount. Accounting for donated services of volunteers and the use of property is another area of controversy. Some accountants argue that no value should be recorded; some believe that it is appropriate to record such contributions. Arguments against recording usually focus on:

- The fact that there is in most cases no effect on the excess of revenues over expenses or on the changes in net assets because recording these items usually involves recording equal amounts of revenue and

expenses. (An exception is when the volunteers create a capitalizable asset such as a building.)

- The fact that no cash changes or ever will change hands.
- The alleged unnecessary effort required to track the hours worked by volunteers and assign a value to them

Arguments for recording are that the effort to track and value volunteers' hours is not that great and, mainly, that failure to record these contributions and related expense understates the extent to which the organization has been the beneficiary of public support, and the extent to which the organization has utilized available resources (including volunteers) in performing its activities. The authors concur with these latter points.

There is an understandable, but not defensible, tendency to be more desirous of recording a value for volunteers who are performing program functions than for those working in administration or fundraising. In fact, fundraising volunteers are rarely recorded for two other reasons: Many of them often work more or less on their own and thus are not under the degree of supervision that allows easy tracking of time worked, and an objective determination of a value to assign per hour is usually not possible, due to the lack of comparable paid work. Another category of volunteer almost never recorded, for the same reasons, is the board member.

The requirements in SFAS 116 standardize accounting for volunteer services by means of two criteria that, if either is met, require recording; if neither criterion is met, recording would be barred. (Disclosure in a note added to the financial statements of unrecorded contributed services is encouraged.) The two criteria are as follows: (1) if the services create or enhance nonfinancial assets; and (2) if the services require specialized skills, are performed by persons possessing those skills, and would otherwise have to be purchased by the recipient if volunteers were not available. The definition of specialized skills, and the determination of whether the organization would have otherwise paid someone to perform the services will require judgment in each situation. (See Appendix 8-C and 8-D in the previous chapter.) The services will be valued in the first case by the value of the asset (less any purchased components), and in the second case by the amount the provider did not charge (which such persons can easily state).

One nonaccounting question is often raised by volunteers: Can the volunteer take a personal tax deduction for the value of the time spent? The answer is unequivocally no, per Income Tax Regulation 1.170A-1(g). Volunteers can deduct certain out-of-pocket expenditures incidental to their work as volunteers.

Fundraisers should be aware that all of the rules defining amounts deductible by donors are complex, and donors should consult their own tax advisers for guidance. Fundraisers should not, unless they are professionally qualified in this area, give tax advice to donors. This has a high probability of leading to trouble later. Areas in which the rules are especially complicated, and in which fundraisers should warn donors to seek competent advice, include all noncash gifts, especially gifts of inventory by businesses, gifts of life insurance, and gifts of appreciated property; gifts to recipients that are classified as private foundations; gifts that constitute a significant percentage of the donor's income for the year; gifts that are bargain sales; gifts payable over several years; bequests; gifts of a partial interest in property (including the split-interest arrangements discussed earlier); and gifts for use outside the United States.

(e) Pass-Through Gifts

Several related accounting issues come into play whenever the simple donor–donee relationship is expanded to include one or more additional parties. The additional party could be a charitable entity whose purpose is to solicit gifts for another organization, or any organization that holds and manages assets for the benefit of an operating not-for-profit entity. (This subject is discussed in additional detail in Chapter 7.) Some not-for-profits establish “captive” or controlled affiliates to either solicit gifts or hold assets; others participate in noncontrolled federated fundraising organizations such as United Way. Some donors give donations to independent third parties such as a bank trust department or a community foundation with instructions to invest the assets and pay the income to specified charitable beneficiaries. In many cases the trustee may not invade the principal of the gift, but in some cases the trustee has discretion about such invasion.

Whenever a not-for-profit establishes a controlled affiliate, a determination is required as to whether the affiliate should be combined with the “parent” for purposes of the parent's financial statements. AICPA Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-For-Profit Organizations*, provides guidance on combinations of these entities.

The FASB currently has combinations of not-for-profit organizations on its technical agenda and is planning to issue an exposure draft after it considers other purchase methods procedures including combinations between mutual enterprises. This determination depends on an assessment of how much control is exercised by the parent over the governance, management, and activities of the affiliate. If the control is very strong, the affiliate should be combined into the parent's financial statements, and in separate statements the affiliate should report gifts to it as amounts held, not as revenue. If control is very weak, the affiliate need

not be combined, and gifts to it are reported as its revenue (and later reported as grant expense when remitted to the parent). A great deal of judgment is required to decide whether the level of control is high enough to qualify as strong.

Factors that should be considered in assessing the strength of control include the degree of overlap of governing boards and management; relevant provisions of governing documents, contractual or other agreements; the extent of required review and approval of the actions of one entity by the other; and the impression given to outsiders by the organizations' fundraising material and annual reports. The last factor is important: When a donor gives to the affiliate, does the donor think of it as really a gift to the parent? If so, there is likely strong control. When assets functioning as endowment are held by an independent third party, the charitable beneficiary of the income may or may not include such assets on its balance sheet depending on the nature of the arrangement. If the trustee has discretion as to when and in what amounts to pay income to the charity, the charity records such amounts as contributions when received. If the trustee has no discretion but must pay over all income as received, the charity records this as investment income.

A parallel determination is whether, in separate financial statements of the affiliate (if prepared), any gifts made to it are properly reported as its revenue or whether such gifts are merely amounts held on behalf of the parent, and not revenue of the affiliate. Such amounts held are reported on the Balance Sheet as liabilities.

SFAS 136, *Transfers of Assets to a Not-For-Profit Organization or Charitable Trust that Raises or Holds Contributions for Others*, provides guidance on when an organization may recognize revenue on gifts received from pass-through organizations. SFAS 136 advises that gifts that are transferred to a recipient organization for the ultimate support of or use by another beneficiary organization should be recorded as liabilities to the beneficiary organization. The recipient organization would not recognize revenue for the pass-through of these gifts. However, the recipient organization would recognize revenue for the pass-through of gifts in two situations: first, if the recipient organization is granted variance power by the donor or, second, if the two organizations are financially interrelated. Variance power means that the recipient organization may choose the beneficiary organization. Financially interrelated organizations are those where one organization may influence the operating and financial decisions of the other and there is an ongoing economic interest in the other.

(f) Internal Accounting Controls

These subjects, well covered in other literature, are mentioned briefly here to reinforce their importance. Primary responsibility for establishing

9.2 ACCOUNTING FOR FUNDRAISING EXPENSES

sound controls and arranging for audits usually belongs to the organization's accounting staff, not the fundraiser. However, these matters are of concern to the fundraiser because of the close relationship among the functions of raising, controlling, and auditing gifts. If the fundraiser senses a lax attitude on the part of management or the accounting staff about these matters, he or she is well advised to bring the problem to the attention of someone in the organization. Not only can weak controls lead to a loss of assets by the organization, but also publicity about instances of loss will hurt the fundraiser's ability to attract gifts.

Contributions to charities are inherently the most difficult of all types of accounting transactions over which to establish strong internal controls and a thorough audit process. This is due to the nonreciprocal nature of the transaction: Cash comes in, but no goods or services are provided in exchange. Thus, many of the checks and balances used in businesses to control sales and cash receipts are not available to a charity. This means that, while management personnel should try to establish as strong a control environment as possible, the challenge to do so is great, and they must always be alert to weaknesses that could allow misappropriation of assets.

9.2 ACCOUNTING FOR FUNDRAISING EXPENSES

Reported fundraising expenses figure prominently in many assessments of the efficiency and effectiveness of fundraising efforts and of the charity overall. Whether this is really good or bad is left to others to discuss, although the authors believe that too much importance is often ascribed to fundraising expenses. Nevertheless, fundraisers must understand them to be able to discuss them intelligently.

Fundraising expenses are those expenses incurred to induce donors to contribute to an organization. Such expenses must be reported separately in the financial statements of organizations that solicit gifts from the general public. SFAS 117 and the AICPA audit guide require such disclosure by all not-for-profits (except where these costs are immaterial to an entity). Issues relating to these expenses include what types of expenses should be called fundraising, when they should be reported as expenses, and when and how to allocate multiple-purpose expenses.

(a) Expenses That Are Fundraising

The short definition given above requires elaboration to fully describe all of the various types of activities comprehended. These include planning fundraising campaigns; managing the fundraising process; actual public solicitation costs (mail, media, and so on); applying for foundation and government grants; recruiting, training, and supervising fundraising volunteers; staff time required to participate in federated fundraising

campaigns; and other costs intended to advance the solicitation effort. Some costs are usually not charged to fundraising, such as accounting for contributions received, which is considered an administrative cost.

The subject of recording a value for the time of fundraising volunteers was mentioned earlier in the discussion of noncash gifts. Generally, as noted, such values are not recorded because the criteria in SFAS 116 are not met. Thus, comparison of fundraising efficiency between two charities, one of which relies heavily on volunteers for fundraising and the other of which uses paid staff, may not be very meaningful. (See also Section 9.1(e) on pass-through gifts for a discussion of fundraising cost issues related to such gifts.)

One other category of costs related to fundraising is usually not reported as fundraising expense: costs directly benefiting participants in “special events” such as dinners, parties, games, athletic activities, and sales of items such as cookies and greeting cards. For example, at a dinner, costs of food, decorations, entertainment, and prizes are for items that benefit attendees, not the organization. On the other hand, costs of invitations, planning, and publicity do not directly benefit attendees. Costs benefiting attendees are reported as an offset to revenue from the event; other costs are fundraising. So if one pays \$500 a plate to attend a dinner and the costs to the organization of putting it on are \$65 for food and entertainment and \$20 for publicity, the financial statements would show \$500 of gross revenue less \$65 direct costs (referred to as “direct donor benefit costs”) for net revenue of \$435, and fundraising expenses of \$20. This is discussed further in paragraphs 13.21 to 13.26 of the audit guide for *Not-for-Profit Organizations*. Two tax matters should be noted here: If the attendee could have purchased a comparable dinner for, say, \$100, the tax deduction available is \$400 (\$500 payment less \$100 value received); and in the IRS Form 990 filed by the organization, it will report \$400 of the ticket price as a contribution (line 1) and \$100 as proceeds from special fundraising events (line 9a). The \$65 is shown as an offset to the \$100 (line 9b), and the \$20 as fundraising expense (line 15). Fundraisers should have at least a basic understanding of these tax matters, especially those that affect donors’ deductions. Further, the organization must advise donors who receive an item of significant value in return for a donation (dinner, books or records, and so on) of the portion of their payment that is not tax deductible; failure to do so (or the use of vague phrases such as “Your gift is deductible to the extent provided by law”) can attract an IRS penalty. Tax matters are discussed further in Chapter 28.

(b) When to Report Fundraising Expenses

Although fundraising costs incurred in one period often result in contributions received in future periods, accountants generally require that

these costs be expensed in the period incurred rather than partly deferred to future periods. This requirement is due largely to the inherent uncertainty of the response to any fundraising activity, which leads to an inability to accurately assess the extent to which such expenses actually have any remaining value at the end of the year in which they were incurred. Even expenses incurred in one year to develop long-range giving programs, such as capital campaigns or deferred (split-interest) gifts and bequests, must be reported as expenses when incurred, not deferred until gifts are received. Thus, comparison of fundraising expenses reported in one accounting period with contributions reported in the same period may or may not accurately reflect the real cause-and-effect relationship of these items.

(c) Allocation of Expenses

The general question of allocation arises whenever an expense benefits more than one activity. For example if office space is shared by two departments, the monthly rent is allocated to the departments, usually on the basis of amount of space occupied. Similar allocations are often required for salaries, utilities, supplies, and other expenses. In most cases, the basis of allocation can be readily determined: salaries by time spent, supplies by usage, or occupancy by space occupied. The allocation process does require additional record-keeping: time sheets or effort reports by personnel, estimates of supply usage, or computation of space occupied. Then worksheet calculations produce the allocated amounts. Once total fundraising costs are determined, by adding directly charged and allocated amounts, it may be desired to subdivide these costs into components representing the costs of each separate fundraising activity—for example, various separate mailings, television advertisements, door-to-door, and solicitation of grants. The process is the same as before; however, the smaller the final pieces, the more difficult it becomes to be objective about the allocations, and the less precise the outcome. That is, in attempting to subdivide fundraising expenses, one must recognize that the result does not have the same level of accuracy as achieved with larger-scale amounts.

One particular allocation problem requires separate discussion: allocation of “joint” costs. These occur when a cost item simultaneously benefits more than one function and there is no objective method available to decide how much of the cost to allocate to each function. In fundraising, this situation most often occurs with multiple-purpose mailings, such as those containing both educational material (for example, the seven warning signs of cancer) and an appeal for donations. The printing costs of each component are not at issue here; those are charged directly to the respective function. The issue is the joint costs: the outside envelope,

mailing list rental, staff time to coordinate the mailing, the (usually the largest item) postage.

Two questions must be answered: Is it at all appropriate to allocate the joint costs and, if so, on what basis? These questions may seem trivial, but they are not. If it were always true that such mailings had a bona fide educational purpose, then the question of whether to allocate would be moot. However, often such mailings are really just solicitations, and any educational component is an afterthought, added to take advantage of the mailing going out anyway. How does one distinguish the genuine program activity? State charity regulators are especially concerned about this issue.

The accounting profession has published guidance in AICPA SOP 98-2, *Accounting for Joint Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fund Raising*. This standard defines several requirements that must all be met in order to allocate joint costs to functions other than fundraising. These requirements are as follows:

- There must be verifiable evidence of the purpose of the activity.
- The content of the activity must include a bona fide purpose other than fundraising.
- The audience targeted must have a legitimate interest in the non-fundraising component of the activity.
- The nonfundraising component must include material designed to motivate its audience to action other than contributing to the organization.

Additional discussion of SOP 98-2 is in Chapter 13. Clearly, professional judgment is required in deciding whether these requirements are met. The first requirement is judged partly on the answers to the other three, as well as on criteria such as written management plans and board resolutions, and assignment of overall responsibility for the activity to persons other than fundraisers. The second requirement is judged on the inherent value of the material and its consistency with the stated purposes of the organization. The third requirement has two components:

1. The assumed wealth of the audience as measured by income statistics for the geographical areas targeted, under the assumption that a wealthier audience is more likely to have been targeted for its fundraising potential
2. The presumed benefit to the audience of receiving the information measured by data such as epidemiological statistics for a disease, demographic data, or other methods

9.3 OTHER TAX CONSIDERATIONS

The fourth requirement is best illustrated by an example. If the “educational” material merely described the seven warning signs of cancer, that would not count. It must say, “Here are the seven warning signs of cancer; if you notice any of them, go to your doctor.” The action is “go to your doctor.” The presumption is that learning about something is of real value only when one takes beneficial action based on that knowledge. The action called for must be fairly specific: “Don’t pollute” is too vague, but “Don’t dump used motor oil in a storm drain” would qualify. The action may benefit the person receiving the message, or it could also benefit other people (“Don’t drink and drive”) or the environment (the motor oil example).

When working with a charity to plan a fundraising activity that will include an educational component, fundraisers should be aware of these requirements so they can help the charity comply with the accounting rules if allocation of some of the costs to program activities is desired.

The second allocation question is what and how to allocate. What to allocate was discussed earlier; how is often a difficult question. It might seem that one could merely measure the relative quantities of educational versus fundraising material (lines of print, square units of space, or some comparable measure). However, first, not all material is of equal value: How does one count photographs, for example, or blank space used for emphasis of surrounding material, or various sizes of type, or sweepstakes tickets? Second, if relative quantity were the sole measure, charities attempting to minimize fundraising costs would simply use the technique well known to writers of school term papers: padding. Educational material would expand to fit the desired outcome, likely with little or no additional benefit to readers; in fact, the benefit might decrease as the message drowns in a sea of fluff. As a result, judgment is significant to the question of how to allocate. Certainly content can be considered, but so too the relative impact and usefulness of the material, the apparent intent of the activity, the need of the audience for the educational material, and other relevant factors.

(d) Assessing Fundraising Efficiency

Although this subject is not an accounting matter, it does depend partly on accounting data. What has been shown here is that the use of accounting data to help assess fundraising efficiency must be done carefully, due to the interaction of various accounting principles that determine when and how contributions and fundraising expenses are reported in financial statements.

9.3 OTHER TAX CONSIDERATIONS

Besides the various tax matters discussed earlier in this chapter, one more is of concern to fundraisers: private foundation status. The subject does

not come up often, but when it does, the consequences can be severe for both donor and donee. Thus, fundraisers should know enough to recognize a potential problem and seek professional advice. This subject is discussed in additional detail in Chapter 28.

Briefly, all organizations exempt from tax under Internal Revenue Code (IRC) § 501(c)(3)—the section that covers most entities to which tax-deductible gifts may be made—are either private foundations or public charities. Public charity status is much more desirable for both the charity and its donors, since private foundation status imposes a number of rather onerous constraints on the charity, and limits the amount of tax deduction available to donors in some cases. The determination of whether an organization is considered a private foundation is based to a great extent on from whom and in what amounts contributions are received. Thus, when soliciting gifts for a charity, fundraisers must be conscious of what types of gifts could include a risk of the charity being reclassified as a private foundation as a result of the gift. Or, if the organization is already a private foundation, the fundraiser should be sure that prospective donors are aware of that fact and its consequences to them. (It is not within the scope of this chapter, or normally within the professional competence of the fundraiser, to discuss these consequences. Donors should obtain their own tax advice.) The types of gifts that can lead to private foundation status are basically any large gift from an individual, company, or private foundation and any gift from so-called disqualified persons: officers, directors, and trustees of the charity, their relatives, and businesses with which they are associated, and previous donors of large gifts. (The definitions of these types of gifts are complex and the exact language of the Internal Revenue Code, in IRC § 509(a), should be consulted.) While a fundraiser may seek such gifts, he or she should do so with awareness of the tax rules and of when additional professional advice is needed.

P A R T T W O

Financial Statement Presentation

CHAPTER TEN

Cash-Basis Financial Statements

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Some not-for-profit organizations keep their records on a cash basis of accounting.¹ As discussed in some detail in Chapter 3, the cash basis does make sense for some organizations; however, they are usually very small organizations with limited resources. One reason for this is the simplicity of recordkeeping. Another reason is that cash-basis financial statements are the easiest type of statements to prepare and understand.

¹ Note, however, that generally accepted accounting principles (GAAP) require accrual-basis statements. Organizations that want an opinion from their CPA that states that their financial statements are prepared in accordance with GAAP must prepare their statements on an accrual basis, unless they meet one of the descriptions cited in AU Section 623.04 of *Codification of Statements on Auditing Standards*, which discusses financial statements prepared in conformity with a comprehensive basis other than GAAP.

CASH-BASIS FINANCIAL STATEMENTS

10.1 SIMPLE CASH-BASIS STATEMENT

Exhibit 10.1 shows the financial statement of a typical small church that keeps cash-basis records. It also follows the principle of writing off all fixed assets when purchased so there are no fixed assets to be reflected in a balance sheet (or statement of assets, liabilities and net assets).

(a) Characteristics

This statement shows not only cash receipts and disbursements but also the cash balances of the church. Because there are no receivables or payables in cash-basis accounting, the only asset reflected is cash. This being so, this presentation shows the readers everything they would want to know about the cash transactions for the 12 months. The words "Receipts"

EXHIBIT 10.1

Example of a Simple Cash-Basis Statement that Combines Both the Activity for the Year and the Ending Cash Balance

ALL SAINTS CHURCH		
STATEMENT OF CASH RECEIPTS, DISBURSEMENTS,		
AND CASH BALANCE		
FOR THE YEAR ENDED DECEMBER 31, 20X2		
	Actual	Budget
Receipts:		
Plate collections	\$ 4,851	\$ 5,000
Envelopes and pledges	30,516	32,200
Special gifts	5,038	4,000
Nursery school fees	5,800	6,000
Total	46,205	47,200
Disbursements:		
Clergy	14,325	15,000
Music	8,610	8,400
Education	6,850	7,000
Church office	5,890	6,200
Building maintenance	4,205	4,300
Missions	2,000	2,000
Other	3,318	1,600
Total	45,198	44,500
Excess of cash receipts over disbursements	1,007	\$ 2,700
Cash balance, January 1, 20X2	4,300	
Cash balance, December 31, 20X2	\$ 5,307	

10.2 SIMPLE STATEMENT WITH LAST YEAR'S FIGURES AND BUDGET

and "Disbursements" have been used, rather than the words "Income" and "Expenses." Traditionally "Receipts" and "Disbursements" are used in cash-basis statements since both words signify an event that has taken place (i.e., cash has been received or disbursed). The words "Income" and "Expense" usually refer to accrual-basis statements.

(b) Budget Comparison

One of the first principles to be remembered in preparing financial statements—whether cash basis or accrual basis—is that the reader should be given a point of reference to help in judging the results. This can be a comparison with the prior year's statement or it can be a comparison with the budget for the current year. The important thing is that the reader's attention is directed to deviations from either past experience or anticipated results. In Exhibit 10.1 a comparison with the budget gives the reader a point of reference. A careful examination will show where receipts and disbursements have deviated from what was expected. In this illustration, "Envelopes and pledges" has not met expectations. Most expenditures (except "other" disbursements) have been close to the budget.

10.2 SIMPLE STATEMENT WITH LAST YEAR'S FIGURES AND BUDGET

While the statement in Exhibit 10.1 has a comparison with the budget, some organizations also add the prior year's figures. A more detailed statement would contain a column showing the amount of deviation of actual receipts and disbursements from the budget. Exhibit 10.2 shows the same statement but with these additional columns to help the reader quickly pinpoint significant changes. Quickly look down the column labeled "Actual Better (Worse) than Budget." See how rapidly the three significant items that have deviated from the budget can be spotted. This is the advantage of the deviation column.

(a) Comparison with Last Year's Actual Figures

The 20X1 comparison column gives additional information to help the reader interpret the current year's statement. For example, note that in 20X2 every category of receipts is up from 20X1, as is every category of disbursements.

The reader might ask whether the board was overly optimistic in budgeting receipts of almost \$7,000 more than the prior year. At the same time, the reader will observe that the board went ahead and spent more than was budgeted. This comparison with both last year's actual and this year's budget helps the reader to obtain insight into the financial situation.

CASH-BASIS FINANCIAL STATEMENTS

In preparing financial reports, consideration must be given to the needs and limitations as well as the degree of sophistication of the reader. Accordingly, statements for the board might contain this full four-column presentation while the statements for the church membership could contain only the two-column presentation in Exhibit 10.1. Or, perhaps the appropriate information for the membership may be the two “Actual” columns. There is nothing wrong with giving different versions of the information to different recipients, as long as people get the information they need and no one is misled.

EXHIBIT 10.2

Example of a Simple Cash-Basis Statement that Shows Last Year’s Actual Figures and this Year’s Budget to Give the Reader a Basis for Drawing Conclusion

ALL SAINTS CHURCH				
STATEMENT OF CASH RECEIPTS, DISBURSEMENTS, AND CASH BALANCE				
(SHOWING A COMPARISON WITH LAST YEAR AND BUDGET)				
FOR THE YEAR ENDED DECEMBER 31, 20X2				
	Actual		20X2	Actual
	20X1	20X2	Budget	Better (Worse) than Budget
Receipts:				
Plate collections	\$ 4,631	\$ 4,851	\$ 5,000	(\$ 149)
Envelopes and pledges	28,722	30,516	32,200	(1,684)
Special gifts	1,650	5,038	4,000	1,038
Nursery school fees	5,650	5,800	6,000	(200)
Total	<u>40,653</u>	<u>46,205</u>	<u>47,200</u>	<u>(995)</u>
Disbursements:				
Clergy	13,400	14,325	15,000	675
Music	7,900	8,610	8,400	(210)
Education	5,651	6,850	7,000	150
Church office	4,317	5,890	6,200	310
Building maintenance	3,105	4,205	4,300	95
Missions	1,500	2,000	2,000	—
Other	3,168	3,318	1,600	(1,718)
Total	<u>39,041</u>	<u>45,198</u>	<u>44,500</u>	<u>(698)</u>
Excess of cash receipts over disbursements	1,612	1,007	<u>\$ 2,700</u>	<u>(\$1,693)</u>
Cash balance, January 1, 20X2	<u>2,688</u>	<u>4,300</u>		
Cash balance, December 31,	<u>\$ 4,300</u>	<u>\$ 5,307</u>		

10.3 COMBINED CASH-BASIS INCOME STATEMENT AND BALANCE SHEET

In Chapter 2 it was noted that cash-basis accounting reflects only transactions involving cash. However, there are assets and liabilities that do result from cash transactions and these assets and liabilities should be reflected on the balance sheet. Three types of transactions are frequently reflected in a cash-basis balance sheet: those involving securities or investments, fixed assets, and amounts payable.

Securities or investments can arise either from an outright purchase for cash, or as a result of a donation. If they result from a donation, they should be treated as income and be recorded as an asset. The fair value of the securities on the date of receipt should be used for valuation purposes.

The purchase of fixed assets for cash may or may not be reflected on the balance sheet depending on the principles being followed for fixed asset accounting. Chapter 5 discussed alternatives for accounting for fixed assets. Occasionally, a cash-basis organization will borrow money from a bank or from an individual. A good example is a church that has a decline in contributions over the summer months and needs a short-term loan to tide it over until fall collections pick up. These loans represent “cash” transactions and should be reflected on the balance sheet. Exhibit 10.3 shows an example of a statement showing assets resulting from cash transactions. The Friends of Evelyn College is a small not-for-profit organization whose function is to raise funds among alumnae for the ultimate benefit of their alma mater.

(a) Characteristics

Note the third line of the title, “Net Assets Resulting from Cash Transactions.” Normally, the use of the words “Balance Sheet” is avoided since these words imply the accrual basis. This format provides a description of the assets held at the end of year at the bottom of the Statement of Income Collected and Expenses Disbursed. This makes it possible for the reader to obtain a total picture of the organization by looking at only one statement. For an organization with activities that are this simple, such a statement is helpful. This organization has used the words “Income Collected” and “Expenses Disbursed,” whereas in Exhibit 10.1 and 10.2 the words “Receipts” and “Disbursements” were used. It was previously noted that the words “Income” and “Expense” generally refer to accrual-basis accounting and should be avoided in cash-basis statements. Here, however, the use of the words “Collected” and “Disbursed” clearly indicate that cash transactions are involved and therefore there is no reason not to use these titles.

The term “Net income” is more familiar to most than the phrase used in this illustration, “Excess of income collected over expenses disbursed”

CASH-BASIS FINANCIAL STATEMENTS

EXHIBIT 10.3

Example of a Simple Cash-Basis Financial Statement that Combines in a Single Statement Both Income and Expenses for the Year and the Assets and Liabilities at the End of the Year

THE FRIENDS OF EVELYN COLLEGE, INC. STATEMENT OF INCOME COLLECTED, EXPENSES DISBURSED, AND NET ASSETS RESULTING FROM CASH TRANSACTIONS FOR THE YEAR ENDED DECEMBER 31, 20X2		
Income collected:		
Contributions received	\$146,797	
Interest income	2,150	
Total		\$148,947
Expenses disbursed:		
Grants to Evelyn College	125,000	
Audit fee	573	
Other expenses	832	
Total		126,405
Excess of income collected over expenses disbursed		22,542
Net assets, January 1, 20X2		20,604
Net assets, December 31, 20X2		<u>\$ 43,146</u>
Net assets consisted of:		
Cash	\$ 943	
U.S. treasury bills, at cost which approximates market	47,211	
Marketable securities at contributed value (market value \$6,958)	4,992	
		\$ 53,146
Less: Loan payable to bank		<u>(10,000)</u>
		<u>\$ 43,146</u>

or the phrase used in Exhibit 10.1 and 10.2, “Excess of cash receipts over disbursements.” As was previously noted, the words “Income” and “Expense” usually refer to accrual-basis transactions. Still, many like to use the words “Net income” in cash-basis statements because they feel the reader understands this term better than one of the other expressions. If the organization wants to use the words “Net income,” it should then add the words “on a cash basis” so there can be no confusion. Note that the market value is shown parenthetically on both the U.S. treasury bills and the marketable securities. Even if marketable securities are carried at cost, it is important to show the market value on the statements so that the reader can see how much unrealized appreciation (or depreciation) there is. Accrual-basis financial statements prepared in accordance with GAAP would require marketable securities be carried at market value.

10.4 SEPARATE STATEMENT OF RECEIPTS AND DISBURSEMENTS

10.4 SEPARATE STATEMENT OF RECEIPTS AND DISBURSEMENTS AND STATEMENT OF NET ASSETS

It is not always possible to combine a Statement of Net Assets with the Statement of Receipts and Disbursements. This is particularly true where the Statement of Receipts and Disbursements is long and complicated or where the assets and liabilities are voluminous. Exhibit 10.4 shows the first two years' operation of a private swim club that purchased land and

EXHIBIT 10.4

Cash-Basis Statements Where Cash Balance Is Shown in the Statement of Cash Receipts and Disbursements, and a Separate Statement of Net Assets Is Also Presented

CROMWELL HILLS SWIM CLUB		
STATEMENT OF CASH RECEIPTS, DISBURSEMENTS, AND CASH BALANCE		
RESULTING FROM CASH TRANSACTIONS		
FOR THE YEARS ENDED DECEMBER 31, 20X1 AND 20X2		
	20X1	20X2
Income collected:		
Membership dues	\$ 25,000	\$ 25,000
Interest income	125	300
Total	25,125	25,300
Expenses disbursed:		
Salary of manager	2,000	2,200
Salaries of lifeguards	12,000	13,000
Payroll taxes	1,071	1,130
Pool supplies	2,000	2,200
Mortgage interest	1,200	2,300
Lawn furniture	800	—
Other miscellaneous	1,129	270
Total	20,200	21,100
Excess of income collected over expenses disbursed	4,925	4,200
Other cash transactions—receipts (disbursements):		
Mortgage principal repayments	(3,800)	(5,700)
Members' capital contributions	50,000	—
Bank loan received	40,000	—
Land acquisition	(25,000)	—
Pool construction cost	(62,500)	—
Net other cash transactions	(1,300)	(5,700)
Excess of cash receipts over (under) disbursements for the year	3,625	(1,500)
Cash balance, beginning of the year		3,625
Cash balance, end of the year	\$ 3,625	\$ 2,125

CASH-BASIS FINANCIAL STATEMENTS

EXHIBIT 10.4 (CONTINUED)

Cash-Basis Statements Where Cash Balance Is Shown in the Statement of Cash Receipts and Disbursements, and a Separate Statement of Net Assets Is Also Presented

CROMWELL HILLS SWIM CLUB			
STATEMENT OF NET ASSETS RESULTING FROM CASH TRANSACTIONS			
DECEMBER 31, 20X1 AND 20X2			
	<u>Net Assets</u>	<u>20X1</u>	<u>20X2</u>
Cash		\$ 3,625	\$ 2,125
Fixed assets, at cost:			
Land		25,000	25,000
Pool		<u>62,500</u>	<u>62,500</u>
Total assets		91,125	89,625
Less—Bank loan		<u>(36,200)</u>	<u>(30,500)</u>
Net assets		<u>\$54,925</u>	<u>\$59,125</u>
	<u>Represented by</u>		
Capital contributions		<u>\$50,000</u>	<u>\$50,000</u>
Excess of income collected over expenses disbursed:			
Beginning of the year			4,925
For the year		<u>4,925</u>	<u>4,200</u>
		<u>4,925</u>	<u>9,125</u>
End of the year		<u>\$54,925</u>	<u>\$59,125</u>

built a pool, borrowing part of the monies needed. Two statements are used although the cash balance is also shown on the Statement of Cash Receipts and Disbursements.

(a) Cash Basis Emphasized

All cash transactions have been included in this Statement of Cash Receipts, Disbursements, and Cash Balance, but all transactions not involving income or expenses as such have been segregated to aid the reader. If these transactions had not been segregated, it would have been more difficult to see what the ongoing pattern of income and expenses would be.

Notice that in this presentation, the statement comes down to the cash balance at the end of the year. The purpose of this is to emphasize the most important asset. The statement could have stopped at the “Excess of cash receipts over disbursements” caption, but by showing the cash balance the importance of cash is emphasized.

10.5 STATEMENT OF INCOME WITH CERTAIN CASH TRANSACTIONS OMITTED

(b) Mortgage Repayments

The mortgage principal repayment is shown as an “Other cash” transaction. This allows the reader to see the cash position at the end of the year. On an accrual basis, neither the loan proceeds nor the mortgage principal repayment would be shown on this statement.

(c) Certain Assets Not Capitalized

Notice that the lawn furniture has not been considered a fixed asset. This is because lawn furniture will be replaced every year or two and therefore there is little point in setting it up as a fixed asset. Cash-basis organizations normally do not depreciate assets and, if these assets were recorded, they probably would have to be depreciated very rapidly since they have such a short life.

10.5 STATEMENT OF INCOME WITH CERTAIN CASH TRANSACTIONS OMITTED

There is still another way to show the Cromwell Hills Swim Club statements. In this presentation, certain cash transactions that affect the Balance Sheet are not shown in the Statement of Income Collected, Expense Disbursed and Capital Contributed as amounts collected or expended. In 20X1 these are the loan of \$40,000, repayment of \$3,800, and the purchases of land (\$25,000) and pool (\$62,500). Exhibit 10.5 shows how statements presented on this basis would look.

(a) Characteristics

As noted, the Statement of Income Collected, Expenses Disbursed, and Capital Contributed does not contain all cash transactions. Those transactions affecting only the Statement of Assets are not reflected. As a result, the last line on the Statement of Income is no longer the cash balance, but “Excess of income collected and capital contributed over expenses disbursed.” This means that the emphasis on the cash balance is gone, and this creates a risk that the reader may misinterpret the meaning of this “Excess” line. Most will readily recognize that the \$54,925 in 20X1 is not the cash balance at the end of the year, but some may think the club had a “cash” surplus in 20X2 of \$4,200. Many will fail to realize that there was a mortgage principal repayment of \$5,700 and that the actual cash balance decreased \$1,500 during the year.

In this presentation, the Statement of Assets could have been added at the bottom of the Statement of Income in a manner similar to that of Exhibit 10.3. Exhibit 10.6 shows how this would look in condensed form. This is a better approach because the reader does not have to make the transition from one statement to another, or to understand the title at the top of the second statement.

CASH-BASIS FINANCIAL STATEMENTS

EXHIBIT 10.5

Example of Cash-Basis Statements Where Certain Cash Transactions Are Not Reflected in the Statement of Income Collected, Expenses Disbursed, and Capital Contributed

CROMWELL HILLS SWIM CLUB		
STATEMENT OF INCOME COLLECTED, EXPENSES DISBURSED,		
AND CAPITAL CONTRIBUTED		
FOR THE YEARS ENDED DECEMBER 31, 20X1 AND 20X2		
	20X1	20X2
Income collected:		
Membership dues	\$25,000	\$25,000
Interest income	125	300
Total	25,125	25,300
Expenses disbursed:		
Salary of manager	2,000	2,200
Salaries of lifeguards	12,000	13,000
Payroll taxes	1,071	1,130
Pool supplies	2,000	2,200
Mortgage interest	1,200	2,300
Lawn furniture	800	
Other miscellaneous	1,129	270
Total	20,200	21,100
Excess of income collected over expenses disbursed	4,925	4,200
Capital contributed	50,000	
Excess of income collected and capital contributed over expenses disbursed	\$54,925	\$ 4,200
STATEMENT OF NET ASSETS RESULTING FROM CASH TRANSACTIONS		
DECEMBER 31, 20X1 AND 20X2		
	20X1	20X2
Cash	\$ 3,625	\$ 2,125
Fixed assets, at cost:		
Land	25,000	25,000
Pool	62,500	62,500
Total assets	91,125	89,625
Less—Bank loan	(36,200)	(30,500)
Net assets	\$54,925	\$59,125

10.6 MODIFIED CASH-BASIS STATEMENTS

In Chapter 2 it was noted that cash-basis organizations often reflect certain noncash transactions in their financial statements. This may be a large receivable from a brokerage house for securities that have been sold at the end of the year, or it may be a large bill owed to someone that would materially distort the financial statements if omitted. In each case, these transactions are reflected in the statements to avoid material distortions.

10.7 CONCLUSION

EXHIBIT 10.6

Example of Cash-Basis Statement in Which the Statement Of Income Is Combined with a Statement of Net Assets

	20X1	20X2
Income collected	\$ 25,125	\$ 25,300
Expenses disbursed	(20,200)	(21,100)
Excess of income collected over expenses disbursed	4,925	4,200
Capital contributed	50,000	
Excess of income collected and capital contributed over expenses disbursed	54,925	4,200
Net assets, beginning of the year	—	54,925
Net assets, end of the year	<u>\$ 54,925</u>	<u>\$ 59,125</u>
Net assets comprised:		
Cash	\$ 3,625	\$ 2,125
Land (at cost)	25,000	25,000
Pool (at cost)	62,500	62,500
Total assets	91,125	89,625
Less—Bank loan	(36,200)	(30,500)
Net assets	<u>\$ 54,925</u>	<u>\$ 59,125</u>

There is nothing wrong with an organization's including such noncash transactions in the statements. However, if noncash transactions are included because they are significant, then all significant noncash transactions should be included. The important thing is that the statements be meaningful. Noncash transactions in the statement should clearly be labeled as such so the reader knows they have been included, and to clearly explain in a footnote the basis on which the statements have been prepared.

10.7 CONCLUSION

Only very small not-for-profit organizations should use cash-basis financial statements. Except where fixed assets and loans are involved, cash-basis statements are very simple to prepare and understand. Even with the complication of fixed assets and loans, it is possible to present meaningful statements that most readers will understand. In developing the appropriate financial statement presentation, the treasurer should

CASH-BASIS FINANCIAL STATEMENTS

consider carefully what emphasis is desired. If the cash position of the organization is the crucial item, then the statement should come down to the cash balance at the end of the period. If cash is not a problem, the last line could be either the caption "Excess of income over expenses on the cash basis" or "Net assets at the end of the year." This is largely a matter of judgment and knowing the sophistication of the readers of the statements.

CHAPTER ELEVEN

Accrual-Basis Financial Statements

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In the previous chapter, several cash-basis statements were illustrated. One of the reasons cash-basis accounting is followed is the simplicity of recordkeeping. Unfortunately for most organizations, cash-basis accounting is just not appropriate. They have too many unpaid bills at the end of the year or too much uncollected revenue. The only meaningful basis of accounting for these organizations is the accrual basis. Accrual-basis accounting is more complicated, but this does not mean that the financial statements prepared on an accrual basis need be complicated or hard to understand. The key, however, is careful planning—the laying out of the financial-statement format so that the statements tell the organization’s story as simply and effectively as possible. Easy-to-understand financial statements do not just happen; they must be carefully prepared with the reader in mind.

In this chapter, three sets of accrual-basis financial statements are discussed. Each has been prepared with the reader in mind. Many of the accounting principles discussed in previous chapters are also illustrated in these statements.

ACCRUAL-BASIS FINANCIAL STATEMENTS

11.1 SIMPLE ACCRUAL-BASIS STATEMENTS

Camp Squa Pan is a typical medium-sized boys' camp sponsored by a local YMCA but operated as a separate entity. It was started in the late 1940s with a contribution of \$50,000 from the local YMCA and, over the years, has broken even financially. Exhibits 11.1 and 11.2 show the financial statements on an accrual basis.

(a) Income

The principal transactions reflected in these statements, which would have been handled differently on a cash basis, is the receipt in the current year of camp deposits for the following year. In 20X1, the camp notices were sent out in October and many deposits had been received by

EXHIBIT 11.1

**Example of a Simple Accrual-Basis Statement of Income, Expenses,
and Changes in Net Assets**

CAMP SQUA PAN, INC.		
STATEMENT OF INCOME, EXPENSES, AND CHANGES		
IN NET ASSETS		
FOR THE YEARS ENDED DECEMBER 31, 20X1 AND 20X2		
	20X1	20X2
Income:		
Campers' fees	\$203,760	\$214,400
Interest	212	412
Total income	203,972	214,812
Expenses:		
Salaries	89,606	93,401
Food	36,978	40,615
Repair and maintenance	25,741	29,415
Horse care and feed	3,983	4,010
Insurance	6,656	6,656
Advertising and promotion	2,563	2,201
Depreciation	12,570	13,601
Other miscellaneous	21,141	26,415
Total expenses	199,238	216,314
Change in net assets	4,734	(1,502)
Net assets, beginning of year	55,516	60,250
Net assets, end of year	\$ 60,250	\$ 58,748

11.1 SIMPLE ACCRUAL-BASIS STATEMENTS

December 31. In 20X2, however, the notices did not go out until almost Christmas and very few deposits had been received. If Camp Squa Pan had been on a cash basis, the income for 20X2 would have been substantially less, since the \$18,275 of deposits received in 20X1 for 20X2 camp fees would have been 20X1 income. Offsetting this would have been the

EXHIBIT 11.2

Example of a Simple Accrual-Basis Balance Sheet

CAMP SQUA PAN, INC.		
BALANCE SHEET		
DECEMBER 31, 20X1 AND 20X2		
ASSETS	20X1	20X2
Current assets:		
Cash	\$ 13,107	\$ 9,997
U.S. treasury bills at market	10,812	—
Accounts receivable	1,632	853
Prepaid insurance	2,702	1,804
Total current assets	28,253	12,654
Fixed assets, at cost:		
Land	13,161	13,161
Buildings	76,773	76,773
Furniture	22,198	23,615
Automobiles	13,456	14,175
Canoes and other equipment	12,025	12,675
	137,613	140,399
Less: Accumulated depreciation	(71,242)	(76,629)
Net fixed assets	66,371	63,770
Total assets	\$ 94,624	\$ 76,424
LIABILITIES AND NET ASSETS		
Current liabilities:		
Accounts payable and accrued expenses	\$ 4,279	\$ 3,416
Camp deposits	18,275	1,610
Total current liabilities	22,554	5,026
Deferred compensation payable	11,820	12,650
Unrestricted net assets:		
Original YMCA contribution	50,000	50,000
Accumulated excess of income over expenses	10,250	8,748
Total net assets	60,250	58,748
Total liabilities and net assets	\$ 94,624	\$ 76,424

ACCRUAL-BASIS FINANCIAL STATEMENTS

\$1,610 of deposits received in 20X2 for 20X3 camp fees. Here is what 20X2 income would have looked like on a cash basis:

20X2 accrual basis income	\$214,400
Less 20X2 deposits received in 20X1	(18,275)
Plus 20X3 deposits received in 20X2	<u>1,610</u>
20X2 cash basis income	<u>\$197,735</u>

As can be seen, there is a \$16,665 difference between the cash and accrual bases. This difference is significant when measured against the excess of expenses over income in 20X2 of \$1,502. On a cash basis, this excess would have been \$18,167 and the cash basis statements would have been misleading.

(b) Depreciation

Depreciation is recorded by Camp Squa Pan. As discussed in Chapter 7, not-for-profit organizations that capitalize their fixed assets are required to depreciate them. In this case, the camp director felt the building and equipment would deteriorate with time and accordingly, he concluded that it was appropriate to depreciate the fixed assets and to include depreciation as an expense in order to properly reflect this as a cost of running the camp.¹

(c) Net Assets

The camp uses the term “net assets” on its balance sheet. This term is similar in meaning to “stockholders’ equity,” “net worth” or “capital.” Because not-for-profit organizations do not normally have stockholders, the term “stockholders’ equity” is not appropriate. In this case, Camp Squa Pan has kept the composition of the net assets segregated on the balance sheet between the original YMCA contribution and the accumulated excess of income over expenses of the camp. Many organizations keep amounts separated in this way on their financial statements, although this is a matter of preference more than anything else. From a practical standpoint, the historical source of the resources is of little significance for a not-for-profit organization except where there are donor imposed restrictions that relate to these amounts. In the example here, there is no reason why a single line could not have been shown with the title “unrestricted net assets” and the amount \$58,748. A minor point to

¹ There are a number of accounting policies that each organization must determine. The handling of fixed assets and depreciation is a good example. Since there are a number of alternatives, each organization should disclose the accounting policies that it has adopted in its notes to the financial statements so that all readers will be fully aware of them.

11.2 ACCRUAL-BASIS STATEMENTS—FUNDRAISING ORGANIZATION

note is that the camp has set up a deferred compensation liability for its caretaker who lives at the camp year round. This will be paid to him sometime in the future, probably when he retires. The point to note is that if the organization has a commitment for this type of expense, it should be recorded currently on an accrual basis.

11.2 ACCRUAL-BASIS STATEMENTS—FUNDRAISING ORGANIZATION

The United Fund Drive of Richmond Hill is a typical community fundraising organization. It solicits contributions on behalf of about 20 agencies serving the Richmond Hill-area. Its annual drive takes place in late September. A substantial portion of the contributions are raised through pledges to be paid from payroll deductions over the period October through May. After the annual drive is completed and the board knows how much has been received or pledged, it makes allocations to the various agencies that will receive funds. As the cash is received, it is turned over to these agencies. The records are kept on an accrual basis and pledges are recorded. The fiscal year ends on July 31. Exhibits 11.3 and 11.4 show the comparative financial statements for the six-month periods ended January 31, 20X1 and 20X2.

(a) Pledges

The Statement of Activities clearly shows both the total pledges and the amount that is estimated to be uncollectible. Many organizations are reluctant to record pledges until received; however, under GAAP they are required to be recorded. Yet experience shows that a fairly consistent pattern of collection will usually exist for most organizations. In this case, if pledges were not recorded, the financial statements would have little meaning.

(b) Fiscal Period

Ideally, the organization's fiscal year-end should not fall in the middle of the period when both collections and payment of the allocations are in process. This is what would happen if December 31 were the year-end. In this case, the year-end is July 31 since pledges are normally paid by May 31. At July 31, the organization will have collected and paid to agencies all of the previous year's fund drive pledges.

(c) Income Statement Format

There is considerable detail on the Statement of Activities but it all concerns the principal function of the drive: allocations to agencies. While there are some administrative expenses, no details have been shown because to do so would distract from the main purpose of the statement. The board, and anyone else who might ask, should receive a supporting

ACCRUAL-BASIS FINANCIAL STATEMENTS

schedule accounting for these expenses. Notice in Exhibit 11.3 the heading "Income available for allocation." It is important in statements of fundraising organizations that the amount actually available for the purposes for which the organization exists be clearly shown.

EXHIBIT 11.3

Example of an Accrual-Basis Statement of Income and Allocations for a Typical United Fund Drive

UNITED FUND DRIVE OF RICHMOND HILL, INC. STATEMENT OF ACTIVITIES		
	Six Months Ended January 31,	
	20X1	20X2
Income available for allocation:		
Pledges	\$597,342	\$726,661
Interest income	90	765
Less Provision for uncollectible pledges	(31,161)	(39,192)
	<u>566,271</u>	<u>688,234</u>
Less Administrative and fundraising expenses	(25,344)	(27,612)
Income available for allocation	<u>540,927</u>	<u>660,622</u>
Allocations to agencies:		
American Red Cross	42,759	50,000
Richmond Hill Area Urban League	17,640	28,025
Big Brothers		13,971
Boy Scouts	70,220	72,385
Camp Fire	40,531	40,905
Black Affairs Council	13,816	15,000
Child Guidance Clinic	6,010	
Day Care Center		15,000
Family and Children's Service	107,026	116,760
Girl Scouts	40,422	56,000
Goodwill Industries	30,650	32,700
Legal Aid Society	11,719	10,700
Salvation Army	36,757	40,967
Summer Youth Program		10,000
Visiting Nurse Association	4,010	6,689
Hebrew Community Center	25,783	28,038
Y.M. and Y.W.C.A.	42,392	43,075
Richmond Hill Hospital	68,127	65,069
	<u>557,862</u>	<u>645,284</u>
Change in net assets	(16,935)	15,338
Net assets, August 1	24,237	9,502
Net assets, January 31	<u>\$ 7,302</u>	<u>\$ 24,840</u>

EXHIBIT 11.4

Example of an Accrual-Basis Balance Sheet for a Typical United Fund Drive

UNITED FUND DRIVE OF RICHMOND HILL, INC. BALANCE SHEET		
	January 31,	
	20X1	20X2
ASSETS		
Cash	\$ 38,727	\$ 59,805
Pledges receivable, less allowance for uncollectible pledges of \$31,161 in 20X1 and \$39,192 in 20X2	<u>168,516</u>	<u>229,517</u>
Total assets	<u>\$207,243</u>	<u>\$289,322</u>
LIABILITIES AND NET ASSETS		
Allocated to agencies	\$557,862	\$645,284
Less Payments to date	<u>(361,536)</u>	<u>(389,517)</u>
Net unpaid	196,326	255,767
Payroll taxes and accounts payable	<u>3,615</u>	<u>8,715</u>
Total liabilities	199,941	264,482
Net assets (unrestricted)	<u>7,302</u>	<u>24,840</u>
Total liabilities and net assets	<u>\$207,243</u>	<u>\$289,322</u>

(d) Balance Sheet Format

Notice that, to make it easier for the reader, on the balance sheet the gross amount allocated to agencies has been shown and then payments to-date have been deducted to arrive at the net amount still payable. It would certainly be correct to show only one figure, the remaining \$255,767, but then it would be more difficult for readers to understand exactly what that figure represented. They might mistakenly conclude this was the total amount allocated. Notice that the estimated uncollectible amount of pledges is shown on the balance sheet. This gives the readers some idea as to the percentage that is expected to be collected.

11.3 ACCRUAL-BASIS STATEMENTS—INTERNATIONAL ORGANIZATION

There are many large not-for-profit organizations, some of which have international operations. This does not mean, however, that the financial statements are necessarily complex or involved. The financial statements of Children Overseas Inc. are a good example. Children Overseas Inc. is a large organization serving children in 11 countries. Its resources are

ACCRUAL-BASIS FINANCIAL STATEMENTS

raised principally by encouraging contributions toward the support of particular children. Exhibits 11.5, 11.6, and 11.7 show the financial statements of this organization.

One of the first things that may strike the reader is that the figures are shown only in thousands of dollars. There is no point in carrying figures out to the last dollar. Round off to the significant figure. The extra digits only make the reader work harder and incorrectly suggest that there is significance in the detail. Where there is concern that the absence of the extra digits reduces the impact of the numbers, an alternative is to use zeros to replace amounts rounded (i.e., \$8,206 becomes \$8,206,000). In this way readability is retained along with the visual impact of the amounts.

(a) Income Statement Format

The Consolidated Statement of Activities (Exhibit 11.5) shows some detailed sources of income, but only total expenses. A separate supporting statement

EXHIBIT 11.5

Example of a Comparative Statement of Income, Expenses, and Changes in Net Assets for a Large International Not-for-Profit Organization

CHILDREN OVERSEAS INC. CONSOLIDATED STATEMENT OF ACTIVITIES IN UNRESTRICTED NET ASSETS (IN THOUSANDS)		
	For the Year Ended June 30,	
	20X1	20X2
Income:		
Pledges for children	\$ 9,210	\$ 9,073
Gifts for special purposes	1,372	1,514
Contributions and bequests	450	661
Government grants	155	82
Investment and miscellaneous income	44	74
Unrealized gain (loss) on investments	(44)	92
Total income	<u>11,187</u>	<u>11,496</u>
Expenses (Exhibit 11.6)		
Aid and services to children	8,649	8,206
Supporting operations	2,081	2,353
Fundraising	454	583
Total expenses	<u>11,184</u>	<u>11,142</u>
Change in unrestricted net assets	3	354
Net assets (deficit), beginning of year	<u>1,449</u>	<u>1,452</u>
Net assets (deficit), end of year	<u>\$ 1,452</u>	<u>\$ 1,835</u>

EXHIBIT 11.6

Example of a Supplementary Statement Showing Details of Expenses. This Statement Would Provide Details Not Shown on the Statement of Activities.

CHILDREN OVERSEAS INC.					
ANALYSIS OF EXPENSES BY COUNTRY					
(IN THOUSANDS)					
YEAR ENDED JUNE 30, 20X2					
<u>Country</u>	<u>Aid and Services to Children</u>	<u>Supporting Operations</u>	<u>Fundraising</u>	<u>Total</u>	<u>20X1 Total</u>
United States	—	\$1,287	\$425	\$ 1,712	\$ 1,767
Canada	—	192	70	262	122
Australia	—	74	8	162	7
Bolivia	\$ 165	59	—	224	107
Brazil	419	59	—	478	392
Colombia	1,116	85	—	1,201	1,223
Ecuador	841	65	—	906	907
Gabon	957	100	—	1,057	1,214
Haiti	851	80	—	931	1,226
Indonesia	67	38	—	105	43
Korea	1,308	98	—	1,406	1,438
Peru	588	85	—	673	592
Philippines	1,165	61	—	1,226	1,257
Vietnam	729	70	—	799	889
20X2 Total	<u>\$8,206</u>	<u>\$2,353</u>	<u>\$583</u>	<u>\$11,142</u>	
20X1 Total	<u>\$8,649</u>	<u>\$2,081</u>	<u>\$454</u>	<u>\$11,184</u>	

ACCRUAL-BASIS FINANCIAL STATEMENTS

EXHIBIT 11.7

Example of a Balance Sheet for a Large International Not-for-Profit Organization

CHILDREN OVERSEAS INC. CONSOLIDATED BALANCE SHEET (IN THOUSANDS)		
	June 30,	
ASSETS	20X1	20X2
Cash	\$ 563	\$ 704
Investments, at market	1,066	1,331
Accounts receivable:		
Estimated unpaid pledges and gifts due from foster parents	155	135
Foreign government grants	24	18
U.S. government grants	3	3
Other receivables	—	22
Prepaid expenses	73	35
Land, building, equipment, net of allowance for depreciation of \$85 in 20X1 and 20X2	60	65
Total assets	\$ <u>1,944</u>	<u>\$ 2,313</u>
LIABILITIES AND NET ASSETS		
Liabilities:		
Accounts payable and accrued payroll taxes	\$ 84	\$ 48
Estimated statutory severance pay liability	92	101
Unremitted gifts for special purposes	316	329
Total liabilities	492	478
Unrestricted net assets	<u>1,452</u>	<u>1,835</u>
Total liabilities and net assets	\$ <u>1,944</u>	<u>\$ 2,313</u>

(Exhibit 11.6) shows the details of the expenses by country, for the interested reader. It would have been possible to include much of this “by country” detail on the Statement of Activities, but this could very well have confused the reader by having too much detail. The supporting schedule has been carefully prepared to help the reader see how it ties into the income statement (\$8,206, \$2,353, \$583, and \$11,142). This makes it easy for the reader to become quickly oriented when looking at this supporting schedule. If the organization had wanted to give even more detail in this supporting schedule, it could have used a wide sheet of paper and listed the details by type of expenses down the side and by country across the page.

The key thing to remember is that if details are going to be given they should have totals that agree to the main statements so the reader knows

11.4 CONCLUSION

exactly what the details represent. For example, in this partial schedule, the \$8,206 agrees to the Statement of Activities.

11.4 CONCLUSION

The illustrations in this chapter show many of the features of accrual-basis financial statements for not-for-profit organizations. There are many possible format variations, but readability is the key element that must be considered when preparing financial statements. What does the organization want to tell its reader? Once it is determined what information to include, it should be possible to design a statement format that will communicate this information to both sophisticated and unsophisticated readers.

CHAPTER TWELVE

Multiclass Financial Statements

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One of the characteristics of not-for-profit organizations is that they have a stewardship responsibility for the resources they receive both to providers of those resources and to the public. This chapter discusses the various financial reports and presentations that can be used to account for the activities of an organization and its stewardship of the resources that have been made available to it.

**12.1 FASB STATEMENT OF FINANCIAL ACCOUNTING
STANDARDS NO. 117, FINANCIAL STATEMENTS
OF NOT-FOR-PROFIT ORGANIZATIONS**

The Financial Accounting Standards Board (FASB) is the body within the United States accounting profession that determines what are to be considered as generally accepted accounting principles (GAAP) for nongovernmental organizations. In 1993, it issued Statement of Financial Accounting Standards (SFAS) No. 117, *Financial Statements of Not-for-Profit Organizations*. As has been previously discussed, net assets of an organization are categorized as “unrestricted,” “temporarily restricted,” or “permanently restricted” depending upon the degree that external donors have or have not placed restrictions on how resources provided can be used. SFAS 117 requires organizations to present in their financial statements, at a minimum, aggregated financial data: total assets, total liabilities, total net assets, and total change in net assets. Organizations are free to present separate data for the classes of net assets, except that donor-restricted revenue, net assets by class, and change in net assets by class must be shown. No other detail by class is explicitly required.

Some not-for-profit organizations receive types of revenue that do have legal restrictions attached to them, but, because the restrictions are not placed by a *donor* on a *gift* to the organization, the revenue (and any

unspent related net assets) are reported in the *unrestricted* class of net assets. Examples of such revenue may include: student dormitory fees at a university, which must be deposited into a sinking fund to be used to repay bonds issued to build the dormitory; a portion of dues paid to a labor union, which must be retained in a separate strike fund for use only to pay benefits to striking members; a special assessment on members of a country club to be used only for the cost of a new swimming pool; revenue of an annual church fair specified for addition to the organization's building fund; royalties from licensing of an organization's logo, which are to be used only for the organization's homeless shelter program.

In these cases the restrictions arise from the bond indenture, the constitution of the labor union, the formal resolution approved by the country club members authorizing the special assessment, the previous vote of the church vestry that the fair proceeds will be put in the building fund, and the contract with the organization that purchased the rights to use the organization's logo, respectively. These are very real restrictions which must be adhered to; they just did not arise in the context of gifts. Therefore, they do not create revenue which is reported in one of the restricted classes as defined in SFAS 117. The permanently restricted net asset class will usually consist principally of amounts restricted by donors as permanent endowment. Some organizations may also have certain capital assets on which donors have placed perpetual restrictions. For example, a donor might give a painting to a museum, with a restriction that the museum can never dispose of it. Another example would be land given to a conservation organization that must be kept as a nature preserve forever. Temporarily restricted net assets will often contain a number of different types of donor-restricted amounts: income from permanent endowments to be used for specified operating purposes, unspent gifts restricted for specified operating purposes, pledges payable in future periods, unspent gifts restricted for use in a specified future time period, unspent amounts restricted for the acquisition of fixed assets, certain fixed assets, unmaturing annuity and life income funds, and term endowments.

**(a) Expenses Are Always Reported As Changes
to Unrestricted Net Assets**

One requirement of SFAS 117 is the reporting of all expenses in the *unrestricted* net asset class, regardless of the source of the financing of the expenses. Since expendable restricted revenue will initially be reported in the temporarily restricted net asset class. When these amounts are spent, they are in effect "released" from their restriction, a reclassification (transfer) is then recorded to match the restricted revenue with the *unrestricted* expenses. (An example of this reclassification is shown in Exhibit 12.1.) This

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.1

Rearrangement of Funds into Classes of Net Assets

Funds	Unrestricted	Temporarily Restricted	Permanently Restricted
Endowment	Quasi-endowment	Term endowment	Permanent endowment
Specific purpose, or current restricted	Board-designated	Donor restricted	N/A
Loan	Board-designated	Donor restricted	Revolving ¹
Split interest (annuity, life income, etc.)	Voluntary excess reserves	Unmatured	Permanent ²
Fixed asset	Expended ³ Board-designated	Donor-restricted unexpended; Expended donated ³	⁴
General/operating	Unrestricted	Donor-time restricted	N/A
Custodian	All (on Balance Sheet only) ⁵	N/A	N/A

¹ A permanently restricted loan fund would be one where only the income can be loaned, or, if the principal can be loaned, repayments of principal by borrowers are restricted to be used for future loans. A loan fund in which principal repayments are available for any use would be temporarily restricted until the loans are repaid, at which time such amounts become unrestricted.

² For example, an annuity fund which, upon maturity, becomes permanent endowment.

³ Expended donor-restricted plant funds will be either unrestricted or temporarily restricted, depending on the organization's choice of accounting principle under paragraph 16 of SFAS 116 (discussed in Chapter 8).

⁴ Fixed assets could be permanently restricted if a donor has explicitly restricted the proceeds from any future disposition of the assets to reinvestment in fixed assets. Museum collection items that were received subject to a donor's stipulation that they be preserved and not sold might also be considered permanently restricted.

⁵ Note that since no transactions related to custodian funds are reported in the income statement of the holder of the assets, and since there is never a net asset amount (assets are always exactly offset by liabilities), reporting of such funds as separate items only becomes an issue when a Balance Sheet is disaggregated into classes. The logic for reporting the assets and liabilities of custodian funds in the unrestricted class is that such assets are not the result of donor-restricted gifts, which is normally a requirement for recording items in one of the restricted classes.

practice had previously been followed by hospitals, but not by other types of organizations.

(b) Capital Gains Are Normally Unrestricted

A second requirement is that capital gains or losses on investments (and other assets or liabilities) will normally be reported in the unrestricted

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

class. This includes gains on endowment investments, even if the endowment principal is donor-restricted. There are two exceptions to this general rule: Gains must be reported in a restricted class if (1) there are explicit donor restrictions on the use of the income and/or gains; or (2) applicable state law is judged by the organization's governing board to require the retention of some or all of the capital gains/losses in a restricted class. Adoption of this practice will often have the effect of increasing the reported unrestricted net asset balance (and decreasing the other net asset balances) compared with the prior reporting method.

(c) Functional Expense Reporting

All organizations must report expenses by functional categories (program, management, fundraising, etc.). Voluntary health and welfare organizations must also report expenses by natural categories (salaries, rent, travel, etc.). Reporting in functional categories was new for some organizations when SFAS 117 was first adopted, mainly those that do not raise significant amounts of contributions from the general public, such as trade associations, country clubs, and many local churches.

(d) Statement of Cash Flows

Cash flows are reported in three categories: operating cash flows, financing cash flows (including receipt of nonexpendable contributions), and investing cash flows. This is required by SFAS 95, *Statement of Cash Flows*, which first applied to not-for-profit organizations when they adopted SFAS 117. SFAS 95 and 117 permit either of two basic methods for preparing the statement of cash flows: the "direct" and the "indirect" methods. Briefly, the indirect method starts with the excess of revenues over expenses and reconciles this amount to operating cash flows. The direct method typically correlates to the income and expenses categories reported in the Statement of Activities but on a cash flow basis.

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

Following is a practical guide to the preparation of a statement of cash flows. Exhibit 12.2 is a balance sheet and Exhibit 12.3 is a statement of financial activity for a hypothetical small not-for-profit organization. Next are two worksheets (Exhibits 12.4 and 12.5) used to create the statement of cash flows, followed by explanations of the worksheets.

(a) Explanation of Cash Flow Statement Worksheets

Following is a summary of the process for preparing a statement of cash flows, using the direct method, from two balance sheets and the

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.2

Sample Performing Arts Organization Balance Sheet (\$000)

	June 30,	
	<u>20X2</u>	<u>20X1</u>
ASSETS		
Cash	\$116	\$169
Short-term investments	154	151
Accounts receivable, net of allowance	70	28
Grants receivable	28	6
Long-term investments, at market value	180	156
Property and equipment, net of depreciation	155	140
Rent and other deposits	4	9
Other assets	<u>11</u>	<u>13</u>
Total assets	<u>\$718</u>	<u>\$672</u>
LIABILITIES AND NET ASSETS		
Accounts payable and accrued expenses	\$111	\$ 66
Deferred season subscription revenue	206	193
Current portion of mortgage	30	30
Mortgage payable, 8%, due 20X4	29	59
Commitments and contingencies (note x)		
Total liabilities	<u>376</u>	<u>348</u>
Net assets:		
Unrestricted:		
Designated by the board for endowment	82	66
Equity in property and equipment	96	51
Undesignated, available for operations	<u>35</u>	<u>94</u>
Total unrestricted net assets	<u>213</u>	<u>211</u>
Temporarily restricted:		
Expendable	31	23
Nonexpendable	<u>21</u>	<u>21</u>
Total temporarily restricted net assets	52	44
Permanently restricted net assets	<u>77</u>	<u>69</u>
Total net assets	<u>342</u>	<u>324</u>
Total liabilities and net assets	<u>\$718</u>	<u>\$672</u>

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

EXHIBIT 12.3

Sample Performing Arts Organization Statement of Financial Activity (\$000) Year Ended June 30, 20X2

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Operating revenue				
Ticket sales	\$ 857			\$ 857
Other performance fees	128			128
Concessions	103			103
Investment income	21	\$ 2		23
Gains/losses on investments	55		\$ 4	59
Net assets released from restrictions	188	(188)		—
Total operating revenue	<u>1,352</u>	<u>(186)</u>	<u>4</u>	<u>1,170</u>
Operating expenses:				
Regular season productions	815			815
Ballet school	201			201
Other productions	378			378
Production administration	497			497
Management and general	390			390
Total operating expenses	<u>2,281</u>			<u>2,281</u>
Deficiency from operations	<u>(929)</u>	<u>(186)</u>	<u>4</u>	<u>(1,111)</u>
Support:				
Annual giving	584	39		623
Grants	140	125		265
Endowment gifts			4	4
Governments	200	30		230
Donated services and materials	43			43
Less: Fundraising costs	(36)			(36)
Net support	<u>931</u>	<u>194</u>	<u>4</u>	<u>1,129</u>
Change in net assets:				
Unrestricted	2			2
Temporarily restricted		8		8
Permanently restricted			8	8
Total change in net assets	<u>2</u>	<u>8</u>	<u>8</u>	<u>18</u>
Net Assets:				
Beginning of year	211	44	69	324
End of year	<u>\$ 213</u>	<u>\$ 52</u>	<u>\$ 77</u>	<u>\$ 342</u>

(Complete comparative prior year information can be presented on a separate page, or a total column for the prior year added at the right side of this page.)

corresponding income statement. The only additional information required, which will not be obvious from those statements is:

- Gross amounts of acquisitions and dispositions of long-term assets and liabilities. This data should be available from the general ledger or the investment ledger.
- Information to identify changes in each of the various current assets and liabilities with their related revenue or expense (operating cash inflow or outflow) categories. This information will be available either from the general ledger, the accounting manual, or the bookkeeper's knowledge of the organization.

Most prepaid expenses and accounts payable will normally relate to the "payments to employees and suppliers" category. Some receivable and deferred-revenue items are obvious: grants receivable relates to grant revenue (entry 7 in the reclassification column of Exhibit 12.6). Some will require further investigation. For example, in the sample worksheet, the change in accounts receivable is entirely related to performance fee revenue (reclassification entry 6), but this is not obvious from looking at only the financial statements. In some cases, one balance sheet item may relate to more than one income statement item, and the change must be allocated among the various income statement items.

- A. Paste comparative balance sheets on worksheet. Details of net assets by class are not needed and should be removed to save space. Total assets and liabilities are not used; total net assets is.
- B. Subtract the prior period numbers from the current period numbers, line by line, including the total change in net assets. Record the differences as either positive or negative according to the usual rules for debits and credits—that is, increases in assets are debits, increases in liabilities and net assets are credits, and so on. In the difference column, debits are written as positive numbers; credits (including an increase in net assets) as negative numbers. Foot the column of differences; it must foot to zero.
- C. Paste the statement of activity below the balance sheet so the total column lines up under the balance sheet difference column. Details of changes in net assets by class and beginning and ending net assets are not required; total change in net assets is.
- D. Depending on the convention used in the statement of activity regarding signs, it may be necessary to change some of the signs from positive to negative so that all credit numbers (i.e., revenue) are negative, and all debit numbers (expenses) are positive, consistent with the signs of the balance sheet differences. *However, do not change the sign of the total change in net assets (\$18), since this is a balancing number. If it is an increase, it will be a positive number, and vice versa; leave it as it is.* Note especially items which have been reported

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

as deductions from other numbers (the \$36 of fundraising costs in the example) so that their sign is correct (double negative = positive—that is, a debit—in the example). Foot this entire column, including the total change in net assets (with the proper sign, as noted before). This column must also add to zero.

EXHIBIT 12.4

Sample Performing Arts Organization Statement of Cash Flows (\$000)

	Year Ended June 30,	
	20X2	20X1
Cash flows from operating activities:		
Cash received from ticket sales	\$ 870	\$ 685
Cash received from contributors	1,079	1,208
Interest and dividends received	23	27
Cash received from other revenue sources	189	72
Cash paid to employees and suppliers	(2,190)	(1,931)
Interest paid	(5)	(7)
Net cash (used) provided by operating activities	<u>(34)</u>	<u>54</u>
Cash flows from investing activities:		
Purchase of equipment	(25)	(31)
Proceeds from sale of equipment	—	16
Purchase of investments	(84)	(108)
Proceeds from sale of investments	116	65
Net cash provided (used) by investing activities	<u>7</u>	<u>(58)</u>
Cash flows from financing activities:		
Proceeds from contributions restricted for:		
Investment in endowment	4	27
Investment in property and equipment	—	31
Other financing activities:		
Payments on mortgage	(30)	(30)
Net cash (used) provided by financing activities	<u>(26)</u>	<u>28</u>
Net (decrease) increase in cash	(53)	24
Cash at the beginning of year	169	145
Cash at end of year	<u>\$ 116</u>	<u>\$ 169</u>
Supplemental data for noncash investing and financing activities:		
Gifts of equipment	\$ 10	\$ 6
Gift of paid-up life insurance, cash surrender value	7	—

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.5

**Reconciliation of Change in Net Assets to Net Cash Provided (Used)
by Operating Activities**

Change in Net Assets	\$ 18
Adjustments to reconcile change in net assets to net cash used by operating activities:	
Noncash revenues and expenses:	
Depreciation	20
Net realized and unrealized gain on long-term investments	(59)
Noncash contributions of long-term assets:	
Equipment	10
Life insurance policy	7
Nonexpendable endowment gift	(4)
Changes in current assets and liabilities:	
Increase in accounts receivable	(42)
Increase in grants receivable	(22)
Decrease in rents and other deposits	5
Decrease in other assets	9
Increase in accounts payable	45
Increase in deferred revenue	13
	<u>13</u>
Net cash used by operating activities	<u>\$ (34)</u>

- E. Reclassify items to put them into the proper categories for the statement of cash flows. The number of reclassification columns is not fixed; it should be based on how complex a set of statements you have and how many entries there will be. In the example, there are two columns: one for items affecting only one of the statements, and one for items affecting both statements. These columns may be further subdivided if more space is needed to post entries. In general, reclassify balance sheet items related to operating cash flows (typically, all current assets and liabilities, and some others) out of the balance sheet section to the related revenue or expense line item. Explanations of the various reclassification entries are on the following page. Be very careful with signs here. Many of the entries will have the effect of zeroing out one of the lines; that part of the entry will have the sign necessary to offset the number(s) already on that line; the other part of the entry will have the opposite sign. (That is, if it is desired to zero out a line with a positive number on it—for example, the accounts receivable line—with a positive \$42 in Column B, a negative \$42 entry [entry 6] is required on that line. The other part of entry 6—on the “other performance fees” line—must have a positive sign, and vice versa.)

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

- F. Foot each reclassification column. They must all foot to zero.
- G. Take a subtotal at this point to ensure everything balances, and to present most of the actual numbers that will end up on the statement of cash flows. Foot this column; it must foot to zero.
- H. Gross up those items involving acquisition and disposition of long-term assets and liabilities. Usual items include investments (those that are not cash equivalents), fixed assets, and long-term debt. There may be others. Information needed to generate the gross-up amounts will be available in the general ledger or (in the case of investments) from the organization's investment manager.
- I. Carry each item from Column H, and from the gross-up columns, *except the change in cash and cash equivalents* (\$53), into the appropriate column (operating, investing, financing) for the statement of cash flows. *Change all signs at this point: All negative numbers become positive, and vice versa*, to show the item with the sign the item will have in the actual statement. Positive items are cash inflows; negative items are cash outflows. Items (other than the change in cash and cash equivalents) still left in the balance sheet (upper) part of the worksheet are investing or financing cash flows. Any grossed-up items must be copied gross to show both acquisitions and dispositions. Items in the income statement (lower) part of the worksheet are mostly operating cash flows, except for contributions restricted for nonexpendable purposes (\$4 endowment gift in the example), which are financing cash flows. Foot the three columns to produce the net cash flows from each category; the sum of the three footings—(\$34), \$7, (\$26)—must equal the change in cash—(\$53); see bottom of cash flow columns.
- J. Certain items require special treatment:
 - The change in cash and cash equivalents is merely copied to the statement of cash flows without changing its sign (as this is also a balancing number).
 - Noncash financing and investing items do not appear in the body of the statement, but are disclosed separately below. These items are identified during the reclassification process (step E, entries 9 and 12 in the example).

Now you are ready to draft the actual statement of cash flows, using the numbers in the last four columns of the worksheet.

(b) Explanation of "Reconciliation" Worksheet

In Exhibit 12.7, steps A and B are the same as for the first worksheet. A copy of that part of that worksheet can be pasted on this worksheet. The statement of activity is not used for this worksheet. The reclassification

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.6

Worksheet for Statement of Cash Flows—Direct Method

		<u>Current</u>	<u>Prior</u>		<u>[Dr. (Cr.)] Balance Sheet Changes</u>
<u>Balance Sheet</u>	[A]			[B]	
Cash		\$ 116	\$169		(53)
Short-term investments		154	151		3
Accounts receivable, net of allowance		70	28		42
Grants receivable		28	6		22
Long-term investments, at market value		180	156		24
Property and equipment, net of depreciation		155	140		15
Rent and other deposits		4	9		(5)
Other assets		<u>11</u>	<u>13</u>		(2)
Accounts payable and accrued expenses		\$ 111	\$ 66		(45)
Deferred season subscription revenue		206	193		(13)
Current portion of mortgage		30	30		0
Mortgage payable, 8%, due 20X3		<u>29</u>	<u>59</u>		30
Total net assets		<u>342</u>	<u>324</u>		<u>(18)</u>
					<u>0</u>
	[C]	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
<u>Income Statement:</u>					
Operating revenue:					
Ticket sales		\$ 857		[D]	\$ (857)
Other performance fees		128			(128)
Concessions		103			(103)
Investment income		21	\$ 2		(23)
Gains/losses on investments		55		\$4	(59)
Net assets released from restrictions		<u>188</u>	<u>(188)</u>		
Operating expenses:					
Regular season productions		815			815
Ballet school		201			201
Other productions		378			378
Production administration		497			497
Management and general		<u>390</u>			<u>390</u>
Total operating expenses		<u>2,281</u>			<u>2,281</u>
Interest					
Support:					
Annual giving		584	39		(623)
Grants		140	125		(265)
Endowments gifts				4	(4)
Governments		200	30		(230)
Donated services and materials		43			(43)
Less: Fundraising costs		<u>(36)</u>			<u>((36))</u>
Change in net assets		<u>2</u>	<u>8</u>	<u>8</u>	<u>18</u>
					<u>0</u>
Noncash financing and investing items (memo):					

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.6 (CONTINUED)

Worksheet for Statement of Cash Flows—Direct Method

1. To group change in short-term investments (other than those that are cash equivalents; these are included with cash) with change in long-term investments.
2. To move change in long-term portion of mortgage to the line related to the actual payment made—that is, the current portion. (This entry is really just a formality, and need not be made.)
3. To break interest paid (requires separate disclosure) out of operating expenses. Number obtained from general ledger.
4. To offset noncash donation against the expense reflecting use of the donated item. (Note: This does not appear as part of the supplemental disclosure of noncash transactions, since it is an operating item, not financing or investing.) Number obtained from contribution records.
5. To include fundraising costs (reported as an offset against contributions) with other cash expenses.
6. To adjust performance fee revenue for change in related receivables.
7. To adjust grant revenue for change in related receivable.
8. To reclassify gain on sale of investments to the investment line.
9. To reduce contribution revenue and the change in fixed assets by the amount of donated fixed assets. (This is one of the supplemental noncash items disclosed, since it is an investing transaction.) Number obtained from contribution records.
10. To reclassify depreciation expense to the fixed assets line. Number obtained from general ledger.
11. To adjust operating expenses for the change in prepaid expenses.
12. To reduce contributions, and change in other assets, by the amount of the donated life insurance policy. Number obtained from contribution records. This is also a separate disclosure item.
13. To adjust operating expenses for the change in other assets. Note that this entry cannot be made until after entry 12 since this is really a plug to zero out the change in other assets, *after* reflecting the change due to the life insurance policy, which must be treated separately since it is a noncash item.
14. To adjust operating expenses by the change in payables and accruals.
15. To adjust ticket sale revenue by the amount of the change in deferred ticket revenue.
16. To offset the two changes in total net assets numbers.

These entries are illustrative only; not all will be required for every organization and additional entries will be required for many organizations.

columns include some but not all of the entries from the first worksheet. Many of these entries are to create the reconciling items between change in net assets and operating cash flows.

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

- One additional entry—number 17—is included: to reclassify non-expendable gifts to the financing cash flows category. (On the first worksheet this was done as part of the drafting of the statement of cash flows itself.)
- Entries not included here are those to reclassify changes in current assets and liabilities to the respective revenue and expense categories (entries 6, 7, 11, 13, 14, and 15), to reclassify certain revenue and expense items (entries 3 and 5), and to offset the change in net assets (entry 16).
- Note that entry 4 (the \$43 gift of services and materials) does appear here. However, since it affects contribution revenue and operating expenses, both of which are part of operating cash flows, the two parts of this entry offset each other and the results of the entry disappear.

As before, all columns through the subtotal (Column G) must foot to zero, and when carrying the items from this column to the statement of cash flows (Columns I), all signs except cash are changed (plus to minus, and vice versa). The items in the operating column of the statement of cash flows now include:

- All changes in current assets and liabilities
- The change in net assets (\$18 in the example)
- The reconciling items referred to earlier

This column must foot to the same amount as net cash flows from operations on the first worksheet—\$34 in the example.

The financing/investing cash flow column is included here only as proof that the worksheet has been accurately prepared. Items that are not part of the operating cash flow column are carried to this column; the total of this column must equal the sum of those two categories on the first worksheet, and this total plus the net operating cash flow amount must equal the change in cash (\$53).

If it is desired to present the statement of cash flows using the indirect method, then the reconciliation prepared on the second worksheet replaces the operating cash flow section of the statement as shown in Exhibit 12.8.¹ (The investing and financing sections of the statement are the same as before.) The first worksheet is not needed; the gross-up information (Columns H) can be included on the second worksheet. An additional separate disclosure required in this case is the amount of interest paid (\$5 in the example).

¹ Although the indirect method is in more common use, a statement of cash flows prepared using the direct method is easier for most readers to understand.

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.7

Worksheet for Reconciliation to Operating Cash Flows

	<u>Current</u>	<u>Prior</u>	[B]	[Dr. (Cr.)] Balance Sheet Changes
<u>Balance Sheet</u>				
Cash	\$116	\$169		(53)
Short-term investment	154	151		3
Accounts receivable, net of allowance	70	28		42
Grants receivable	28	6		22
Long-term investments, at market value	180	156		24
Property and equipment, net of depreciation	155	140		15
Rent and other deposits	4	9		(5)
Other assets	<u>11</u>	<u>13</u>		<u>(2)</u>
	[A]			
Accounts payable and accrued expenses	\$111	\$ 66		(45)
Deferred season subscription revenue	206	193		(13)
Current portion of mortgage	30	30		0
Mortgage payable, 8%, due 20X3	<u>29</u>	<u>59</u>		<u>30</u>
Total net assets	<u>342</u>	<u>324</u>		<u>(18)</u>
				<u>0</u>
Items to reconcile to operating cash flows:				
Gain on sales				
Depreciation				
Noncash contributions:				
Equipment				
Life insurance				
Services and materials				
Expense representing use of donated services and materials				
Nonexpendable gift				
Financing cash flow—nonexpendable gift				
(Steps C, D not used)				

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

[E]	[F]	[G]	[H]	[I]		[J]	
Reclassifications			Gross-up		[Source (Use)] Statement of Cash Flows		
Within B/S or P/L	Between B/S & r P/L	Subtotal	Purchases	Sales	Operating	Investing	Financing/Other
		(53)					(53)
¹ (3)		—					
		42			(42)		
		22			(22)		
¹³	⁸ (59)	(32)	84	(116)		32	
	⁹ (10) ²⁰ ¹⁰	25				(25)	
		(5)			5		
	¹² (7)	(9)			9		
		(45)			45		
		(13)			13		
²³ 0		30				(30)	
² (30)		—					
		(18)			18		
	⁸ 59	59			(59)		
	¹⁰ (20)	(20)			20		
	⁹ 10	10			(10)		
	¹² 7	7			(7)		
⁴ (43)		0					
		0					
⁴ (43)		4					
¹⁷ 4		4			(4)		
¹⁷ (4)		(4)				4	
<u>0</u>	<u>0</u>	<u>0</u>	=	=	<u>(34)</u>	+ <u>(19)</u>	= <u>(53)</u>
						[F] - (26)	
						[I] - 7	
						<u>(19)</u>	

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.8

Worksheet for Statement of Cash Flows—Direct Method

<u>Balance Sheet</u>	[A]	<u>Current</u>	<u>Prior</u>	[B]	[Dr. (Cr.)] <u>Balance Sheet Changes</u>
Cash		\$	\$		
Short-term investments					
Accounts receivable, net of allowance					
Grants receivable					
Long-term investments, at market value					
Property and equipment, net of depreciation					
Rent and other deposits					
Other assets		_____	_____		
Accounts payable and accrued expenses		\$	\$		
Deferred season subscription revenue					0
Current portion of mortgage					0
Mortgage payable, 8%, due 20X3		_____	_____		
Total net assets		_____	_____		0
	[C]	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
<u>Income Statement:</u>					
Operating revenue:					
Ticket sales		\$		[D]	\$
Other performance fees					
Concessions					
Investment income			\$		
Gains/losses on investments				\$	
Net assets released from restrictions		_____	()	—	_____
Operating expenses:					
Regular season productions					
Ballet school					
Other productions					
Production administration					
Management and general		_____			-
Total operating expenses		_____	_____	—	_____
Interest					
Support:					
Annual giving					
Grants					
Endowments gifts					
Governments					
Donated services and material					
Less: Fundraising costs		_____	_____	—	(()
Change in net assets		_____	_____	—	_____
					0
Noncash financing and investing items (memo):					

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

[E] Reclassifications	[G]		[H]		[I]			[J]
	Within B/S or P/L	Between B/S & P/L	Gross-up		[Source (Use)] Statement of Cash Flows			
		Subtotal	Purchases	Sales	Operating	Investing	Financing	Other
1		0						
	6	0						
	7	0			[
1	8				-[
	9	10						
	11							
	12	13	0					
	14	0						
	15	0						
2								
2		0						
	16	0						
	15							
	6]-							
]							
	8							
	10]							
-[⁴	11]-							
[⁵	13]							
[³	14]							
3								
	12]							
	9]							
	7]-							
]							
4		0						
		0						
	16	0						
		0						
		0						
[F]								
	9							
	12							
					Equipment			\$
					Life insurance			

(continued)

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.8 (CONTINUED)

	<u>Current</u>	<u>Prior</u>	[B]	<u>[Dr. (Cr.) Balance Sheet Changes]</u>
<u>Balance Sheet</u>				
Cash	\$	\$		
Short-term investment				
Accounts receivable, net of allowance				
Grants receivable				
Long-term investments, at market val				
Property and equipment, net of depreciation				
Rent and other deposits				
Other assets	_____	_____		
	[A]			
Accounts payable and accrued expenses	\$	\$		
Deferred season subscription revenue				
Current portion of mortgage				
Mortgage payable, 8%, due 20X3	_____	_____		
Total net assets	_____	_____		_____
				<u>0</u>
Items to reconcile to operating cash flows:				
Gain on sales				
Depreciation				
Noncash contributions:				
Equipment				
Life insurance				
Services and materials				
Expense representing use of donated services and materials				
Nonexpendable gift				
Financing cash flow—nonexpendable gift				
(Steps C, D not used)				

12.2 PREPARATION OF STATEMENT OF CASH FLOWS

[E]	[F]	[G]	[H]	[I]	[J]		
Reclassifications			Gross-up		[Source (Use)] Statement of Cash Flows		
Within B/S or P/L	Between B/S & r P/L	Subtotal	Purchases	Sales	Operating	Investing	Financing/Other
1		-					
1	8						
	9	10					
	12						
2							
2		-					
	8						
	10()	()					
	9						
	12						
4							
		0					
4							
17							
17							
<u>0</u>	<u>0</u>	<u>0</u>			<u> </u>	+ <u> </u>	= <u> </u>
					<u> </u>	[F] - <u> </u>	
						[I] - <u> </u>	
						<u> </u>	

(continued)

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.8 (CONTINUED)

SAMPLE _____ ORGANIZATION		
STATEMENT OF CASH FLOWS (\$000)		
YEAR ENDED _____	20XX	20XX
Cash flows from operating activities:		
Cash received from ticket sales	\$	\$
Cash received from contributors		
Interest and dividends received		
Cash received from other revenue sources		
Cash paid to employees and suppliers		
Interest paid	_____	_____
Net cash provided (used) by operating activities	_____	_____
Cash flows from investing activities:		
Purchase of equipment		
Proceeds from sale of equipment		
Purchase of investments		
Proceeds from sale of investments	_____	_____
Net cash provided (used) by investing activities	_____	_____
Cash flows from financing activities:		
Proceeds from contributions restricted for:		
Investment in endowment		
Investment in property and equipment		
Other financing activities:		
Payments on mortgage	_____	_____
Net cash provided (used) by financing activities	_____	_____
Net increase (decrease) in cash		
Cash at beginning of year	_____	_____
Cash at end of year	\$ _____	\$ _____
Supplemental data for noncash investing and financing activities:		
Gifts of equipment	\$	\$
Gift of paid-up life insurance, cash surrender value		
Reconciliation of change in net assets to net cash provided (used) by operating activities		
Change in net assets	\$	\$
Adjustments to reconcile change in net assets to net cash used by operating activities:		
Noncash revenues and expenses:		
Depreciation		
Net realized and unrealized gain on long-term investments		
Noncash contributions of long-term assets:		
Equipment		
Life insurance policy		
Nonexpendable endowment gift		
Changes in current assets and liabilities:		
Increase in accounts receivable		
Increase in grants receivable		
Decrease in rent and other deposits		
Decrease in other assets		
Increase in accounts payable		
Increase in deferred revenue	_____	_____
Net cash used by operating activities	\$ _____	\$ _____

12.3 "CLASS" FINANCIAL STATEMENTS EXPLAINED

(a) Balance Sheet

The "Balance Sheet" (other titles, such as "Statement of Financial Position," may also be used) should show the total amounts of assets, liabilities, and net assets, as well as the aggregate net assets for each of the three classes: unrestricted, temporarily restricted, permanently restricted. However, the requirement is for disclosure of these amounts in the net assets section of the balance sheet, and not for disclosure of the specific assets and liabilities associated with each class. Accordingly, a balance sheet in which all assets and liabilities are commingled is acceptable (and recommended for most organizations) provided the net assets section clearly discloses the amounts of net assets that are unrestricted and amounts that are temporarily and permanently restricted. Exhibit 12.9 shows an example of such a balance sheet.

(b) Classes of Net Assets Subdivided

The requirement to disclose the aggregate of the net assets of each of the three classes does not preclude subdividing any or all of the net asset amounts into two or more subcategories. However, where this is done, these subcategories must be aggregated to show the total net assets of that class. Exhibit 12.10 shows an example of such subdividing of the unrestricted class.

EXHIBIT 12.9

Example of a Balance Sheet Showing the Three Classes of Net Assets

THE McLEAN COMMUNITY SERVICE CENTER BALANCE SHEET		
	August 31,	
	20X1	20X0
Cash	\$ 64,000	\$ 37,000
Pledges receivable	13,000	10,000
Investments	295,000	230,000
Equipment	<u>70,000</u>	<u>65,000</u>
Total assets	442,000	342,000
Less—Accounts payable	<u>(20,000)</u>	<u>(25,000)</u>
Net assets:		
Unrestricted	130,000	57,000
Temporarily restricted	11,000	10,000
Permanently restricted	<u>281,000</u>	<u>250,000</u>
Total	<u>\$422,000</u>	<u>\$317,000</u>

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.10

Example of a Balance Sheet Showing Subdivisions of Unrestricted Net Assets

BALANCE SHEET	
AUGUST 31, 20X1 (CONDENSED)	
Total assets	\$442,000
Less—Accounts payable	<u>(20,000)</u>
Net assets:	
Unrestricted:	
Designated for investment	25,000
Net equity in fixed assets	70,000
Available for operations	<u>35,000</u>
Total unrestricted	130,000
Temporarily restricted	11,000
Permanently restricted	<u>281,000</u>
Total net assets	<u><u>\$422,000</u></u>

Some not-for-profit organizations choose to segregate their fixed assets in a separate fixed asset category. The resources that are used to purchase such fixed assets can be both restricted and unrestricted. SFAS 117 requires that all net assets amounts be categorized into one of the three classes.

(c) Showing Liquidity

SFAS 117 requires not-for-profit organizations to present on their balance sheets, or in footnotes, information about the “liquidity” of their financial position. In other words, are they likely to have enough cash in the near future to pay their bills as these come due? The most common way to give this information is to present assets and liabilities in a sequence representing, in the case of assets, their nearness to conversion to cash, and, in the case of liabilities, the approximate order in which they will have to be paid. In this format, shown in Exhibit 12.9, the most liquid items (closest to cash/have to be paid soonest) are at the top of the balance sheet, and the least liquid (longest time to convert to cash/last to be paid) at the bottom.

Another way to show this is to classify assets and liabilities as short-term and long-term. This will result in a so-called “classified” balance sheet in which current assets and current liabilities are clearly shown. Also in some cases, liquidity will be evident from the nature of the classes of net assets that imply the current or long-term nature of the related assets and liabilities—for example, investments reported as part of permanent endowment are not very liquid.

(d) Statement of Activities

"Statement of Activities" is the name given in SFAS 117 to a statement that shows all of the organization's financial activity from the beginning to the end of the year. The title of the statement could be any one of a number of different names, including "Statement of Revenue, Expenses, and Changes in Net Assets," "Statement of Changes in Net Assets," "Statement of Revenue, Expenses, Capital Additions, and Changes in Net Assets," or "Statement of Income and Expenses." The title is not particularly important as long as the statement clearly shows all relevant activity.

At the same time, the Statement of Activities could be broken into two sections, and each treated as a separate statement—that is, a section showing revenue, expenses, and nonexpendable additions, and a section showing changes in net assets. However, there seems little purpose in creating a separate Statement of Changes in Net Assets since the only types of transactions normally shown in the "changes in net assets" section of the Statement of Activities are the addition of the excess revenue over expenses for the year and any reclassifications between classes not shown earlier. The authors would expect that most organizations will prepare a single all-inclusive Statement of Activities.

It is also permitted to present separate statements for the unrestricted and restricted classes (examples are in SFAS 117) so long as all unrestricted activity is presented together.

(e) Total of All Classes

One of the controversial issues in not-for-profit accounting has been the use of a "Total of all classes" column in the financial statements where a multi-column presentation is shown. As noted earlier, many believe that the use of such totals is misleading since a total column may imply that interchanges and substitutions between assets are always possible, despite restrictions on certain net assets, or even occasionally on certain individual assets.

SFAS 117, while not requiring a total *column*, indicates that it is preferable to include one. It does require presentation of the total change in net assets for all classes together. This is another significant step toward recognizing that not-for-profit organizations are single entities and not a series of separate entities called funds. At the same time, the document notes that care must be taken to assure that all appropriate disclosures are made either in the net assets section or in the footnotes to the financial statements, to make certain the captions are not misleading.

(f) Excess of Revenue over Expenses

SFAS 117 neither requires nor forbids a caption such as "Excess of Revenues over Expenses" or similar caption intended to delineate an operating

measure. The Statement does require a caption called "Change in Net Assets," which is the final change after all items of revenue, expense, gains/losses, and reclassifications have been shown. The question is whether an organization wishes to present any subtotals *above* the final change number. One possibility is to categorize revenues and expenses into so-called "operating" and "nonoperating" groups, and present a subtotal after the operating revenues and expenses (i.e., an operating measure). The authors believe this approach will be found desirable by those organizations having many items of income or expense that are only peripherally related to their main purposes.

Whether or not an operating/nonoperating subtotal is shown, if there are reclassifications other than those resulting from the release of temporary restrictions on net assets (which are usually shown in the revenue section—as illustrated in Exhibit 12.11), the authors recommend that organizations show a subtotal before such reclassifications. This will clearly distinguish between those items in the statement that are revenues and expenses, thus changing the overall net worth of the organization, and those that are only shifts of resources from one class to another and have no effect on the overall net worth. This is also shown in Exhibit 12.11.

(g) Reclassifications

Reclassifications between classes of net assets are shown in two places in the statement. One type of reclassification results from the release of temporary restrictions through the passage of time or fulfillment of the restricted purpose. These are normally shown in the revenue section of the statement, although it is not required that this be done; they could be shown elsewhere.

The second type is all other reclassifications. Under the new, simplified format called for in SFAS 117, there will be very few of these, compared to past practice. The reason for this is that by showing fewer categories in the statement, there are fewer transactions that affect more than one category. The most common types of "other" reclassification will result from (1) the use of unrestricted resources to meet matching requirements of challenge grants where the donor of the challenge grant has restricted the gift; and (2) reclassifications of unrestricted amounts between subcategories of the unrestricted class, such as to or from an unrestricted investment fund. Two other types, less often encountered, can occur when a donor changes a previously imposed restriction on a gift, and when it becomes necessary to correct an error in previously issued financial statements. All these reclassifications are shown after the "Excess of revenue over expenses" caption in the Statement of Activity. It is not acceptable to reflect a reclassification above this line, except for those reclassifications resulting from the release of restrictions on temporarily restricted net assets shown in the revenue section of the statement.

EXHIBIT 12.11

Example of a Columnar Statement of Income, Expenses, and Changes in Net Assets

	<u>Unrestricted</u>	<u>Temporarily Restricted</u>	<u>Permanently Restricted</u>	<u>Total</u>
THE McLEAN COMMUNITY SERVICE CENTER				
STATEMENT OF INCOME, EXPENSES, AND CHANGES IN NET ASSETS				
FOR THE YEAR ENDED AUGUST 31, 20X1				
Income:				
Contributions and gifts	\$ 85,000	\$ 24,000	\$ 25,000	\$134,000
Service fees	110,000			110,000
Investment income from endowment	20,000			20,000
Gains on sale of investments	40,000		6,000	46,000
Other	13,000			13,000
	<u>268,000</u>	<u>24,000</u>	<u>31,000</u>	<u>323,000</u>
Net assets released from restrictions	23,000	(23,000)		—
Total income	<u>291,000</u>	<u>1,000</u>	<u>31,000</u>	<u>323,000</u>
Expenses:				
Program services	163,000			163,000
Administration	43,000			43,000
Fundraising	12,000			12,000
Total expenses	<u>218,000</u>			<u>218,000</u>
Excess of income over expenses	73,000	1,000	31,000	105,000
Reclassification of unrestricted net assets to meet terms of challenge grant	(25,000)		25,000	—
Change in net assets	48,000	1,000	56,000	105,000
Net assets, beginning of year	82,000	10,000	225,000	317,000
Net assets, end of the year	<u>\$130,000</u>	<u>\$ 11,000</u>	<u>\$281,000</u>	<u>\$422,000</u>

(h) Statement of Cash Flows

As discussed earlier in this chapter, this statement is required by SFAS 117.

12.4 COLUMNAR FORMAT PRESENTATION

One of the things that can be done to simplify financial statements is to present the activities of all units of the organization in a columnar format, using as few columns as possible, while still achieving the required disclosures. In this type of presentation, the activity of each class of net assets is shown in a separate column, side by side. In this manner, it is possible to see all the classes at one time. Exhibits 12.11 and 12.12 show the McLean Community Service Center’s statements in this columnar format.

(a) Characteristics and Advantages

Once the reader has become oriented to this format, it is possible to see at a glance the total activity of the Center. It is significant that the Center had a total excess of income over expenses of \$105,000 for the year, and not \$73,000, which is the first impression that the reader gets when looking at only the separate current unrestricted column in this statement. In this presentation the total excess of income over expenses of the other net asset classes can also be seen, and by being given a total the reader doesn’t have to work to get the overall results of operations. While the

EXHIBIT 12.12

Example of a Columnar Balance Sheet

McLEAN COMMUNITY SERVICE CENTER				
BALANCE SHEET				
AUGUST 31, 20X1				
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Cash	\$ 55,000	\$ 9,000		\$ 64,000
Pledges receivable	2,000		\$ 11,000	13,000
Investments	25,000		270,000	295,000
Equipment	70,000			70,000
Due from (to) other classes	(2,000)	2,000		—
Total assets	<u>150,000</u>	<u>11,000</u>	<u>281,000</u>	<u>442,000</u>
Less—Accounts payable	(20,000)			(20,000)
Net assets	<u>\$130,000</u>	<u>\$11,000</u>	<u>\$281,000</u>	<u>\$422,000</u>

\$31,000 of permanently restricted net assets (endowment) income may not be available for general purposes, it represents a real asset that will generate unrestricted income in the future. The reader should be fully aware of this amount.

Some accountants argue against showing a total column. They point out that this implies that all of the organization's resources can be used for any purpose, whereas in reality there are restrictions. In this example, one-third of the excess of income of \$105,000 is permanently restricted gifts and gains that cannot be used currently.² They feel that to add the two together is mixing apples and oranges. This is true to a point, but as long as the column headings across the page are descriptive as to the type of restrictions involved, no one can be seriously misled by this columnar approach.³ Furthermore, the reader who doesn't understand the significance of the separate statement presentation is more likely to be misled and may come away thinking the excess of income was only \$73,000.

(b) Reclassification and Net Assets Section

Notice the ease in handling the reclassification from the temporarily restricted class to the unrestricted class. While any reclassification can cause confusion, the confusion is minimized when both sides of the transaction are shown in a single statement as they have been here. When more than one class is shown in a columnar format, one or two of the classes may have very little activity and a number of the captions will not be applicable to them. This is particularly so in this instance with the temporarily restricted class. Yet the blank spaces should not detract from the statement, and the very absence of figures in this column is informative because it tells the reader that, in fact, there has been little activity.

Expenses are grouped according to functional category. In this instance, all of the expenses in the "program expense" category are shown together, and no detail is given. This may not be satisfactory, in which case a supporting schedule could be prepared showing the details of the \$163,000. However, even if a supporting schedule is prepared, the figures should still be shown "in total" in the columnar statement. Otherwise the reader will not be able to see the total picture. There is a risk of confusion in having the same figures in two statements but this can be minimized by putting a caption on the separate supporting statement along the lines of "Included in total on Statement of Income, Expenses, and Changes in Net Assets."

² With respect to gains on endowment fund investments, SFAS 117 states that these should be shown in the unrestricted class unless restricted by the donor or by law. The amount shown in the permanently restricted class is only that portion of the gains that is considered restricted.

³ If there is any question about the reader's understanding the restrictions, a detailed description should be included in the notes to the financial statements, appropriately crossreferenced to the column heading.

(c) Statement Omitting Changes in Net Assets

It will be noted that in Exhibit 12.11 the statement is labeled Statement of Income, Expenses, and Changes in Net Assets. Some organizations prefer to omit reference to “Changes in Net Assets” and present only a Statement of Income and Expenses and a balance sheet. When this is done, the change in net assets for the year is shown in a separate Statement of Changes in Net Assets.

12.5 A COMPLICATED SET OF CLASS FINANCIAL STATEMENTS

The McLean Community Service Center statements are relatively straightforward and not particularly complicated. In many organizations, this simplicity is not possible. The thing that often complicates the statements is wanting to show a number of “name” funds. These are frequently permanently restricted endowment, but may also include amounts restricted for specified purposes, and possibly unrestricted investments. One characteristic of “name” funds is that the donor’s name is associated with the fund. As was discussed in Chapter 4, the use of “name” funds, if carried to an extreme, can cause confusion because it adds detail. The real risk is that the reader will not see the forest for the trees.

There are two principal financial statements that most readers want to see. Most important is a Statement of Income and Expenses and, of lesser importance, the balance sheet. If all transactions have been skillfully summarized on these two statements, it is then possible to provide a third schedule that shows the appropriate detail of the information on the two primary statements. The key to successful presentation in this third schedule is showing totals that tie back into the Statement of Income and Expenses.

The J. W. M. Diabetes Research Institute financial statements are a good example of how substantial detail can be provided on “name” funds without detracting from the reader’s overall understanding of the results of operations. While these statements relate to a medical service and research institute, the form would essentially be the same for almost any type of organization. Exhibits 12.13, 12.14, and 12.15 show these statements.

(a) Overall Impression of Complexity

The reader’s first impression of these statements may be that they “look” complicated and will be hard to understand. This is particularly so with respect to Exhibit 12.15, which shows changes in the individual “name” funds. Before studying this statement, however, take a few minutes to study the first two statements (Exhibits 12.13 and 12.14) to get an overall impression of what has happened during the year. Look first at the “Total” column on the Statement of Income and Expenses and the description of the items of income

and expense. The reader should focus on the total picture before looking at some of the detail by individual funds. The same thing should be done with the balance sheet. Look first at the total and only then at the detail by funds.

The statement of activity by individual “name” funds (Exhibit 12.15) is more difficult. The stewardship concept has been introduced in considerable detail on this statement. Apart from the many individual “name” funds, this statement also shows these funds segregated by the type of restriction associated with each fund. Some funds contain restrictions only with respect to the original principal; others restrict both the income and the principal. While this statement is complicated, there is a great deal of information on the statement that the reader should be able to understand if some time is taken to study it. On the other hand, if the reader is not interested in this detail, the overall Statement of Income and Expenses still clearly summarizes all income and expenses. This is a key point—everything is summarized in total, and readers are required to look at detail only to the extent they wish to do so.

One final observation about the overall impression these statements make. If these same statements had been presented in a separate statement format, including separate statements for each “name” fund, the resulting set of statements would most certainly have discouraged and probably confused all but the most determined readers. There would be just too much detail; few readers would be able to get any meaningful understanding of the overall financial picture of this organization. So while the supplementary summary on individual “name” funds may seem complex, the alternative would be far less comprehensible.

(b) Statement of Activities

On the Statement of Activities, the number of columns is only what is needed to show the three classes of net assets, with the unrestricted class being subdivided into an investment fund and the operating fund. While there are varying types of restrictions associated with the various restricted amounts, no attempt is made to indicate these on the face of the statement because this represents a detail that can best be left to a supporting statement or footnote. It is important that the reader not get lost in detail on the summary statement.

(c) Reclassifications

There are two reclassifications in the bottom part of this statement. The first is a reclassification from the permanently restricted class of an endowment on which the restrictions were released by the donor. This reclassification of \$7,119 went directly to the unrestricted class since this amount became unrestricted. The second reclassification is from the unrestricted general fund to the unrestricted investment fund, in the amount of \$42,119. In the unrestricted general fund column, only the net amount of \$35,000 is shown.

EXHIBIT 12.13

Example of a Columnar Balance Sheet

J. W. M. DIABETES RESEARCH INSTITUTE					
BALANCE SHEET					
JUNE 30, 20X2					
	Unrestricted				
	General Fund	Investment Fund	Temporarily Restricted	Permanently Restricted	Total
ASSETS					
Current assets:					
Cash	\$ 174,860	\$ 2,315	\$ 20,515	\$ 15,615	\$ 213,305
Marketable securities, at market		256,610	255,310	2,231,080	2,743,000
Contract receivables	7,500				7,500
Other receivables	2,345				2,345
Inventories of books and supplies	14,200				14,200
Total current assets	<u>198,905</u>	<u>258,925</u>	<u>275,825</u>	<u>2,246,695</u>	<u>2,980,350</u>

Fixed assets at cost:				
Land	100,000			100,000
Buildings	1,749,250			1,749,250
Vehicles	25,500			25,500
Total	1,874,750			1,874,750
Less: Accumulated depreciation	(1,056,200)			(1,056,200)
Net fixed assets	818,550			818,550
Total assets	\$1,017,455	\$275,825	\$2,246,695	\$3,798,900
LIABILITIES AND NET ASSETS				
Accounts payable	\$ 47,845			\$ 47,845
Withholding taxes	6,300			6,300
Grants paid in advance	42,085			42,085
Payable (receivable)	35,000	\$ (4,970)	\$ 12,089	—
Total current liabilities	131,230	(4,970)	12,089	96,230
Net assets:				
Restricted		280,795	2,234,606	2,515,401
Unrestricted	886,225			1,187,269
Total	886,225	280,795	2,234,606	3,702,670
Total liabilities and net assets	\$1,017,455	\$275,825	\$2,246,695	\$3,798,900

EXHIBIT 12.14

Example of a Columnar Statement of Activities for All Classes

J. W. M. DIABETES RESEARCH INSTITUTE						
STATEMENT OF ACTIVITIES						
FOR THE YEAR ENDED JUNE 30, 20X2						
	Unrestricted					
	General Fund	Investment Fund	Total Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Income:						
Grants and contracts	\$ 424,701		\$ 424,701			\$ 424,701
Contributions and legacies	341,216		341,216	\$ 27,515	\$ 122,504	491,235
Investment income	92,793		92,793	16,556	1,640	110,989
Gain on sales of investments	263,660		263,600	3,486	29,344	296,480
Net assets released from restrictions	54,356		54,356	(54,356)		—
Total	<u>1,176,726</u>		<u>1,176,726</u>	<u>(6,799)</u>	<u>153,478</u>	<u>1,323,405</u>
Expenses:						
Client services	482,813		482,813			482,813
Research	275,844		275,844			275,844
Administration	112,044		112,044			112,044
Total	<u>870,701</u>		<u>870,701</u>			<u>870,701</u>
Excess of income over expenses for the year	306,025		306,025	(6,799)	153,478	452,704
Reclassifications	(35,000)		7,119		(7,119)	—
Change in net assets	271,025	\$ 42,119	313,144	(6,799)	146,359	452,704
Net assets, beginning of the year	615,200	42,119	874,125	287,594	2,088,247	3,249,966
Net assets, end of the year	<u>\$ 886,225</u>	<u>\$301,044</u>	<u>\$1,187,269</u>	<u>\$280,795</u>	<u>\$2,234,606</u>	<u>\$3,702,670</u>

It should be noted that there are no contributions or gains shown directly in the unrestricted investment fund. All unrestricted contributions or gains are shown in the unrestricted general fund. The board can then transfer any portion of such income to the unrestricted investment fund but it should not show such income directly in that fund. Unrestricted income must be reported initially in the unrestricted general fund.

(d) Unrestricted Investment Income

It will be noted that unrestricted investment income of \$92,793 (\$81,142 from endowment and \$11,651 from unrestricted investment funds) has been shown directly in the unrestricted general fund. It would not have been appropriate for the board to have left this amount in the endowment and unrestricted investment funds since this income contains no restrictions as to its use. To assist the reader in seeing how much income each separate fund earned, this unrestricted income is also shown in the Statement of Changes in Individual Funds in the column “Reported Directly in General Fund.” Inclusion of this column in the statement is optional.

(e) Gains and Losses

Endowment gains aggregating \$296,480 have been shown partly in each of the three classes, as discussed in Chapter 6. Unrestricted investment fund gains should be reported entirely in the unrestricted general fund. These gains, as with investment income, represent unrestricted income and should be reported as such. There is no reason why the board cannot reclassify all or part of these gains back to the unrestricted investment fund, but this should be handled as a reclassification.

(f) Comparison with Last Year’s Figures

An additional column may be added to the balance sheet and the Statement of Activities to show last year’s actual figures so the reader has a point of reference. This comparison is usually to the total column, although sometimes a comparison is made only to the unrestricted general fund. If the comparison column is to the total column, then this additional column should be next to the current year’s total column to make it easier for the reader. If the comparison is only to the unrestricted general fund, it should be set up with heads as shown below. Instead of a comparison to last year’s figures, the comparison could have been to this year’s budget.

		Unrestricted		Temporarily Restricted	Permanently Restricted	Total
General Fund		Investment	Fund			
Last Year	This Year					

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.15

Example of a Supplementary Statement Illustrating How Changes in Individual Name Funds Can Be Presented for a Fairly Complex Fund Accounting Structure

J.W.M. DIABETES			
STATEMENT OF CHANGES IN INDIVIDUAL UNRESTRICTED (TEMPORARILY RESTRICTED)			
FOR THE YEAR ENDED			
(All income and expenses have been shown in total on the			
		<u>Investment Income</u>	<u>Capital Gains</u>
	Contributions and Legacies	Reported Directly in General Fund	Reported Directly in General Fund
		Other	
*Unrestricted Investment Fund			
Elmer C. Bratt Fund		\$11,651	\$ 33,660
*Funds for specified purposes:			
Charity Fund	\$ 3,000	\$ 6,683	\$ 15,821
Library Fund	18,615	603	1,756
Staff pensions	4,150	3,742	10,811
Malmar Repair Fund	700	5,078	312
100th Anniversary Fund	<u>1,050</u>	<u>450</u>	<u>1,300</u>
Total funds for specified purposes	<u>\$ 27,515</u>	<u>\$16,556</u>	<u>\$ 33,486</u>
Endowment funds:			
Principal and income restricted:			
The Malmar Fund			\$ (3,015)
Clyde Henderson Fund		\$ 1,150	8,165
Evelyn I. Marnoch Fund		<u>490</u>	<u>(2,156)</u>
		<u>1,640</u>	<u>2,994</u>
*Principal only restricted:			
The Roy B. Cowin Memorial Fund		\$73,859	184,035
The Lillian V. Fromhagen Fund		2,392	6,911
Donna Comstock Fund	\$ 16,153	1,670	3,661
Josephine Zagajewski Fund	100,000	2,250	
The Peter Baker Fund	<u>6,351</u>	<u>688</u>	<u>1,580</u>
	<u>122,504</u>	<u>80,859</u>	<u>225,521</u>
*Restrictions released by donor in 20X1:			
The Alfred P. Koch Fund		<u>283</u>	<u>819</u>
Total endowment funds	<u>\$122,504</u>	<u>\$81,142</u>	<u>\$233,660</u>

* Funds have been "pooled" for investment purposes. See Chapter 26 for a discussion of pooled investments.

12.5 A COMPLICATED SET OF CLASS FINANCIAL STATEMENTS

**RESEARCH INSTITUTE
INVESTMENT FUNDS* FOR SPECIFIED PURPOSES
AND ENDOWMENT FUNDS**

JUNE 30, 20X2

Statement of Activities)

(Losses)

<u>Left in Fund</u>	<u>Disbursed for Specified Purpose</u>	<u>Other Interfund Transfers Add (Deduct)</u>	<u>Net Change in Fund</u>	<u>Net Assets Beginning of Year</u>	<u>Net Assets End of Year</u>
		<u>\$42,119</u>	<u>\$ 42,119</u>	<u>\$ 258,925</u>	<u>\$ 301,044</u>
\$ 3,486	\$ (9,200)		\$ 3,969	\$ 164,337	168,306
	(18,156)		1,062	15,267	16,329
			(13,608)	93,978	80,370
			278	2,712	2,990
			<u>1,500</u>	<u>11,300</u>	<u>12,800</u>
			<u>\$ (6,799)</u>	<u>\$ 287,594</u>	<u>\$ 280,795</u>
				\$ 107,685	\$ 107,685
			\$ 1,150	33,766	34,916
			490	8,715	9,205
			<u>1,640</u>	<u>150,166</u>	<u>151,806</u>
					1,854,669
					60,076
					47,974
					100,000
					<u>20,081</u>
					<u>2,082,800</u>
					—
<u>\$29,334</u>	<u>\$(27,356)</u>	<u>\$(7,119)</u>	<u>\$146,359</u>	<u>\$2,088,247</u>	<u>\$2,234,606</u>

The authors believe that showing comparative information for the prior year is generally desirable, and recommend its inclusion in financial statements in most circumstances.

(g) Balance Sheet

Fixed assets have not been set up as a separate category. Instead, they have been included as a part of the unrestricted class. This greatly simplifies the problem of depreciation since depreciation can then be handled in the same manner as it would be handled by a commercial enterprise. The presentation problems in handling depreciation if a separate fixed asset category is used are discussed more fully in Chapter 7.

One of the principal reasons why many prefer to see fixed assets in a separate category is that the unrestricted general fund balance then represents the current assets of the organization. In our illustration the net assets of \$886,225 is mostly represented by fixed assets. If the fixed assets had been shown separately, the unrestricted general fund balance would have been only \$67,675. But this lower figure has limited significance because there are other unrestricted current assets that are available for general purposes if the board chooses to use them. These other unrestricted current assets are the \$301,044 of otherwise unrestricted investment funds.

Some will argue that the fixed asset amounts should not be included in the “unrestricted” figure since the organization could not exist without its buildings. This may be so, but there is no reason why the institute has to use its present buildings. They could be sold and new ones built on less expensive land or in a better location. Or property could be rented. These are all decisions that the board is free to make and, being free to make them, the assets are unrestricted. An alternative presentation that avoids the problem of mixing currently available net assets with the fixed assets is to show the fixed assets on a separate line as in Exhibit 12.11. The authors recommend this approach whenever fixed assets are a significant part of total assets, and especially if the financial condition of the organization is not very liquid. If an organization has a large total unrestricted net assets balance, but most of it is represented by fixed assets, there might not be enough cash available to pay current bills as they come due.

Sometimes an organization will even have a fixed assets balance in excess of its total unrestricted net assets. In this case, there is effectively a deficit in available resources, and serious financial trouble may not be far away.

In the McLean Community Service Center statements, the balance sheet (Exhibit 12.9) was set up to show total assets less liabilities equaling net assets:

Total assets	\$442,000
Less—Liabilities	<u>(20,000)</u>
Net Assets	<u><u>\$422,000</u></u>

In the J. W. M. Diabetes Research Institute statements (Exhibit 12.12), the more conventional balance sheet approach was followed showing total assets equaling the sum of the liabilities and net assets:

Total assets	<u>\$3,798,900</u>
Liabilities	\$ 96,230
Net assets	<u>3,702,670</u>
Total liabilities and net assets	<u>\$3,798,900</u>

Either approach is acceptable. The first is more appropriate for organizations with relatively few categories of liabilities, and therefore for smaller organizations.

(h) Statement of Changes in Individual Funds

Notice the line at the top of Exhibit 12.15, “All income and expenses have been shown in the total on the Statement of Activities.” This or a similar statement helps readers to recognize that they don’t have to add the income and expenses shown on this statement to the amounts shown on the Statement of Activities (Exhibit 12.14) in order to get total income and expenses. While technically there is no requirement that this type of caption be shown, it helps in understanding the nature of this statement. Most of the totals shown on this statement can be tied in directly to the Statement of Activities.

(i) Restricted Income from Endowments

Income on permanent or term endowment that is restricted to a specified purpose should be recorded directly in the net asset category for that purpose. Note that in the Malmar endowment fund no investment income has been shown. Actually \$4,970 of income was received but it was reported directly in the fund for specified purposes in a separate fund maintained for this income (Malmar Repair Fund). This \$4,970 plus \$108 of income earned on this restricted fund balance is the \$5,078 reported as investment income.

There are two other endowment funds with restrictions on the income. In both instances, the income has been left in the endowment fund. Presumably the donor specified that the income was to be accumulated for a period of time before it could be spent. There is no disclosure of the terms of the fund on the statement, but if they were significant a footnote could be added to tell the reader. There is no reason why unrestricted investments couldn’t also have “names” associated with them. Here all of the unrestricted investments are shown as the Elmer C. Bratt Fund. The board could also have had other “name” funds, all part of the total unrestricted investment fund.

While it is not obvious from this statement, most of the investments are “pooled” together and individual funds have a percentage or share interest in the total investment portfolio. Since all of the individual funds are “pooled” together, each gets its proportionate share of income and gains or losses on the sale of investments. Chapter 26 discusses the mechanics of “pooling” investments.

(j) Other Supporting Statements

Besides the Statement of Cash Flows, discussed earlier in this chapter, there are other statements that could be included with the three statements we have just discussed. For example, many readers might want to see a great deal more of the details of the expense categories than are shown in total on the Statement of Activities, and perhaps also a comparison with the budget or last year’s actual figures. Exhibit 12.16 shows an example of this type of supporting schedule. Again, as with all supporting or supplementary statements, the format must be so designed that the reader clearly sees how the figures tie into the main statement.

The reader interested in detail gets a great deal of information from looking at this type of analysis. There is comparison both with budget for the year and with last year’s actual expenses, by type of expense and function. It must be remembered that the more detail provided, the greater the risk that the reader will get lost in the detail. Financial statements are not necessarily improved by providing details or additional supporting schedules. In fact, often they detract from the overall effectiveness.

12.6 SUMMARY OR CONDENSED STATEMENTS

Frequently for fundraising purposes or for the general information of the membership, the board will want to distribute summary or condensed financial statements. Often the board will prefer not to show a large excess of income since this might discourage fundraising. In the case of the J. W. M. Diabetes Research Institute, the board might want to show only the unrestricted general fund activities, which, as will be recalled, had an excess of income of \$306,025. Yet actually the institute had a total “all funds” excess of \$452,704.

The board may prefer issuing statements for only the unrestricted general fund. This is not recommended. At some point, the credibility of the board and its statements may come into question if some of the readers feel information is being withheld. Also, if the board wished to have an auditor’s opinion accompany the financial statements of the unrestricted general fund, the auditor would have to call attention in the report to the fact that other funds of the organization were not included. This requirement is to alert readers that they are not seeing the whole picture.

EXHIBIT 12.16

Example of an Analysis of Expenses by Both Function and Types of Expense, Along with a Comparison to Both Budget and Last Year's Actual

J. W. M. DIABETES RESEARCH INSTITUTE						
ANALYSIS OF EXPENSES AND COMPARISON WITH BUDGET AND LAST YEAR'S ACTUAL						
FOR THE YEAR ENDED JUNE 30, 20X2						
	Actual Last Year	Budget This Year	Actual This Year	Client Services	Research	Administration
Salaries and payroll taxes	\$581,615	\$615,000	\$618,686	\$425,851	\$133,588	\$ 59,247
Retirement benefits	23,151	33,000	33,833	21,463	8,720	3,650
Major medical	3,656	4,500	4,578	3,155	1,013	410
Clinic supplies	34,616	42,000	41,374	29,488	11,886	
Office supplies	3,518	6,900	8,356		5,500	2,856
Laboratory supplies	47,717	40,000	33,596		33,596	
Insurance	5,751	6,000	5,951			5,951
Telephone	3,748	5,000	6,116		3,800	2,316
Depreciation	39,516	43,000	43,525	2,856	30,309	10,360
Contracted repairs and maintenance	14,819	9,600	15,054			15,054
Utilities and fuel	19,151	20,000	19,268		11,316	7,952
Other	36,118	35,000	40,364		36,116	4,248
Total	<u>\$807,376</u>	<u>\$860,000</u>	<u>\$870,701</u>	<u>\$482,813</u>	<u>\$275,844</u>	<u>\$112,044</u>
Budget		<u>\$860,000</u>		<u>\$480,000</u>	<u>\$280,000</u>	<u>\$100,000</u>
Actual last year	<u>\$807,376</u>			<u>\$451,254</u>	<u>\$251,348</u>	<u>\$104,774</u>

MULTICLASS FINANCIAL STATEMENTS

EXHIBIT 12.17

Example of a Condensed Statement of Income And Expenses for All Funds, Suitable for Inclusion in an Annual Report or Fundraising Literature

J. W. M. DIABETES RESEARCH INSTITUTE CONDENSED STATEMENT OF INCOME AND EXPENSES FOR THE YEAR ENDED JUNE 30, 20X2 (in thousands)		
Income:		
Grants and contracts	\$425	
Contributions and legacies	491	
Investment income	111	
Gain on sale of investments	<u>296</u>	
Total income		\$1,323
Expenses:		
Client services	483	
Research	275	
Administration	<u>112</u>	
Total expenses		<u>870</u>
Excess of income over expenses		<u>\$ 453</u>
Excess restricted by donor	147	
Unrestricted	<u>306</u>	
Total		<u><u>\$ 453</u></u>

There is an acceptable approach open to the board. This is to present a condensed statement showing income and expenses for the entire organization but clearly indicating the amount of the excess of income that was donor-restricted. Exhibit 12.17 shows this presentation. It would be entirely inappropriate, however, to eliminate the unrestricted investment fund activities from the condensed statement. Unrestricted investment funds have all of the characteristics of unrestricted general funds since the board can act at any time to convert unrestricted investment funds back into unrestricted general funds. These funds must be considered part of general unrestricted funds any time when condensed financial statements are presented.

12.7 CONCLUSION

This chapter discussed in detail the significant requirements in financial reporting by not-for-profit organizations brought about by SFAS 117. The chapter then presented a number of illustrations to help the reader more

12.7 CONCLUSION

readily understand the complexities of presenting financial statements that include details for multiple net asset classes. The use of the columnar approach has been discussed because it offers many advantages over presenting separate statements for each category, the approach followed by many organizations. It is extremely important that these statements be all-inclusive so that the reader can get a broad overall picture of the activities of the organization before getting down into the detail. Several illustrations were given showing how typical detail can be presented with a minimum risk of confusing the reader. Finally, condensed or summary financial statements were discussed and the importance of disclosing all income (either in the body of the statement or in footnotes) was emphasized. Failure to do so creates a credibility gap that can only hurt the organization.

Following, as Appendix 12–A, is a checklist to help preparers of financial statements avoid the most common pitfalls noted during review of draft statements using the FASB and AICPA accounting and reporting standards discussed throughout this book.

APPENDIX 12–A

Financial Statements of Not-for-Profit Organizations—Review Points⁴

(a) All Financial Statements

“Other” or “Miscellaneous” captions should be avoided as much as possible. If used, the amounts associated with such captions should be small—at least not much larger than any other amount in the same section (e.g., assets, liabilities, revenue, expenses). For example, presenting prepaid expenses of \$100 and other assets of \$800 will give a reader the impression that the organization is trying to hide something it is embarrassed about.

(b) Balance Sheet

There should not be dues receivable unless there is a contractual obligation on the part of the member to pay for goods or services already received (this circumstance will be very rare). There should not be deferred fundraising costs (except for inventoriable items such as brochures).

If the balance sheet is disaggregated by class:

- The only items normally found in either of the restricted classes are cash, investments, pledges receivable, assets held by others under trust agreements, annuity liabilities, and net assets; however fixed assets are allowed:
 - In the temporarily restricted class if the organization’s accounting policy is to consider the restriction on donated fixed assets (and fixed assets purchased with donated restricted gifts for that purpose) to expire ratably over the assets’ useful lives.
 - In the permanently restricted class if it is reasonable for the organization to have such assets—for example, capitalized museum collection items that cannot be disposed of, undeveloped land held by a conservation organization under a perpetual conservation easement, investment real estate received as a permanent endowment gift, and the like.
- Amounts receivable under cost-reimbursement grants are unrestricted because any temporary restrictions originally associated

⁴ Other than the normal matters of articulation of numbers among and within statements and notes, adequate disclosure (see Appendix A, Accounting and Disclosure Guide for Not-for-Profit Organizations), mathematical accuracy, format, terminology, etc.

APPENDIX 12-A

with such amounts have been released by the activity giving rise to the receivable.

- Pledges are normally only in the temporarily (usually) or permanently (if the pledge is stipulated by the donor for permanent endowment) restricted columns. Any pledges in the unrestricted class must be explained.
- Prepaid expenses and accounts payable are permitted in the temporarily restricted class only in the uncommon circumstances where expenses have been incurred under the terms of a restricted contribution but the restriction itself has not yet been met. An example is receipt of a gift to commission and perform a new piece of music; progress payments are made to the composer; but the restriction will not be lifted until the piece is complete and has been performed.
- Deferred revenue will be unrestricted and may not include any contributions (except in the relatively rare case of the pooled income fund form of a split-interest gift).
- Liabilities related to annuities held in a trust are temporarily restricted (unless the proceeds will be permanently restricted upon maturity).

NET ASSETS

- The amount of temporarily (normally) and/or permanently restricted net assets must equal or exceed pledges receivable.
- If the unrestricted net assets caption includes a subcaption for equity in fixed assets, this caption should equal (or at least approximate) the net of fixed assets minus long-term debt.
- Permanently restricted net assets should normally be no larger than investments (including restricted cash and revolving fund loans receivable, if any) plus permanently restricted pledges (unless there are also permanently restricted fixed assets—see first item in this list).
- No subpart of the temporarily restricted class may show a debit (negative) balance, because it is not possible to release more restricted amounts than were started with. Any overspending in a restricted fund is charged to the unrestricted class, unless there is an unconditional pledge to cover the deficit, in which case recording the pledge will cause the temporarily restricted net assets class to show at least a break-even balance.
- It is not possible to designate an amount of the unrestricted class which exceeds the total available (defined as total unrestricted net assets less equity in fixed assets) unrestricted net assets.

MULTICLASS FINANCIAL STATEMENTS

- Board designation of otherwise unrestricted net assets does not create temporarily or permanently restricted net assets.

(c) Statement of Activity (Revenue and Expenses)

The only revenue items that can be in either of the restricted classes are contributions (and similar captions such as gifts, grants, allocations, etc.), investment return (interest, dividends, rent, realized and unrealized gains, etc.), and the negative side of the release of temporary restrictions. All earned income (even though there may be legal limitations on its use) and other revenue, and all expenses, are unrestricted. Gains and losses (and prior period adjustments and cumulative effects of accounting changes, if any) may be in any class. Contribution revenue related to pledges receivable is normally temporarily restricted; but, if the donor has stipulated that when collected the pledge becomes permanently restricted, the revenue is initially recorded directly in that class.

Investment income is reported directly in the class of net assets appropriate to any donor-imposed restriction (or lack thereof) on the income itself. For example, it may not be first reported in the permanently restricted class and then reclassified to the unrestricted class. Revenue and related expenses may not be shown net (exception: investment management expenses against investment income), but they may be shown as:

Gross
(Less deduction)
Net

Depreciation and occupancy (operation and maintenance of plant, or similar captions) are not functional expense categories and must be allocated to other functions. (This allocation may be shown in a footnote, but the authors do not recommend this.) Interest and payments to affiliates should be allocated if possible. If an organization wishes to show such expense categories as separate line items on the face of an income statement (not recommended), then a footnote must disclose their functional allocation.

Fundraising expense is a required disclosure. If there is fundraising expense but this disclosure is not made because the amount is immaterial, it is recommended that the accounting policy footnote state that “immaterial amounts of fundraising expenses are included in [management and general] expense.”

Reclassifications/transfers are:

- Not permitted out of permanently restricted
- Not permitted into temporarily or permanently restricted except for the matching portion of a restricted challenge (matching) gift/grant

Exceptions to above include the following.

- Any reclassification is permitted as a correction of an error (prior-period adjustment); these will be rare.
- Any reclassification is permitted if a donor of a gift changes the nature of a restriction in a year subsequent to initial recording of the gift (organization may wish to consult an attorney regarding the legality of certain types of reclassification (e.g., the placing of a restriction on a previously unrestricted gift).

Nothing may go below “Change in Net Assets” (except beginning and ending net assets and prior period adjustments).

(d) Statement of Functional Expenses (If Presented)

All relevant expense categories must be allocated to all affected functions, including fundraising. For example, it is not appropriate to automatically include all occupancy, utilities, insurance, etc., in management expenses. Even if the amount properly allocated to a function is small, the allocation should be made to avoid the impression to a reader that the client (or the auditor!) does not understand proper allocation procedures.

(e) Statement of Cash Flows

Noncash financing and investing transactions—such as receipt of donated fixed assets and donated investment securities, forgiveness of debt—must be disclosed. The subsequent sale of donated noncash assets is an investing transaction. (If donated long-term assets are sold immediately after receipt, the cash proceeds may be reported as a financing cash flow instead.)

Purchases and sales of investments and other long-term assets must be shown gross, not net. If the indirect method is used, separate disclosure of interest paid and taxes paid is required.

P A R T T H R E E

**Accounting and Reporting
Guidelines**

CHAPTER THIRTEEN

Voluntary Health and Welfare Organizations

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The term voluntary *health and welfare organization* first entered the accounting world with the publication in 1964 of the first edition of the so-called “Black Book,” *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, by the National Health Council and the National Social Welfare Assembly and published by Kendall/Hunt Publishing.¹ The term has been retained through three successor editions of that book, and was used by the AICPA in the title of its audit guide, *Audits of Voluntary Health and Welfare Organizations*, first published in 1966.

In 1974, the AICPA issued a revised audit guide, prepared by its Committee on Voluntary Health and Welfare Organizations. This audit guide was prepared to assist the independent auditor in examinations of voluntary health and welfare organizations. Included in the revised audit guide was a discussion of accounting and reporting principles that were considered appropriate for this type of organization.

In 1993, the Financial Accounting Standards Board (FASB) issued two new accounting pronouncements, SFAS 116, *Accounting for Contributions Received and Contributions Made*, and 117, *Financial Statements of Not-for-Profit Organizations*, which superseded many provisions of the AICPA audit guide.² Then, in 1996, the AICPA Not-for-Profit Organizations Committee issued a new audit and accounting guide, *Not-for-Profit Organizations*, that replaced the existing guides for voluntary health and welfare organizations, colleges, and universities and other not-for-profit organizations, this audit guide is updated annually.

This chapter summarizes the accounting and reporting principles discussed in the FASB and AICPA standards as they particularly apply to voluntary health and welfare organizations. For the most part, the FASB standards prescribe the same accounting treatment for a given transaction by all types of not-for-profit organizations. One exception to that rule is a requirement that voluntary health and welfare organizations continue to present a statement of functional expenses. Other types of organizations are not required to present this statement, although they may if they wish. More detailed discussions of certain accounting and reporting standards in the FASB documents will also be found in other chapters of this book. For example, a full discussion of accounting for contributions is in Chapter 8.

“Voluntary health and welfare organizations” are those not-for-profit organizations that “derive their revenue primarily from voluntary contributions from the general public to be used for general or specific purposes

¹ It can be obtained from the National Health Council, 1730 M Street, N.W., Washington D.C. 20036.

² Chapter 19 discusses in more detail the formal rule-making procedures of the accounting profession, and in particular the relationship of the FASB and the AICPA.

13.2 ACCOUNTING FOR CONTRIBUTIONS

connected with health, welfare, or community services.”³ Note that there are two separate parts to this definition: First, the organization must derive its revenue from voluntary contributions from the general public, and second, the organization must be involved with health, welfare, or community services. Many organizations fit the second part of this definition, but receive a substantial portion of their revenues from sources other than public contributions. For example, an opera company would not be a voluntary health and welfare organization because its primary source of income is box office receipts, although it exists for the common good. A YMCA would be excluded because normally it receives most of its revenues from membership dues and program fees. On the other hand, a museum would be excluded, even if it were to receive most of its revenue from contributions, since its activities are educational, not in the areas of health and welfare.

13.1 ACCOUNTING PRINCIPLES

Summarized in the following subsections are the accounting principles (or practices) that are commonly followed by voluntary health and welfare organizations.

(a) Accrual Basis

The accrual basis of accounting is normally necessary for financial statements prepared in accordance with generally accepted accounting principles. While cash basis statements are not prohibited, the auditor cannot issue an opinion on cash basis financial statements which states that the statements are prepared in accordance with generally accepted accounting principles, unless these financial statements do not differ materially from the statements prepared on the accrual basis. The same caution is made with respect to modified accrual-basis statements (discussed in Chapter 3).

13.2 ACCOUNTING FOR CONTRIBUTIONS

See also the discussion of pass-through gifts in Section 7.2(a). Additional discussion of contributions is in Chapter 8 of this book and in Chapters 5 and 6 of the audit guide for *Not-for-Profit Organizations*.

(a) Unrestricted Gifts

All unrestricted gifts are recorded as revenue or “support” of the current unrestricted fund. As noted above, some organizations may choose to

³ *Audits of Voluntary Health and Welfare Organizations* (New York: American Institute of Certified Public Accountants, 1974), v (and repeated in SFAS 117).

internally “restrict” (a better term is “designate”) certain donations, but such self-imposed limitations in no way change the legal characteristics of the gift and such gifts must be recorded in the current unrestricted fund and reported in the unrestricted class of net assets.

(b) Restricted Gifts

Most organizations receive up to three types of restricted gifts: gifts for a “current” purpose (recorded internally in the current restricted fund), gifts for building fund purposes (recorded in the land, building, and equipment fund), and gifts for endowment (recorded in the endowment fund).

(i) Current Restricted Gifts. All current restricted gifts and other income should be recorded as revenue in the year in which a gift or an unconditional pledge is received (or pledged). If a donor makes a contribution for a current restricted purpose of \$50,000 but the organization expends only \$40,000 during the current year, the full \$50,000 would still be reported as income in the temporarily restricted class.

(ii) Building Fund Gifts. For internal recordkeeping these gifts would be recorded in the fixed-asset fund. As was noted above, however, SFAS 117 does not prohibit combining the fixed-asset fund and the current unrestricted fund. If this combining is done, receipt of restricted building fund gifts would then be recorded in the current restricted fund.⁴

(iii) Endowment Fund Gifts. As noted above, these gifts would be recorded in a separate endowment fund; only gifts restricted by a donor or by law should be recorded here. Gifts of term endowment, or the various types of split-interest gifts, would be reported in the financial statements in the temporarily restricted class of net assets. Gifts of permanent endowment would be reported in the permanently restricted class.

(c) Donated Services

This subject is discussed further in Chapter 8. SFAS 116 sets forth fairly specific criteria that, if met, require the recording of donated services, or, if not met, preclude their recording. Even if the criteria are met, donated services would still only be recorded when there is an objective and clearly measurable basis for the amount.

⁴ If a significant amount of restricted building fund gifts were received, the title of the fund would probably have to be changed, or possibly two separate funds used (i.e., current restricted fund and restricted building fund gifts). If the organization elects to do so, amounts expended for fixed assets which are placed in service in the same year may be reported in the unrestricted class, leaving unexpended restricted amounts in the temporarily restricted class.

Certain categories of services would not normally be recorded; these include supplementary efforts of volunteers that are in the nature of incidental services to beneficiaries of the organization, volunteers assisting in fundraising drives and members of the organization's governing board when serving in their capacity as board members.

But where the requirements of SFAS 116 are met, and where the amounts are material, there is no option. Donated services must be recorded or the external auditor will be required to qualify the opinion.

(d) Donated Materials

Donated materials are normally recorded as a contribution at their estimated fair value, appropriately disclosed. The principal exception would be where the amounts are not significant or where there is no readily measurable basis for valuing such materials. In addition, donated materials that merely pass through the hands of the organization to a beneficiary may or may not be recorded since the organization is merely acting as an agent for the donor. This is discussed further in Chapter 7.

(e) Donated Securities

Donated securities are treated in the same way as donated cash; that is, if the donated securities are to be used for a donor-specified purpose or endowment, the gift would be recorded as revenue in the appropriate fund at the fair market value at the date of receipt. If the gift is not restricted by the donor, the gift would be recorded directly in the current unrestricted fund in the same manner as any other cash gift.

(f) Donated Equipment and Fixed Assets

Donated fixed assets would be recorded at their fair market value as revenue of the fixed-asset fund, provided a separate fixed-asset fund is used. If, on the other hand, the donated asset will be sold shortly after receipt and the cash received from the sale is unrestricted, these fixed-asset gifts would be recorded in the current unrestricted fund at the time of initial receipt.

(g) Timing of Reporting of Gifts

Because SFAS 116 requires pledges and restricted gifts to be recorded as revenue in the period the gift or pledge is received (not the period in which the pledge is collected) and reported in the financial statements in the temporarily restricted class of net assets.

Even if a calendar-year organization normally solicits contributions late in its fiscal year with the clear understanding in its solicitation literature that the amounts raised will be used for the organization's following

year, or if a large unsolicited gift is unexpectedly received toward the end of the year (say, on December 28), the entire amount of these gifts should be recorded as income in the current year. The fact that a contribution is an extraordinarily large one, or that it is received toward the end of the year, does not justify deferring its recognition as income.

(i) **Bequests.** Accounting for bequests is discussed in Chapter 8.

(ii) **Pledges.** Unconditional pledges (called “promises to give” in SFAS 116) are something valuable that will benefit the organization, and thus should be recorded as assets. The same is true with allocations from United Fund and similar campaigns that have been made but not received in cash at the end of the period. Under SFAS 116, pledges beyond one year are discounted to their estimated present value to reflect the time value of money. The discount is then accreted (or built up) to fair value over the period between the time the pledge is made and the time it is due to be paid. This accretion is reported as additional contribution income. In addition, an appropriate provision for estimated uncollectible pledges should be established based on prior experience.

13.3 ACCOUNTING FOR OTHER INCOME

(a) Investment Income

Additional discussion is in Chapter 6 of this book and in Chapter 8 of the audit guide for *Not-for-Profit Organizations*.

All unrestricted investment income (dividends and interest) must be recorded directly in the unrestricted net asset class in the revenue section. Endowment income that has been restricted to a specified purpose would be recorded directly in the temporarily restricted net asset class. Investment income from temporarily restricted fund net asset class or plant fund investments is normally considered “restricted” and would be recorded in the temporarily restricted class.

(b) Gains or Losses on Investments

Gains or losses (including unrealized appreciation or depreciation for investments carried at market; see below) on all unrestricted and restricted investments would be recorded in the unrestricted class (unless donor stipulations or state law require otherwise) in the revenue section, as shown in Exhibit 13.2.

(c) Total Return Concept

See the discussion in Chapter 6.

13.4 ACCOUNTING FOR EXPENSES

Because this subject is more related to financial statement presentation, it is discussed in Section 13.7 of this chapter.

13.5 ACCOUNTING FOR ASSETS

(a) Carrying Value of Investments

See the discussion in Chapter 6 about FASB SFAS 124 for marketable securities. Briefly, it requires such investments to be reported at current market value.

SFAS 124 covers only equity securities with a readily determinable fair value (except investments accounted for under the equity method, or investments in consolidated subsidiaries) and all debt securities. It does not set a standard for valuing other types of investments such as nonmarketable equity securities, real estate, partnerships, oil and gas interests, and so on. The audit guide for *Not-for-Profit Organizations* says (in paragraph 8.09 and Appendix 6–A in Chapter 6 of this book) that these other investments should be reported in accordance with whichever one of the old audit guides was applicable to the type of organization concerned.

Accordingly, voluntary health and welfare organizations should report such “other” investments at either cost (if purchased, or fair market value at the date of donation if donated) or at current fair market value. The same method must be used for all such investments. If investments are carried at other than current market value, and current market value is below cost, a provision for decline in value may need to be recorded if there has been a material decline that is considered other than temporary in nature.

(b) Fixed-Asset Accounting

All organizations must capitalize fixed assets *and* must follow depreciation accounting procedures, similar to those followed by business entities.

(i) Reason for Depreciation. In discussing the question of depreciation accounting, the *Voluntary Health and Welfare Audit Guide* stated:

The relative effort being expended by one organization compared with other organizations and the allocation of such efforts to the various programs of the organization are indicated in part by cost determinations. Whenever it is relevant to measure and report the cost of rendering current services, depreciation of assets used in providing such services is relevant as an element of such measurement and reporting process. Although depreciation can be distinguished from most other elements of cost in that it requires no current equivalent cash outlay, it is not optional or discretionary. Assets used in providing services are both valuable and exhaustible. Accordingly, there is a cost expiration associated with the use of depreciable assets, whether they are owned or

VOLUNTARY HEALTH AND WELFARE ORGANIZATIONS

rented, whether acquired by gift or by purchase, and whether they are used by a profit-seeking or by a not-for-profit organization.

Where depreciation is omitted, the cost of performing the organization's services is understated. Depreciation expense, therefore, should be recognized as a cost of rendering current services and should be included as an element of expense in the Statement of Support, Revenue, and Expenses of the fund in which the assets are recorded and in the Statement of Functional Expenses. SFAS 93 requires that depreciation accounting be followed. If depreciation accounting is not followed, the external auditor will be required to qualify the opinion.

This does not mean that every \$10 purchase must be capitalized and depreciated. The cutoff point is left to the organization to determine and many may conclude that this cutoff should be fairly high to minimize record-keeping. While each organization will have to make its cutoff decision based on its size and extent of fixed asset activity, most organizations will establish a cutoff between \$100 (for a small organization) and \$5,000 (for a large one). Organizations receiving federal grants will have to consider federal guidelines on this subject.

(ii) Fixed Assets Where Title May Revert to Grantors. As noted in Chapter 5, some organizations purchase or receive fixed assets under research or similar grants which provide that, at the completion of the grant period, the right of possession of these fixed assets technically reverts to the grantor. If the grantor is not expected to ask for their return, a fixed asset, whether purchased or donated, should be recorded as an asset and depreciated as with any other asset.

This method is discussed in paragraph 9.04 of the audit guide for *Not-for-Profit Organizations*.

13.6 NET ASSETS

(a) Appropriations

The board may "designate" a portion of the unrestricted net assets for some specific purpose. This appropriation or designation, however, would be reported only in the net assets section of the balance sheet. The appropriation or designation may *not* be shown as a deduction on the Statement of Support, Revenue and Expenses, and Changes in Net Assets.

Accordingly, it is not appropriate for an organization to charge expense directly against "appropriated" balances. The expense must be included in the Statement of Support, Revenue and Expenses, and Changes in Net Assets. All an appropriation does is to allow the board to designate *in the net assets section* of the balance sheet how it intends to spend the unrestricted net assets in the future. For example, the unrestricted net assets of the National Association of Environmentalists of \$135,516 (Exhibit 13.1) could be split into several amounts, representing the board's present intention of how it plans to use this amount. Perhaps \$50,000 of it is intended for Project Seaweed, and the balance is available

13.7 FINANCIAL STATEMENTS

for undesignated purposes. The net assets section of the balance sheet would appear as follows:

Net assets:	
Designated by the board for Project Seaweed	\$ 50,000
Undesignated, available for current purposes	85,516
	<hr/>
	\$135,516
	<hr/> <hr/>

As monies are expended for Project Seaweed in subsequent periods, they would be recorded as an expense in the Statement of Support, Revenue and Expenses, and Changes in Net Assets. At the same time, the amount of the net assets designated by the board for Project Seaweed would be reduced. See Chapter 4 for a comprehensive discussion of appropriation accounting techniques.

13.7 FINANCIAL STATEMENTS

SFAS 117 provides for four principal financial statements for voluntary health and welfare organizations. The first three of those have already been discussed in Chapter 12. Additional examples are shown in this chapter, tailored to the particular types of organizations covered by this chapter, and in Chapter 16. Also the last of the four statements is discussed for the first time here. These four statements are:

1. Balance Sheet, or Statement of Financial Position (Exhibit 13.1)
2. Statement of Support, Revenue and Expenses, and Changes in Net Assets (Exhibit 13.2)
3. Statement of Cash Flows (Exhibit 13.3)
4. Statement of Functional Expenses (Exhibit 13.4)

The sample financial statements presented in SFAS 117 are for illustrative purposes only, and some variation from the ones presented may be appropriate, as long as the required disclosure elements are shown. Additional examples are found in the AICPA practice aid, *Financial Statement Presentation and Disclosure Practices for Not-for-Profit Organization*.

(a) Balance Sheet

Exhibit 13.1 shows a Balance Sheet for the National Association of Environmentalists. Although SFAS 117 only requires (and illustrates) a single-column balance sheet showing the totals of assets, liabilities, and net assets (and net assets by class), many organizations will wish to show more detail of assets and liabilities.

EXHIBIT 13.1
Balance Sheet Prepared in Columnar Format

NATIONAL ASSOCIATION OF ENVIRONMENTALISTS						
BALANCE SHEET						
DECEMBER 31, 20X2 AND 20X1						
	December 31, 20X2			December 31, 20X1		
	Current Funds	Endowment Funds	Fixed Asset Funds	Total All Funds	Total All Funds	December 31, 20X1
	Unrestricted	Restricted				
ASSETS						
Current assets:						
Cash	\$ 62,901	\$ 12,642	\$ 2,150	\$ 86,109		\$ 11,013
Savings accounts	40,000			40,000		
Accounts receivable	3,117			3,117		918
Investments, at market	86,195	226,119		312,314		269,289
Pledges receivable		5,509		5,509		769
Total current assets	<u>192,213</u>	<u>18,151</u>	<u>2,150</u>	<u>447,049</u>		<u>281,989</u>

EXHIBIT 13.2

Income Statement in the Columnar Format Recommended in the AICPA Audit Guide for Voluntary Health and Welfare Organizations, Which Meets the Requirements of SFAS 117

	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
NATIONAL ASSOCIATION OF ENVIRONMENTALISTS				
STATEMENT OF SUPPORT, REVENUE AND EXPENSES, AND CHANGES IN NET ASSETS				
FOR THE YEAR ENDED DECEMBER 31, 20X2				
Support:				
Contributions and gifts	\$174,600	\$38,400	\$ 10,000	\$223,000
Bequests	<u>60,000</u>		<u>21,500</u>	<u>81,500</u>
Total support	<u>234,600</u>	<u>38,400</u>	<u>31,500</u>	<u>304,500</u>
Revenues:				
Membership dues	20,550			20,550
Research projects	127,900			127,900
Advertising income	33,500			33,500
Subscriptions to nonmembers	18,901			18,901
Dividends and interest income	14,607			14,607
Appreciation of investments	<u>30,000</u>		<u>3,025</u>	<u>33,025</u>
Total revenues	<u>245,458</u>		<u>3,025</u>	<u>248,483</u>
Total support and revenues	<u>480,058</u>	<u>38,400</u>	<u>34,525</u>	<u>552,983</u>
Net assets released from restriction		<u>(26,164)</u>		

Expenses:				
Program services:				
<i>National Environment</i> magazine	110,500			110,500
Clean-up month campaign	126,617			126,617
Lake Erie project	115,065			115,065
Total program services	<u>352,182</u>			<u>352,182</u>
Supporting services:				
Management and general	33,516			33,516
Fundraising	5,969			5,969
Total supporting services	<u>39,485</u>			<u>39,485</u>
Total expenses	<u>391,667</u>			<u>391,667</u>
Excess (deficit) of revenues over expenses	114,555	12,236	34,525	161,316
Other changes in net assets:				
Transfer of unrestricted resources to meet challenge grant	(10,000)		10,000	—
Change in net assets	104,555	12,236	44,525	161,316
Net assets, beginning of year	124,631	5,915	190,010	320,556
Net assets, end of year	<u>\$229,186</u>	<u>\$18,151</u>	<u>\$234,535</u>	<u>\$481,872</u>

(i) **Funds versus Net Asset Classes.** Note that the columns on the Balance Sheet reflect the funds used for bookkeeping purposes. This is not required but is permissible, as long as the net asset amounts for each of the three net asset classes defined in SFAS 117 are shown in the net assets section of the Balance Sheet.

(ii) **Comparison Column.** In Exhibit 13.1 we have shown the totals for the previous year to provide a comparison for the reader. SFAS 117 does not require a comparative presentation, but the authors strongly recommend such a comparison. In a columnar presentation it is practical to show this comparison with the previous year for only the “total all funds” column, although it is possible also to show a comparison for a second column.⁵

(iii) **Designation of Unrestricted Net Assets.** While it is a little more awkward to show when the Balance Sheet is presented in a columnar fashion as in Exhibit 13.1, it is still possible to disclose the composition of the unrestricted net assets of \$135,516. This is shown earlier in this chapter.

(b) Statement of Support, Revenue and Expenses, and Changes in Net Assets

Exhibit 13.2 shows a Statement of Support, Revenue and Expenses, and Changes in Net Assets for the National Association of Environmentalists. This is the format shown in SFAS 117, with some modifications discussed in the following subsection.

(c) Reporting of Expenses

Additional discussion is in Chapter 13 of the audit guide for *Not-for-Profit Organizations*.

(i) **Functional Classification of Expenses.** Traditionally, not-for-profit organizations used to report in terms of amounts spent for salaries, rent, supplies, and the like (called a “natural” expense classification). SFAS 117 is based on the conclusion that not-for-profit organizations exist to perform services and programs and therefore should be reporting principally in terms of individual program activities or functions. Exhibit 13.2 shows the expenses of the National Association of Environmentalists reported on a functional basis. This

⁵ Many accountants object to including this total comparison column, saying that insufficient information on the nature of the restricted portions is reported. There is some validity to this argument, but the authors feel this total column is preferable to no comparison. However, if only the total column is presented then a footnote should point out that the prior year information is not a full GAAP presentation and refer the reader to the previous year’s audited financial statements.

type of presentation requires management to tell the reader how much of its funds were expended for each program category and the amounts spent on supporting services, including fundraising.

In many instances, the allocation of salaries between functional or program categories should be based on time reports and similar analyses. Other expenses such as rent, utilities, and maintenance will be allocated based on floor space. Each organization will have to develop time and expense accumulation procedures that will provide the necessary basis for allocation. Organizations have to have reasonably sophisticated procedures to be able to allocate expenses between various categories. An excellent reference source is the fourth edition (1998) of the “Black Book,” *Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations*, discussed in the beginning of this chapter. United Way of America has also published a comprehensive book to guide “human service organizations” in identifying their program classifications. This book is referred to as *UWASIS—United Way of America Services Identification System*.

(ii) Program Services. Not-for-profit organizations exist to perform services either for the public or for the members of the organization. They do not exist to provide employment for their employees or to perpetuate themselves. They exist to serve a particular purpose. SFAS 117 reemphasizes this by requiring the organization to identify major program services and their related costs. Some organizations may have only one specific program category, but most will have several. Each organization should decide for itself into how many categories it wishes to divide its program activities.

(iii) Supporting Services. Supporting services are those expenses that do not directly relate to performing the functions for which the organization was established, but which nevertheless are essential to the continued existence of the organization.

The Statement of Support, Revenue and Expenses, and Changes in Net Assets must clearly disclose the amount of supporting services. These are broken down between fundraising and administrative (management and general) expenses. This distinction between supporting and program services is required, as is the separate reporting of fundraising. Absence of either the functional reporting approach or information on fundraising would result in a qualified opinion by the external auditor.

Management and General Expenses. This is probably the most difficult of the supporting categories to define because a major portion of the time of top management usually will relate more directly to program activities than to management and general. Yet many think, incorrectly,

that executive management should be considered entirely “management and general.” The AICPA audit guide defines management and general expenses as follows:

Management and general activities are those that are not identifiable with a single program, fund-raising activity, or membership-development activity but that are indispensable to the conduct of those activities and to an organization’s existence. They include oversight, business management, general record keeping, budgeting, financing, soliciting revenue from exchange transactions, such as government contracts and related administrative activities, and all management and administration except for direct conduct of program services or fund-raising activities. The costs of oversight and management usually include the salaries and expenses of the governing board, the chief executive officer of the organization, and the supporting staff. (If such staff spend a portion of their time directly supervising program services or categories of other supporting services, however, their salaries and expenses should be allocated among those functions.) The costs of disseminating information to inform the public of the organization’s “stewardship” of contributed funds, announcements concerning appointments, and the annual report, among other costs, should similarly be classified as management and general expenses. The costs of soliciting funds other than contributions, including exchange transactions (whether program-related or not), should be classified as management and general expenses.

Some suggested methods of computing the allocation of certain types of expenses to the various functions are described in the audit guide for *Not-for-Profit Organizations*. Other methods may also be appropriate and could be used.

Advertising Expenses. As noted in the last sentence of the definition of management and general activities in the previous subsection, advertising costs intended to promote sales of goods and services provided by an organization are considered part of this expense category. These expenses are normally reported in the period they are incurred, not over the expected period of the resulting response by “customers.” An exception to this is made (in AICPA SOP 93-7) for “direct response” advertising when certain criteria are met; such costs may be deferred over the expected response period. Note that SOP 93-7 explicitly excludes fund-raising expenses from the category of direct response advertising costs eligible for deferral.

Other Expense Allocations. The AICPA audit guide states that certain other expenses should be reported as follows.

- Occupancy and maintenance of property is not a separate function, and these costs should be allocated to program, management, and fundraising as appropriate. Although it is permitted to show this allocation in a footnote, the authors recommend that it be included in the functional categories on the face of the statement of revenue and expenses.

- Interest expense should be allocated to specific functions to the extent possible; any remaining amount is management expense. For example, interest on a mortgage on a building used solely for program activities would be a program expense.
- Payments to affiliates should also be allocated to the extent that there is information available to permit meaningful allocation; any remaining amount is a separate supporting service.
- Costs of all fundraising activities of federated fundraising organizations (e.g., United Way) are fundraising expense (even though, as some would argue, fundraising *is* the program of these organizations).

Fundraising Expenses. Fundraising expenses are a very sensitive category of expense because a great deal of publicity has been associated with certain organizations that appear to have very high fundraising costs. The cost of fundraising includes not only the direct costs associated with a particular effort, but a fair allocation of the overhead of the organization, including the time of top management.

Fundraising expenses are normally recorded as an expense in the Statement of Activity at the time they are incurred. It is not appropriate to defer such amounts. Thus the cost of acquiring or developing a mailing list that has value over more than one year would nevertheless be expensed in its entirety at the time the list was purchased or the costs incurred. The reason for this conservative approach is the difficulty accountants have in satisfying themselves that costs that might logically be deferred will in fact be recovered by future support related thereto. Further, if substantial amounts of deferred fundraising costs were permitted, the credibility of the financial statements would be in jeopardy, particularly in view of the increased publicity surrounding fundraising expenses.

If fundraising is combined with a program function, such as educational literature that also solicits funds, the total cost should be allocated between the program and fundraising functions on the basis of the use made of the literature, as determined from its content, reason for distribution, and audience, if the criteria of AICPA SOP 98-2 are met. These criteria are discussed in the next section.

(iv) Allocation of Joint Costs of Multipurpose Activities. SOP 98-2 provides that if it can be demonstrated that a bona fide program or management function has been conducted in conjunction with an appeal for funds, joint costs should be allocated between fundraising and the appropriate other function. Otherwise, such joint costs are to be reported as fundraising expense. Under SOP 98-2, if the criteria for allocation are not

met, not only must the joint costs be reported as fundraising, but so must the separate costs of any nonfundraising component. Allocation, when made, should be on the basis of content of the activity; the audience to whom the activity is targeted; the action, if any, requested of the audience; and other evidence as to the purpose of the activity.

Typically such costs are for a mailing that contains both educational information and an appeal for contributions. The direct cost of printing the educational information is reported as a program service expense, and that of printing the appeal is reported as a fundraising expense. The difficult questions are whether and, if so, how to allocate the joint costs: the envelope and (mainly, as it is usually the largest cost component) the postage to send the piece. The accountant must also consider what costs are properly allocable—for example, should part of the salary of the person who organizes the mailing be included as a joint cost? The accounting profession has given considerable attention to the question of whether, but less to what and how.

Charities, understandably, want to allocate as much as possible to program expense, as they believe this will make a better impression on donors and prospective donors, thus motivating them to greater giving to the charity. Those who regulate charities and who assess the performance of charities are concerned that some charities may be overallocating to program expense, to make their reported expenses more appealing than is actually the case.

The requirements of SOP 98-2 are that joint costs are presumed to be fundraising unless it can be demonstrated that a bona fide program or management function has also been conducted. Demonstrating this requires verifiable evidence such as the nature of the content of the activity, the characteristics of the audience targeted by the activity, and the nature of any action requested of the recipients. This is the “whether to allocate” part of the question. If this is answered no, the other two parts are moot.

As to what and how to allocate, the not-for-profit accounting literature has heretofore offered very little guidance. Standard books on cost accounting may be helpful in discussing general principles useful for answering these questions. SOP 98-2 includes some guidance. The “what” question is answered rather broadly by saying that production and distribution costs as well as measurable applicable indirect costs can be allocated. Types of costs mentioned include salaries, postage, rent, and telephone. How to allocate is dealt with by describing three standard methods and noting that they generally result in a reasonable allocation. The user is left to decide which is most appropriate in a given situation. The three methods are physical units, standalone costs, and relative direct costs. The physical units method is the one most commonly used,

but it is subject to much judgment as to just which portions of an activity in fact constitute fundraising versus other purposes and how to measure the units (lines, square inches, etc.). This method is also subject to abuse by a charity that stuffs a mailing, for example, with quantities of ostensibly educational material that is, however, of little real value to the recipient. A summary of the provisions of SOP 98-2, with the same numbering, follows; however, the original document should be consulted for more details.

6. Applies to not-for-profit organizations and state and local governments that solicit contributions.
7. If criteria of purpose, audience and content are met, costs of a joint activity (defined in the glossary as, "an activity that is part of the fundraising function and has elements of one or more other functions, ...") identifiable with a function should be charged to that function, and joint costs (defined as "costs of conducting joint activities that are not identifiable with a particular component of the activity ...") should be allocated between fundraising and the appropriate program or management function.

If any criteria are not met, all costs of the joint activity are fundraising, including costs that might otherwise be program or management.

Except: costs of sales for exchange transactions (e.g. direct donor benefits of special event) are not fundraising.

8. *Purpose criterion* is met if purpose of joint activity includes accomplishing program or management functions.
9. To accomplish program functions, the activity should call for specific action by the audience that will help accomplish the entity's mission.

Education alone is not a call to specific action. However some educational information can be considered to implicitly call for action, if the need for and benefits of the specific action are clearly evident from the educational message, e.g., learning about environmental problems caused by not recycling may be an implicit call to increase recycling. Also, for an entity whose mission is general education (e.g., a college) motivating the audience to attend educational events is considered a call for specific action.

10. For considering whether the purpose criterion is met, consider the following, in order:
 - o Whether a majority of compensation for performing the activity is based on contribution raised: If so, criterion is failed; if this test is not determinative, continue with:

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- Whether a similar program or management activity is conducted separately and on the same scale: criterion is met if either:
 - Program component calls for specific action that will help meet organization's mission, and a similar program component is conducted without the fundraising component, or
 - A management activity similar to management component is conducted without fundraising component using the same medium and on a similar or greater scale. If this test is not determinative, continue with:
- Consider other available positive and negative evidence such as the types of evidence in paragraph 11:

11. Positive:

- Entity measures program results (other than educating the public without a call for specific action)
- Entity conducts program (or management) component, without significant fundraising component, in a different medium.

Negative:

- Evaluation of performance, or some, but less than a majority, of compensation, varies based on contributions raised for that discrete joint activity.

Positive or negative:

- Relative weight placed by entity on accomplishing program goals vs. effectiveness in raising contributions in evaluating accomplishments of activity
- Qualifications of those performing joint activity: The experience of and range of services provided by third parties, or range of job duties of employees
- Tangible evidence of intent, e.g.:
 - Entity's written mission statement
 - Minutes of meetings
 - Restrictions imposed by unrelated donors on gifts to fund activity
 - Plans or policies
 - Written instructions to other entities about the purpose, audience, or conduct of activity
 - Internal management memos

12. *Audience criterion* is not met if audience includes prior donors or otherwise selected for ability or likelihood of contribution: But, this may be overcome if audience is also selected for one or more of

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reasons in paragraph 13. In deciding whether this is overcome, the relative significance of contribution potential vs. other factors should be considered.

13. If audience includes no prior donors and is otherwise not selected for contribution potential, audience criterion is met if selected for one or more of:
 - Need or reasonable potential to use the action called for by the program component,
 - Ability to take action to assist entity in meeting program goals,
 - Entity is required to direct management component to particular audience, or audience has reasonable potential for use of management component.
14. *Content criterion* is met if activity supports program or management functions, as follows:
 - (Program) Activity calls for specific action by recipient to help accomplish entity's mission; if need for and benefits of action are not clear, information describing action and benefits is provided.
 - (Management) Activity fulfills one or more of entity's management responsibilities (but required state disclosures in charitable solicitations are considered fundraising).
15. Information describing entity, needs to be met, how gifts will be used is considered fundraising.
16. *Allocation methods* should be rational and systematic, result in reasonable allocation, be applied consistently in same circumstances.
17. If *incidental activities* are conducted along with a primary activity, and criteria for allocation are met, joint costs may, but do not have to be, allocated to incidental activity. (If nonfundraising activity is incidental to fundraising, it is unlikely that allocation criteria would be met.)
18. Disclosures:
 - Types of activity for which joint costs are incurred
 - Statement that joint costs are allocated
 - Total amount allocated, and portion to each functional category
19. Encouraged, but not required: amount of joint costs allocated to each joint activity.

Appendix 13–A contains a checklist that may be helpful to charities and their auditors in applying the rules of SOP-98-2. The theme of the list is that being the passive recipient of information is, in and of itself, of no value to someone, no matter how useful the information might potentially

be. The potential usefulness of the information is realized only if the recipient is urged to take some beneficial action based on the information. The action need not be taken immediately, as long as the recipient is urged to take it at some later appropriate time—for example, when the symptoms of a disease appear. Nor need the action directly benefit the recipient; it might be something that benefits others: specific groups, humanity, or the environment generally.

(v) **All Expenses Reported as Unrestricted.** SFAS 117 requires all expenses, regardless of the origin of the resources used to finance the expenses, are shown in the unrestricted class of net assets, and no expenses to be shown in the temporarily restricted class. This is shown in Exhibit 13.2. The method of relating the restricted revenue to the expenses financed out of that revenue is to reclassify an amount of temporarily restricted net assets equal to the expenses to the unrestricted net assets class (\$26,164 in Exhibit 13.2).

(d) Columnar Presentation

The statement presentation is in a columnar format and, as can be observed in Exhibit 13.2, includes all three classes on one statement. This format is very similar to the format recommended in earlier chapters of this book. It is also possible to present the information in a single column. In that format, information for the three classes is shown sequentially, including the change in net assets for the class, followed by the total change in net assets for the year. An advantage of such a format is the ease of showing comparative prior year information for each class; a disadvantage is the inability to present a total column.

It should be noted that this statement provides a complete picture of all activity of this organization for the year—not just the activity of a single class or fund. Further, by including a “total” column on the statement, the reader is quickly able to see the overall activity and does not have to add together several amounts to get the complete picture. This represents a major advance in not-for-profit accounting.

(i) **Unrestricted Activity in a Single Column.** One of the most significant features of this presentation is that all unrestricted revenues and all expenses are reported in the single column representing the unrestricted class of net assets. The use of a single column in which all unrestricted activity is reported greatly simplifies the presentation and makes it more likely that a nonaccountant will be able to comprehend the total picture of the organization.

Many organizations, of course, will want to continue to keep board-designated accounts within their bookkeeping system. This is fine, but, for reporting to the public, all unrestricted amounts must be combined and reported as indicated in this illustration.

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While not recommended, there would appear to be no prohibition to an organization's including additional columns to the *left* of this total "unrestricted" column to show the various unrestricted board designated categories of funds that make up the total unrestricted class. However, where an organization does so it must clearly indicate that the total unrestricted column represents the total unrestricted activity for the year and that the detailed columns to the left are only the supplemental subdivisions of the amounts making up this total. Probably an organization is better advised to show such detail in a separate supplementary schedule, if at all.

Where an organization chooses to show its unrestricted class broken into two columns and has only one class with restricted resources, it may be acceptable to eliminate the total unrestricted column in the interest of simplicity. An example of the column headings might be:

Unrestricted		Temporarily Restricted	Total All Classes
General Fund	Investment Fund		

The key to whether this would be acceptable is the extent of activity in the various columns. For example, if the temporarily restricted class in the above illustration were relatively minor in amount, then the total column would largely reflect the unrestricted class (i.e., the general fund and the investment fund). This is a judgmental question.

(ii) Temporarily Restricted Column. The "temporarily restricted" column represents those amounts that have been given to the organization for a specified purpose other than for permanent endowment or for use after a certain date. It should be observed that the amounts reported as revenues in this fund represent the total amount the organization received during the year, and not the amount that was actually expended.

(e) Appreciation of Investments

As required by SFAS 124, the National Association of Environmentalists (see Exhibit 13.1) carries its investments at market. This means that the organization must reflect appreciation (or depreciation) on its Statement of Support, Revenue and Expenses, and Changes in Net Assets. In this instance, the net appreciation of investments was \$33,025. Assuming there were no sales or purchases of investments during the year, this amount would have been determined by comparing the market value of the investments at the end of the year with the market value at the beginning of the year. Normally, however, there will be some realized gain or loss during the year. While there is no technical objection to reporting the

realized gain or loss separately from the unrealized appreciation (or depreciation), there seems little significance to this distinction.

(i) Activity of Restricted Net Asset Categories. It is significant to note that SFAS 117 calls for recording changes in the restricted net asset categories in an income statement format, including their excess of revenues over expenses. (In the past, many argued that such restricted activity should not be reported in an income statement format but rather as individual “changes” in net assets without any indication of the overall net change for the year.) This approach is significant because it permits the reader to see the total activity of the organization, both restricted and unrestricted. Thus SFAS 117 is saying that we have a single entity on which we are reporting, as distinct from several subentities for which there is no total. In this example, the total excess of revenues over expenses was \$161,316, whereas the activity of the unrestricted class resulted in an excess of only \$114,555.

(ii) Other Changes in Net Assets. In the statement presented “other changes” include only reclassifications. In this illustration, \$10,000 was reclassified from the unrestricted class to the permanently restricted class to match a challenge grant received that year. There are, of course, any number of “other changes” that in different circumstances could be reported in this section.

(iii) Operating Statement. A variation on this statement which some may wish to use is to present “operating” and “nonoperating” revenues and expenses in separate sections, with a subtotal of “operating” revenue in excess of “operating” expenses. This would focus the reader’s attention on what the organization considers its core “operations,” as distinguished from matters it considers peripheral or incidental to its operations. SFAS 117 permits, but does not require, this presentation. If an organization chooses this presentation, it will decide for itself what it considers to be its operations, versus other activities. Appendix 13–B contains a checklist to help organizations decide what they may wish to consider as operating versus nonoperating transactions.

(f) Statement of Cash Flows

A Statement of Cash Flows is a summary of the cash made available to an organization during the year and the uses made of such cash. SFAS 117 requires presentation of a Statement of Cash Flows by all not-for-profit organizations. Full discussion of preparation of this statement is in SFAS 95 and in Chapter 12 of this book. Exhibit 13.3 shows a Statement of Cash Flows. In some ways it is similar to a Statement of Cash Receipts and Disbursements, in that it presents cash received and spent. It differs

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EXHIBIT 13.3

Statement of Cash Flows, Prepared Using the Direct Method, Derived from Data Included in Exhibits 13.1 and 13.2

NATIONAL ASSOCIATION OF ENVIRONMENTALISTS STATEMENT OF CASH FLOWS FOR THE YEAR ENDED DECEMBER 31, 20X2	
Operating cash flows:	
Cash received from:	
Sales of goods and services	\$198,835
Investment income	14,607
Gifts and grants:	
Unrestricted	230,860
Restricted	37,400
Cash paid to employees and suppliers	(265,854)
Cash paid to charitable beneficiaries	(83,285)
Interest paid	(350)
Net operating cash flows	<u>132,213</u>
Financing cash flows:	
Nonexpendable gifts	31,500
Proceeds from borrowing	5,000
Repayment of debt	(5,000)
Net financing cash flows	<u>31,500</u>
Investing cash flows:	
Purchase of building and equipment	(38,617)
Purchase of investments	(60,000)
Proceeds from sale of investments	50,000
Net investing cash flows	<u>(48,617)</u>
Net increase in cash	115,096
Cash: Beginning of year	11,013
End of year	<u><u>\$126,109</u></u>
Reconciliation of Excess of Revenues over Expenses to Operating Cash Flows:	
Excess of revenues over expenses	\$161,316
Add—Depreciation expense	13,596
Less—Appreciation of investments	(33,025)
Changes in: Receivables	(6,939)
Payables and deferred income	28,765
Nonexpendable contributions	(31,500)
Operating cash flows	<u><u>\$132,213</u></u>

by grouping transactions into three groups: Operating, Investing, and Financing cash flows. Also, there is less detail of specific types of operating cash flows, since such detail is already shown for revenue and expenses in Exhibit 13.2. (Chapter 12 contains a practical guide for preparation of a Statement of Cash Flows.)

(g) Statement of Functional Expenses

Exhibit 13.4 is a statement that analyzes functional or program expenses and shows the natural expense categories that go into each functional category. It is primarily an analysis to give the reader insight as to the major types of expenses involved. In order to arrive at the functional expense totals shown in the Statement of Support, Revenue and Expenses, and Changes in Net Assets, an analysis must be prepared that shows all of the expenses going into each program category. The Statement of Functional Expenses summarizes this detail for the reader. SFAS 117 requires voluntary health and welfare organizations to present a statement of functional expenses. Other types of not-for-profit organizations are encouraged to present this statement, but are not required to do so.

EXHIBIT 13.4

Analysis of the Various Program Expenses Showing the Natural Expense Categories Making Up Each of the Functional or Program Categories

	NATIONAL ASSOCIATION OF ENVIRONMENTALISTS									
	STATEMENT OF FUNCTIONAL EXPENSES									
	FOR THE YEAR ENDED DECEMBER 31, 20X2									
	Program Services					Supporting Services				
	<i>National Environment Magazine</i>	Clean-up Month Campaign	Lake Erie Project	Total Program	Management and General	Fundraising	Total Supporting			
Salaries	\$24,000	\$68,140	\$60,633	\$152,773	\$15,000	\$3,000	\$18,000			
Payroll taxes and employee benefits	3,120	8,857	7,882	19,859	1,950	390	2,340			
Total compensation	27,120	76,997	68,515	172,632	16,950	3,390	20,340			
Printing	63,191	18,954	515	82,660	1,161	250	1,411			
Mailing, postage, and shipping	10,754	1,188	817	12,759	411	1,055	1,466			
Rent	3,000	6,800	5,600	15,400	3,000	600	3,600			
Telephone	895	400	1,953	3,248	2,151	216	2,367			
Outside art	3,165	11,700	—	14,865	—	—	—			
Local travel	—	165	915	1,080	661	—	661			
Conferences and conventions	—	1,895	2,618	4,513	1,815	—	1,815			
Depreciation	2,260	2,309	5,616	10,185	3,161	250	3,411			
Legal and audit	—	—	—	—	2,000	—	2,000			
Supplies	—	1,831	28,516	30,347	761	119	880			
Miscellaneous	115	4,378	—	4,493	1,445	89	1,534			
Total	\$110,500	\$126,617	\$115,065	\$352,182	\$33,516	\$5,969	\$39,485			

APPENDIX 13–A

Checklist: Factors to Be Considered in Deciding Whether Allocation of Joint Costs of Multipurpose Activities (under AICPA SOP 98-2) Is Appropriate

The following is a list of factors which may be helpful to:

- *Charities*, in deciding whether to allocate joint costs of multipurpose activities
- *Auditors*, in assessing the appropriateness of the client’s decision

No one of these factors is normally determinative by itself; all applicable factors should be considered together. These factors relate only to the question of whether to allocate at all, not to determining which costs are allocable or how to allocate. The text of SOP 98-2 should be consulted for further guidance.

Factors whose presence would indicate allocation may be appropriate	Factors whose presence would indicate allocation may not be appropriate
1. Activity is directed at a broad segment of the population, or at a population specifically in need of the program services of the organization.	Activity is directed primarily at individuals with higher income, or at previous contributors. ¹
2. The group intended to benefit from the “program” activity and the benefits to be derived is well-defined.	The group and/or the benefits are not well-defined.
3. Specific tangible action by the recipient, which will benefit the recipient or other parties, is explicitly urged; the action is unrelated to providing financial or other support to the organization itself. ² (<i>Required factor</i> .)	Action urged is not specific, tangible, or explicitly stated, or consists primarily of supporting the organization itself. ³
4. The “program” activity urged is consistent with the organization’s stated mission.	The “program” activity urged is inconsistent with or only marginally related to the mission.
5. The “program” content of the activity is high.	The fundraising content is high.
6. It is likely the activity would be carried on (in some form) even if the fundraising component were not present.	It is doubtful the activity would be carried on if the fundraising component were not present.
7. There is tangible evidence to support the existence of a bona fide program component of the activity. ⁴	Evidence of program content is only intangible, hearsay, speculative, management assertions, etc.

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Factors whose presence would indicate allocation may be appropriate	Factors whose presence would indicate allocation may not be appropriate
<p>8. The person actually supervising the activity is not a professional fundraiser, and is compensated by a fee or salary.</p>	<p>The person is a professional fundraiser or is compensated by a bonus or a percent of amounts raised.</p>
<p>9. The person within the organization responsible for overseeing the activity is part of the program staff.</p>	<p>The person is part of the development staff.</p>

¹ However, this factor would not necessarily be a bar to allocation if it can be demonstrated that higher-income persons or previous contributors in fact are in a better position to make use of or benefit from the “program” content of the activity. For example, previous contributors to an organization whose program is to change public policy are presumably especially likely to act on an appeal to write to government officials.

² Examples of such action (or, in some cases, refraining from an action) include:

- If you are suicidal, *call* our hot line.
- If you notice these symptoms, *go* to your doctor.
- *Write* or *call* your legislator [other public officials, etc.]
- *Eat* more healthy foods [examples given].
- *Stop* smoking.
- *Give* blood. (This is not considered a request to support the blood bank as it is merely acting as an agent for the ultimate recipient. Requests to give to the charity cash or commercially available items—clothing, food, etc.—are considered fundraising even if the items are passed on to others, whereas requests to give such items directly to those in need—e.g., victims of disaster—are not fundraising for the charity. Blood is a special case due to its unique source of supply and special processing requirements.)
- *Volunteer* to help out at your local nursing home. (Fundraising if urged by the nursing home; program if urged by a charity whose purpose is to make life better for the elderly.)
- *Don’t drink and drive.*
- *Say no* to drugs.
- *Protest.* (Must describe object of protest and specific method of protest, such as a time and place to demonstrate, a person/organization to communicate with, or other specific action; a general call to protest against something is too vague to qualify as program.)
- *Pray.* (If urged by an organization connected with a religious denomination for which prayer is a central focus of activity.)
- *Boycott* some specific company or product.
- *Complete and return* the enclosed questionnaire. (*Only* if the questionnaire is an essential part of a bona fide scientific research project, the results of which will be broadly used to further some social good. If the results will merely be compiled and disseminated by the organization itself as a matter of interest, or if the questionnaire is included only as a method of motivating recipients to respond, it does not qualify as a program activity.)
- *Contribute* to a charity [one in no way affiliated with the entity conducting the activity].

³ Examples of actions that are too vague to qualify as “program” activity include:

- Support your local police. (To qualify as program, there would have to be specific suggestions as to how such support should be manifested.)
- Wear a ribbon [or other item]. (To qualify as program, there would have to be specific suggestions as to how wearing a ribbon would, in and of itself, contribute to achieving some social good. Usually this would happen only through other specific actions such as demonstrating, lobbying, boycotting, etc.)
- Protest. (Unless specific time/place/method of protest is specified.)
- Read [the accompanying literature]. (Learning about a problem may be helpful, but is of no public or personal benefit unless the learner proceeds to take some action based on the knowledge gained. To qualify as program, the activity would have to urge some specific subsequent action.)
- Save energy. (To qualify as program, there would have to be specific examples of things to do to save energy.) Similarly for “Don’t pollute,” “Drive safely,” and other general slogans.

⁴ Examples of such tangible evidence include:

- Written instructions to other persons/organizations regarding the purpose of the activity, audience to be targeted, method of conducting the activity, etc.

(continued)

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- Contracts with unrelated scriptwriters, mailing houses, list brokers, consultants, etc.
 - Content of the activity.
 - Mission of the organization as stated in its IRS Form 1023/4, fundraising material, annual report, etc.
 - Restrictions imposed by donors (who are not related parties) on gifts intended to fund the activity.
- Other tangible evidence that may be helpful, but, because it is solely internal to the organization, is not so persuasive as audit evidence:
- Minutes of board of directors, committees, etc.
 - Internal management memoranda.
 - Budget, long-range plan, operating policies.
 - Job descriptions of organization staff.

APPENDIX 13-B

Checklist: Consideration of Whether Items Might Be Reported as Operating or Nonoperating (within the Context of Paragraph 23 of SFAS 117)

Paragraph 23 of SFAS 117 leaves it to each organization (if it wishes to present a subtotal of “operating” results) to determine what it considers to be operating versus nonoperating items in a statement of activity; if it is not obvious from the face of the statement what items are included/excluded in the operating subtotal, footnote disclosure of that distinction shall be made. Following are some items that might be considered as nonoperating. This is not intended to express any preferences, nor to limit the types of items that a particular organization might report as nonoperating, but merely to provide a list for consideration of various types of items.

Items which would usually be considered nonoperating as to the current period:

- Extraordinary items
- Cumulative effects of accounting changes
- Corrections of errors of prior periods
- Prior period adjustments, generally
- Results of discontinued operations

Items that many persons might consider nonoperating in some situations:

- Realized and unrealized capital gains on investments carried at market value⁶
- Contributions that qualify as “unusual grants,” as defined in IRS Regulation 1.509(a)-3(c)(3)
- Items that meet some, but not all, of the criteria in APB 30/SFAS 4 for extraordinary items, or APB 30/SFAS 16 for prior period adjustments

Items that some people might consider nonoperating in some situations:

- Bequests, and other “deferred gifts” (annuity, life income funds, etc.) received
- Gains and losses, generally (as defined in SFAC 6, par. 82–89)
- Unrelated business income (as defined in the Internal Revenue Code § 512) and related expenses

⁶ Except for amounts treated as operating under the Total Return Concept, see Section 6.2 in Chapter 6.

APPENDIX 13-B

- Revenue and expenses related to activities not explicitly listed on the organization's IRS Form 1023
- Revenue and expenses directly related to transactions that are reported as financing or investing cash flows in the statement of cash flows—e.g., investment income not available for operating purposes, interest expense, write-offs of loans receivable, nonexpendable gifts (as contemplated by paragraph 30d of SFAS 117), adjustment of annuity liability
- Contributions having the characteristics of an “initial capital” contribution to an organization, even though they do not meet the requirements of an extraordinary item, or an unusual grant (above)

The characterization of an item of expense as operating versus nonoperating is not driven by its classification as program, management, or fundraising expense. In general, expenses should follow related revenue—for example, if contributions are considered operating, then fundraising expenses normally would be also and vice versa.

CHAPTER FOURTEEN

Colleges and Universities

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Among the most important and influential types of not-for-profit institutions are colleges and universities. The extent of their influence is suggested by the fact that there are more than 15 million students currently attending more than 4,000 colleges and universities in the United States, most of which depend heavily on support from gifts and contributions from alumni and the general public. These institutions have the same need to report on their activities and to effectively communicate their financial needs and financial health as do other not-for-profit organizations.

14.1 AUTHORITATIVE PRONOUNCEMENTS

(a) AICPA Audit Guide

In 1993, the FASB issued SFAS 116 and 117. Then, in 1996 the AICPA issued a new audit guide (most recently published in 2004) for all not-for-profit

organizations, superseding the previous audit guides and authoritative sources which had been used by colleges and universities up to that time, namely, *Not-for-Profit Organizations*. The detailed provisions of SFAS 116 and 117 are discussed earlier of this book in the various chapters that discuss the topics covered by the standards (especially Chapters 8 and 12), and are referred to below within the appropriate topic headings.

14.2 THE PRINCIPAL FINANCIAL STATEMENTS

In accordance with SFAS 117, most institutions present the same three basic statements as other not-for-profit organizations:

1. Balance Sheet or Statement of Financial Position (Exhibit 14.1)
2. Statement of Revenues, Expenses, and Changes in Net Assets (Exhibit 14.2)
3. Statement of Cash Flows (example in Chapter 13, Exhibit 13.3)

There may also be other supporting statements that provide detail which should agree with these three principal statements. While the supporting statements provide information that the board or other specific users of the statements may want, it is important not to confuse the general reader of the financial statements by providing more detail than is appropriate.

The reporting format prescribed by SFAS 117 intends to focus readers' attention on the financial soundness of the institution and whether it is better or worse off financially than it was the year before.

The key to understanding college financial statements is to recognize what types of transactions are included in each of the principal statements required by SFAS 117 and the accounting principles applicable to these transactions. A description of some of the accounting principles and reporting principles appears in a later section of this chapter.

(a) Balance Sheet

Exhibit 14.1 shows an example balance sheet for Mary and Isla College in an SFAS 117-compliant format.

SFAS 117 does not require any particular format for a balance sheet as long as certain components are disclosed: total assets, total liabilities, total net assets, and net assets for each of the three classes: unrestricted, temporarily restricted and permanently restricted. SFAS 117 illustrates a balance sheet with only a single column (plus a column showing comparative prior-year information). There is no prohibition against presenting additional columns, if an organization desires. If additional columns are presented, they can be columns that show assets, liabilities, and net assets

EXHIBIT 14.1

Example of a Columnar Presentation of a Balance Sheet for a Small College

MARY AND ISLA COLLEGE	
BALANCE SHEET	
JUNE 30, 20X1	
ASSETS	
Current assets:	
Cash	\$ 1,601,000
Short-term investments	\$ 1,480,000
Accounts receivable	98,000
Inventories	20,000
Prepaid expenses	<u>25,000</u>
Total	3,224,000
Long-term investments	4,215,000
Invested in plant, net of depreciation	<u>23,450,000</u>
Total assets	<u><u>\$30,889,000</u></u>
LIABILITIES AND NET ASSETS	
Current liabilities:	
Accounts payable	\$ 608,000
Current portion of debt	170,000
Tuition deposits	<u>110,000</u>
Total	<u>888,000</u>
Long-term debt	<u>580,000</u>
Refundable advances	<u>30,000</u>
Net assets:	
Unrestricted	26,861,000
Temporarily restricted	965,000
Permanently restricted	<u>1,565,000</u>
Total	<u>29,391,000</u>
Total liabilities and net assets	<u><u>\$30,889,000</u></u>

grouped by class of net assets, by operating unit (such as the college, the hospital, etc.), or by managed fund group (roughly equivalent to the traditional fund structure).

SFAS 117 does not prescribe the order of presentation of assets and liabilities, however it does indicate that they should be presented in order of liquidity or maturity and can be split into a current and noncurrent presentation. The notes to the statements should provide further information, where relevant, as to liquidity, maturity, and any restrictions on use.

(b) Statement of Revenues, Expenses, and Changes in Net Assets

The Statement of Revenues, Expenses, and Changes in Net Assets summarizes all of the activity of the institution for the entire period that effect a change in its net assets (net worth). Exhibit 14.2 shows the Statement of Revenues, Expenses, and Changes in Net Assets for Mary and Isla College.

This format essentially follows an income statement format (i.e., revenues less expenses equals change in net assets for the year) and is a reasonably concise summary of the net change in the net worth of the institution for the entire year. To draw a comparison to corporate or not-for-profit entities, this statement is the equivalent of an income statement combined with a statement of changes in equity.

(i) “Total” Column. While SFAS 117 does not require a total *column*, it does require the presentation of the total change in net assets for the year. This disclosure can be made using either a multicolumn format with a total column, or a single-column format; both are illustrated in SFAS 117. Whichever format is chosen it must, however, present revenues, as well as the change in net assets for the year, separately for each of the three classes of net assets. As has been noted in earlier chapters, the authors recommend use of a total column and accordingly have included one in the example presented in Exhibit 14.2 and subsequent illustrations.

(ii) Revenues and Expenses. The revenue and expense sections of the statement include only items which are truly revenue and expense to the organization—that is, inflows and outflows of resources, accounted for on an accrual basis, which change the total net assets of the organization. SFAS 117 does not specify a prescriptive order that must be followed in the presentation of revenues and expenses; however it does suggest a number of alternatives that can be used. These are discussed in more detail in the earlier chapters of this book. There is more discussion on the classification of nonexchange revenues in the later sections of this chapter.

(iii) Change in Net Assets for the Year. The inclusion of this caption is quite important because, appropriately, it tells the reader what the net change was for the year in each class and for the institution as a whole. SFAS 117 requires the display of subtotals for the change in each net asset class, before the presentation of any extraordinary items, discontinued operations or accounting changes and the total change in net assets.

(iv) Operating versus Nonoperating (“Operating Measure”). If an institution wishes, it may report “operating” revenues and expenses separately from “nonoperating” revenue, expenses and other changes. The

EXHIBIT 14.2

Example of an All-Inclusive Statement of Activities

MARY AND ISLA COLLEGE STATEMENT OF ACTIVITIES FOR THE YEAR ENDED JUNE 20, 20X1				
	Unrestricted	Temporarily Restricted	Permanently Restricted	Total
Operating revenues:				
Tuition and fees	\$ 1,610,000			\$ 1,610,000
Governmental appropriations	400,000			400,000
Research grants		\$ 190,000		190,000
Auxiliary activities	125,000			125,000
Gifts and bequests	900,000	240,000		1,140,000
Investment income	350,000	47,000		397,000
Net assets released from restrictions	550,000	(550,000)		
Total operating revenues	<u>3,935,000</u>	<u>(73,000)</u>		<u>3,862,000</u>
Operating expenses:				
Educational:				
Engineering	930,000			930,000
Arts	410,000			410,000
Business	625,000			625,000
Research	850,000			850,000
Other revenues:				
Gifts and bequests			\$ 395,000	395,000
Realized and unrealized appreciation			20,000	150,000
Total other revenues	<u>130,000</u>		<u>415,000</u>	<u>545,000</u>
Change in net assets	570,000	(73,000)	415,000	912,000

definition of what is considered operating and nonoperating in determining its “operating measure,” is up to each institution. However, the institution must be clear, either from the face of the statement or the disclosures in the footnotes, about what measurement has been used to distinguish operating and nonoperating.

This subject is discussed further in Chapter 13. Organizations are not prohibited from making further classifications within this statement, for example, revenues, expenses and changes in net assets may be presented by business segment if that is appropriate for the organization.

(c) Statement of Cash Flows

This statement is discussed in Chapters 12 and 13 and is essentially the same for all not-for-profit organizations.

14.3 ACCOUNTING PRINCIPLES

Summarized below are the accounting principles prescribed by SFAS 116 and by the AICPA Audit Guide for *Not-for-Profit Organizations*. A number of these are discussed in earlier chapters.

(a) Accrual Basis

The accrual basis of accounting is necessary for financial statements prepared in accordance with generally accepted accounting principles (GAAP). Items such as investment income and an allowance for uncollectible receivables should be recorded on an accrual basis unless unrecorded amounts would not be material. Also, revenues and expenses relating to a summer session, of which only a very small part occurs in one fiscal year, and the most significant part in another should be reported in the fiscal year in which the summer session principally occurs. If a semester or session overlaps two accounting periods such that a significant part of the session falls into both periods, then the revenues and expenses should be allocated between the two periods.

(b) Unrestricted Gifts

Additional discussion on accounting for contributions is in Chapter 9 of this book, and in Chapters 5 and 6 of *Not-for-Profit Organizations*. All unrestricted gifts, donations, and bequests are recorded as unrestricted revenue in the Statement of Revenues, Expenses, and Changes in Net Assets in the year received. While the board is free to designate any portions of such unrestricted gifts or bequests as “board-designated endowment” or for other designated purposes. Such gifts must, nonetheless, be reported initially in the unrestricted class of net assets. After being so

reported, these amounts may then be segregated within the unrestricted class to indicate the nature of the board designation.

(c) Temporarily Restricted Gifts

Gifts restricted by the donor for a particular purpose, or restricted by time (i.e., the gift is due to be received in a future period), are reported in their entirety in the temporarily restricted class in the Statement of Revenue, Expenses, and Changes in Net Assets, until either the purpose or time restriction is satisfied. Except, an institution may elect to recognize as “unrestricted revenues” gifts that are secured and expended for the restricted purpose in the same operating period. If they adopt this policy, it must be disclosed in the accounting policies footnote.

(d) Permanently Restricted Gifts

If a donor made a contribution for permanently restricted purposes, it would be reported directly in that class (assuming that the donor had made clear the intention, presumably in writing). Further discussion of the treatment of appreciation and depreciation on endowments is included in Chapter 8 of this book.

(e) Pledges

In accordance with SFAS 116, all not-for-profit organizations are required to record unconditional promises to give (pledges) as assets and revenue at the time notification of the pledge is received by the institution. In addition, it must disclose in the footnotes the amount of conditional pledges received but not recorded as of the financial statement date if they are material. Since the leading fundraisers are often not in a financial position with the college or university—for example, the university president—communication with the accounting group is one of the keys to ensuring appropriate and timely recognition. Further discussion of accounting for pledges is in Chapter 9.

(f) Investment Income, Gains, or Losses on Investments

All investment income (dividends and interest) must be reported as revenues directly in the class of net assets appropriate to any restrictions of the revenue. All investment income must be reported as revenue in the year in which earned.

Investment income on permanently restricted net assets is normally considered unrestricted income unless the donor has specified a restricted use for the investment income. Accordingly, unrestricted endowment income should be reported directly in the unrestricted class.

Additional discussion is in Chapter 8 of this book and in Chapter 8 of *Not-for-Profit Organizations*.

SFAS 117 requires that gains and losses be reported in the unrestricted class, unless a restriction is stipulated by the donor of the principal or by state law, which is discussed further in Chapter 8 of this book. Unrealized appreciation or depreciation would be reported in the same manner as the realized gains or losses. (See the discussion in Chapter 8 of this book about SFAS 124 on accounting for losses on restricted endowment funds.)

(g) Presentation of “Investment Income”

Presentation of investment income as well as realized and unrealized gains or losses in the statement of activities is very inconsistent among colleges and universities, especially when institutions present an “operating measure.” The presentation is further complicated if the institution uses the total return concept (explained hereafter) and adopts a “spending formula” for its legally available and expendable “income.” It is a common practice to present income on short-term operating investments as well as the portion of the income and gains designated as the spending formula for the period among operating income. The balance of the income, gains, or losses from long term investments are shown as nonoperating items even though the specific presentation methodologies vary.

(h) Carrying Value of Investments

See the discussion in Chapter 8 of this book about SFAS 124 on accounting for marketable securities. Briefly, it requires such investments to be reported at current fair market value. SFAS 124 covers only equity securities with a readily determinable fair value (except investments accounted for under the equity method, or investments in consolidated subsidiaries) and all debt securities. It does not set a standard for valuing other types of investments such as nonmarketable equity securities, real estate, partnerships, oil and gas interests, and the like. *Not-for-Profit Organizations* states in paragraphs 8.03 and 8.33 that these other investments should be reported in accordance with whichever one of the audit guides is applicable to the type of organization concerned. The same method must be used for all such investments. If investments are carried at other than current market value, and current market value is below cost, a provision for decline in value may need to be recorded if there has been a material decline that is considered other than temporary in nature.

(i) Total Return Concept

As indicated in the previous subsection, it is also appropriate, if an institution wishes, to segregate investment return within the statement of revenues and expenses—for example, an amount computed under the total return concept (“spending formula” amount) might be reported as operating revenue, and the difference between that amount and the actual investment return for the year as nonoperating revenue. (See Exhibit 6.2 of this book for an illustration.) However, it should be noted that to the extent gains are included in the “spending formula” amount reported as revenue, the cash associated with such gains, is not considered “operating cash” when determining cash flow from operating activities on the Cash Flow Statement. These gains are considered, as they are for all entities, to result from “arresting” activities and must be reported as such in the Cash Flow Statement.

(j) Fixed-Asset Accounting

All fixed assets (purchased or donated) must be capitalized and carried on the balance sheet. This means that a college or university should not “expense” material fixed-asset purchases in the year in which acquired. This is discussed further in Chapter 6 of this book and in Chapter 9 of the AICPA audit guide for *Not-for-Profit Organizations*.

(k) Depreciation Accounting

Under SFAS 117, colleges include depreciation along with other expenses in the unrestricted class of the Statement of Revenues, Expenses, and Changes in Net Assets. If expenses are shown by functional categories, depreciation will be allocated among the various functions (e.g., education research, academic support) that benefit from use of depreciable assets. Chapter 5 of this book discusses depreciation further.

(l) Tuition Revenue

Accounting for tuition revenue is fairly straightforward: Prepayments are deferred and amortized over the period of instruction. Unpaid amounts for which a student (or other payor) is contractually liable are receivables, offset by an appropriate allowance for estimated uncollectible amounts.

Accounting for fees such as dormitory and meal charges is the same as for tuition. Note that dormitory fees are reported as unrestricted revenue even though, under the terms of a bond indenture, the fees may be restricted to be used for debt service. This is because the fees are not contributions, and under SFAS 116 and 124 only contributions and investment income may be included in either of the restricted classes of net assets.

Paragraph 12.05 of the AICPA audit guide for *Not-for-Profit Organizations* states that when an “organization regularly provides discounts (such as financial aid for students that is not reported as an expense, reduced fees for services, or free services) to certain recipients of its goods or services, revenues should be reported net of those discounts.” Paragraph 13.07 in the same guide then says that such discounts should be reported as expenses if the discounts are given in exchange for goods or services, such as part of a faculty compensation package.

(m) Expenses

Like all not-for-profit organizations, colleges and universities are required to report expenses on a functional basis (program, management, and fundraising) to comply with SFAS 117 and the AICPA audit guide for *Not-for-Profit Organizations*. Reporting by natural categories (personnel, occupancy, travel, supplies, etc.) is not required, but this information is often of interest to management and the governing board. The functional expenses may be presented either on the face of the statement of revenue and expenses and change in net assets (statement of activity) or in a separate schedule or footnote.

Disclosure of fundraising expenses is required; however, for many higher education institutions, fundraising expenses are not significant in relation to total expenses, since much fundraising is done by affiliates such as foundations or alumni associations whose financial statements do not meet the requirements for consolidation.

Further discussion of accounting for expenses is in Chapter 13 of this book and in Chapter 13 of the AICPA audit guide for *Not-for-Profit Organizations*. Because of their frequent significance to universities, two items from Chapter 13 of this book are repeated here:

1. Occupancy and maintenance of property is not a separate function, and these costs should be allocated to program, management, and fundraising as appropriate.
2. Interest expense should be allocated to specific functions to the extent possible; any remaining amount is management expense. For example, interest on a mortgage on a laboratory building would be a program expense.

The External Financial Statement Reporting Model for Public Colleges and Universities and Other Not-for-Profit Organizations Reporting under the GASB

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15.1 INTRODUCTION

When the Governmental Accounting Standards Board (GASB) issued *Basic Financial Statements—and Management’s Discussion and Analysis—for State and Local Governments* (Statement No. 34) followed shortly thereafter with *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities* (Statement No. 35), the impact was felt by every state and local government, including public colleges and universities, in the United States of America. This standard significantly changed the way that state and local governments (including public colleges, universities and affiliated not-for-profit organizations) presented their financial information to external financial statement users such as citizens, legislators, investors, and creditors. For the first time, state and local governments present consolidated—single-column—financial statements. Also, a statement of cash flows became one of the basic financial statements for most institutions, and new and expanded footnote disclosures enhance the reader’s understanding of the financial statements. In addition, Statement No. 34 required the presentation of Management’s Discussion and Analysis (MD&A). MD&A precedes the basic financial statements to provide a meaningful description of the institution’s financial position and activities based on currently known facts, circumstances, or conditions.

These new reporting standards moved institutions from a fund group financial reporting model to a financial reporting model that more closely conforms to the financial statement presentations of other organizations. (The other organizations would include state and local governmental entities, private colleges and universities, and other not-for-profit organizations.) The basic tenet of Statement No. 34 is that the external financial statements of the reporting entity should report on the overall state of the institution’s financial position, results of activities, and cash flows.

This chapter is divided into sections that are intended to help the reader understand the reporting model as well as the more significant elements of the basic financial statements, footnote disclosures, and MD&A as they relate to public colleges and universities (hereinafter often referred to as *institutions*).

15.2 BACKGROUND

The GASB is a private, nonprofit organization that was formed in 1984 to set accounting and financial reporting standards for state and local governments. Prior to the creation of the GASB, the establishment of accounting and financial reporting standards for state and local governments was performed by the National Council on Governmental

Accounting (NCGA). The GASB is comprised of seven board members, supported by a full-time staff. Board members include users, preparers, and auditors of state and local government financial statements, as well as a member of academia. It is the governmental equivalent of the Financial Accounting Standards Board (FASB), which sets accounting standards for the nongovernmental sector. Both organizations operate under the auspices of the nonprofit Financial Accounting Foundation (FAF), which appoints the members of both boards.

The GASB is responsible for establishing generally accepted accounting principles (GAAP) for both state and local governments. GAAP is designed to provide the basic information needed by financial statement users. Under the rules of the American Institute of Certified Public Accountants (AICPA), state and local governments must follow GASB standards to obtain unqualified opinions from their auditors. Also, the laws of certain state and local governments require their financial statements to be prepared according to GAAP. Finally, under the provisions of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, auditors must report whether the financial statements of recipients of federal awards conform with GAAP.

According to the GASB, governmental financial reporting must demonstrate accountability. In fact, the GASB noted that a governmental organization must be “publicly accountable” (GASB Concepts Statement No. 1, ¶ 77). In the background information to its Concepts Statement, the GASB discussed the meaning of accountability, quoting Frederick C. Mosher. Mosher wrote *The GAO: The Quest for Accountability in American Government* (GAO stands for the U.S. General Accountability Office). We think it is helpful to repeat the quotation here, because it reinforces the GASB’s objectives in financial reporting. Mosher writes:

Even in simpler times, accountability was hard to define and harder to assure. But there seem always to have been three essential elements. The first of these is information: information about the decisions and actions of those individuals and organizations who are held accountable to those others who are holding them to account. ... A second requisite of accountability is that there be some individuals or organizations, outside receivers and/or discoverers of the information, who are able and willing to examine it, investigate it if necessary, digest it, and report it or initiate appropriate action based upon it. And the third has to do with recourse on the basis of such information (1) to correct deficiencies and improve performance and/or (2) to reward honorable and effective performance or penalize dishonesty, concealment, fraud, inefficiency, or ineffectiveness. ...

The foundation for Statement No. 34 is predicated on the GASB’s Concepts Statement No. 1, *Objectives of Financial Reporting*, which established accountability as the principal objective of governmental financial reporting (see Exhibit 15.1). To meet their obligation to be accountable, governments are required to provide useful, relevant, reliable, and understandable information that addresses the principal needs of a variety of users. Concepts

EXHIBIT 15.1

Purposes of Financial Reporting for Governmental Organizations

Financial reporting should fulfill a governmental organization's duty to be publicly accountable, and it should enable users to assess the organization's accountability by providing information to:

- Determine whether current-year revenues were sufficient to pay for current-year services.
- Demonstrate whether resources were obtained and used in accordance with the organization's legally adopted budget and to demonstrate compliance with other finance-related legal or contractual requirements.
- Assist users in assessing the service efforts, costs, and accomplishments of the organization.

Financial reporting should assist users in evaluating the governmental organization's operating results by providing information about:

- Sources and uses of financial resources.
- How the organization financed its activities and met its cash requirements.
- Whether the organization's financial position improved or deteriorated as a result of the year's operations.

Financial reporting should assist users in assessing the level of services that can be provided by the governmental organization as well as its ability to meet its obligations by providing information about its:

- Financial position and condition.
- Physical and other nonfinancial resources having useful lives that extend beyond the current year, including information that can be used to assess the service potential of those resources.
- Legal or contractual restrictions on resources and the risk of potential loss of resources.

Statement No. 1 further noted that an annual financial report should allow users to assess a government's accountability. It should assist them in determining compliance with finance-related laws, rules, and regulations, as well as in making economic, social, and political decisions. The GASB identified citizens, legislative and oversight bodies, and investors and creditors as the three groups of primary users.

15.3 ACCOUNTING AND FINANCIAL REPORTING FOR NONEXCHANGE TRANSACTIONS

Before Statement No. 34 could be issued, the GASB recognized that it had to modify and standardize the recognition guidance for nonexchange transactions. To meet this need, in 1999 the GASB issued Statement No. 33. In nonexchange transactions, a government gives (or receives) value without directly receiving (or giving) equal value in return. Examples of nonexchange transactions for a public college or university are gifts, contributions, capital contributions, and state appropriations. Prior to Statement No. 33, different governments have used different criteria for when to recognize nonexchange transactions for reporting purposes. Statement No. 33 defines nonexchange transactions and provides a uniform set of criteria to be met in determining when to report the results of nonexchange transactions.

Statement No. 33 defines four different types of nonexchange transactions:

1. Derived tax revenues
2. Imposed nonexchange revenues
3. Government-mandated nonexchange transactions
4. Voluntary nonexchange transactions

A more detailed description of the different types of nonexchange transactions can be found in Statement No. 33. The type of nonexchange transactions most commonly found at public colleges and universities are voluntary nonexchange transactions—which result from legislative or contractual agreements, rather than exchanges, entered into willingly by two or more parties (footnote to Statement No. 33, ¶ 7(d)). Examples of voluntary nonexchange transactions include donations by nongovernmental entities, including individuals (private donations), and certain grants. The principal characteristics of a voluntary nonexchange transaction are: (1) They are not imposed on the provider or the recipient; and (2) fulfillment of eligibility requirements is essential for a transaction (other than the provision of cash or other assets in advance) to occur.

Recognizing that there was inconsistency in the accounting and financial reporting of nonexchange transactions that had stipulated time requirements, purpose restrictions, or both, Statement No. 33 established standards for when and how to recognize nonexchange transactions when time requirements, eligibility requirements, or purpose restrictions are stipulated by the provider.

(a) Time and Eligibility Requirements

Time requirements specify the period or periods when resources are required to be used or when use may begin. A time requirement may specify that resources are to be used in a certain period or fiscal year, or they may specify that the resources may not be disbursed until a certain time or event has occurred. Eligibility requirements are conditions established by enabling legislation or the provider that are required to be met before a transaction (other than the provision of cash or other assets in advance) can occur. That is, until those requirements are met, the recipient does not have a receivable, the provider does not have a liability, and the recognition of revenues or expenses for resources transmitted or received in advance should be deferred (footnote to Statement No. 33, ¶ 19).

There are four types of eligibility requirements associated with voluntary nonexchange transactions:

1. *Required characteristics of recipient*—the recipient is required to have the characteristics specified by the provider.

2. *Time requirements*—the time requirements established in enabling legislation or by the provider are required to be met.
3. *Reimbursements*—the provider offers resources on a reimbursement basis, and the recipient is required to have incurred allowable costs under the applicable program.
4. *Contingencies*—the provider's offer of resources is contingent upon a specified action of the recipient.

Institutions should recognize assets/revenues and liabilities/expenses from voluntary nonexchange transactions when all eligibility requirements have been met. Recognition of assets/liabilities and revenues/expenses should not be postponed pending completion of purely routine requirements that are ancillary in nature (e.g., filing an application for reimbursement of preapproved expenditures). Resources transmitted before the eligibility requirements have been met should be reported as advances by the provider and deferred revenues by the recipient (footnote to Statement No. 33, ¶ 21).

There is an exception when resources (cash or other assets) are transmitted to an institution with the stipulation that those resources cannot be sold, disbursed, or consumed until after a specified number of years have passed or a specific event has occurred, if ever. In these cases, the recipient should recognize revenues when the resources are received, provided all eligibility requirements have been met. The time requirement is deemed to be met as soon as the recipient begins to honor the provider's stipulation not to sell, disburse, or consume the resources and continues to be met for as long as the recipient honors that stipulation (footnote to Statement No. 33, ¶ 22). Examples of these types of transactions are permanently nonexpendable additions to endowments, term endowments, and contributions of capital assets.

Promises of cash or other assets that nongovernmental entities, including individuals, voluntarily make to institutions are generally referred to as pledges or promises to give. Recipients of nonendowment or capital-asset-related pledges or promises to give should recognize receivables and revenues (net of estimated uncollectible amounts) when all eligibility requirements are met, provided that the promise is verifiable and the resources are measurable and probable of collection. Recipients of pledges or promises to give of endowment or capital assets should not recognize revenues until the assets are received and all other eligibility requirements have been met. Note that this is different from the accounting required by FASB SFAS 116 for private colleges and universities that are required to recognize revenue for unconditional pledges, including those for endowment and capital assets.

(b) Purpose Restrictions

Purpose restrictions specify the purpose or purposes for which the resources are required to be used. In contrast to time requirements, purpose restrictions do not affect the timing of recognition for any class of nonexchange transaction. Rather, recipients of resources with purpose restrictions should report resulting net assets as prescribed under GASB Statement No. 34, as restricted until the resources are used for the specified purpose or for as long as the provider requires the resources to remain intact.

With the implementation of GASB Statement No. 33, there is now conformity among state and local governments on how to recognize assets, liabilities, revenues, and expenses for both exchange and nonexchange transactions.

15.4 EXTERNAL FINANCIAL REPORTING FOR PUBLIC COLLEGES AND UNIVERSITIES

In June 1999, after many years of research and deliberation, the members of the GASB approved the issuance of Statement No. 34, which established new financial reporting requirements for all state and local governments in the United States. It retained some of the information previously provided by state and local governments in their comprehensive annual financial reports; but it also required additional information that was intended to make external financial statements more comprehensive and easier to understand and use. Statement No. 34 represented the most comprehensive and far-reaching reporting model for state and local governments ever developed as it was subsequently amended by Statement No. 37, *Basic Financial Statements—Management’s Discussion and Analysis—for State and Local Governments Omnibus: An Amendment of GASB No. 21 and 34*, and by Statement No. 38, *Certain Financial Statement Note Disclosures*.

Statement No. 34 specifically excluded public colleges and universities from its scope because the GASB intended to issue a separate standard that addressed a new external financial reporting model for public colleges and universities. The GASB considered public colleges and universities to be unique. But then in late 1999, the GASB discontinued its plan for a separate financial reporting model for public colleges and universities, and instead issued Statement No. 35, *Basic Financial Statements—and Management’s Discussion and Analysis—for Public Colleges and Universities*, which simply amended Statement No. 34 to include public colleges and universities within Statement No. 34’s reporting guidance afforded for special-purpose governments. It is important to note that Statement No. 34 was written primarily for governments, not public colleges and

universities (i.e., those engaged in business-type activities [BTA] as discussed further below). Because of this, much of Statement No. 34 is not applicable to most public colleges and universities. Also, as you will see, because it was not written with BTA public colleges, universities and other not-for-profits in mind, some requirements of Statement No. 34 are not harmonious with traditional presentations of financial information.

15.5 AN OVERVIEW OF GASB STATEMENT NO. 35: THE EXTERNAL REPORTING MODEL FOR PUBLIC COLLEGES AND UNIVERSITIES

Of primary importance is that Statement No. 35 alone does not establish the financial reporting requirements for public colleges and universities. Statement No. 35 establishes accounting and financial reporting standards for public colleges and universities within the financial reporting guidelines of Statement No. 34. Statement No. 35 allows qualified public colleges and universities to elect to report their external financial information as a Special-Purpose Government Engaged Only in Business-Type Activities (BTA). Accordingly, public colleges and universities that qualify and elect to report as a BTA should present only the financial statements required for an enterprise fund (Statement No. 34, ¶ 138). An enterprise fund is used to report any activity for which a fee is charged to external users for goods or services. An institution qualifies to report as an enterprise fund if any one of the following criteria is met:

- The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity
- Laws or regulations require that the activity's costs of providing services, including capital costs, be recovered with fees and charges rather than with taxes or similar revenues
- The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (Statement No. 34, ¶ 67)

It is important to note that institutions should apply each of these criteria in the context of the activity's principal revenue source.

Although most public institutions are regularly subsidized, they also cover a major portion of their costs through external user charges for their services. For most institutions, the principal revenue sources are tuition and fees, federal grants and contracts, and auxiliary operations. Therefore, according to paragraphs 44 through 47 of Statement No. 35 and related paragraph 67 of Statement No. 34, public institutions are permitted to use BTA reporting, which enables presentation of external financial statements that are somewhat comparable with their not-for-profit counterparts.

15.6 BASIC FINANCIAL STATEMENTS

There are exceptions, however. Because certain two-year institutions have taxing authority, they do not qualify as an enterprise fund. Therefore, they may report as Special-Purpose Governments Engaged Only in Governmental-Type Activities, or as Special-Purpose Governments Engaged in Both Governmental and BTA (Statement 35, ¶¶ 27 and 46). Because most institutions are financed in whole or in part by fees charged to external parties for goods and services (i.e., tuition, fees, grants, and contracts), this chapter only covers external financial reporting for institutions that elect to report as BTAs.

15.6 BASIC FINANCIAL STATEMENTS

The three basic financial statements of an enterprise fund, and therefore of institutions that have elected to report as a BTA, are as follows:

1. Statement of Net Assets or Balance Sheet
2. Statement of Revenues, Expenses, and Changes in Net Assets or Fund Equity
3. Statement of Cash Flows

The basic financial statements should be accompanied by footnote disclosures, as well as MD&A, which is *required supplemental information* (RSI). An overview of the basic financial statements, footnote disclosures, and MD&A are presented in the sections that follow.

The basic financial statements should focus on the institution as a whole and should meet the information needs of the financial statements' external users. As evidenced by the GASB's issuance of Statement No. 33, *Accounting and Financial Reporting for Nonexchange Transactions*, the objectives of the GASB's more recent pronouncements are to enhance the understandability, relevance, and comparability of the financial statements of governmental entities. The financial statements, footnotes, and MD&A should give an aggregated view of the institution and should provide information on its financial position, results of operations, and financial liquidity.

(a) Statement of Net Assets

The Statement of Net Assets includes the following key features:

- Consolidated presentation—The statement of net assets should report the financial position of the overall institution without displaying individual funds or fund types.
- Classified format—The Statement of Net Assets should be presented in a classified format to distinguish between current and

long-term assets and liabilities. In order to determine whether an asset or liability is current or long-term in nature, preparers should refer to Chapter 3 of Accounting Research Bulletin No. 43 (ARB 43).

- Net assets—Net assets should be classified into three categories of net assets:
 1. Invested in capital assets, net of related debt consist of capital assets, net of accumulated depreciation and reduced further by the outstanding balances of any bonds, mortgages, notes, or other borrowings that are attributable to the acquisition, construction, or improvement of those assets. If there are significant unspent related debt proceeds at year-end, the portion of the debt attributable to the unspent proceeds should not be included in the calculation of invested in capital assets, net of related debt.
 2. Restricted net assets consist of assets and liabilities that have constraints placed on their use by third parties (e.g., creditors, donors, and laws and regulations of other governments). Constraints also may be placed on the net assets by the organization's enabling legislation. Enabling legislation authorizes the institution to assess, levy, charge, or otherwise mandate payment of resources (from external resource providers), and it includes a legally enforceable requirement that those resources be used only for the specific purposes stipulated in the legislation. Examples of restricted net assets include:
 - Unspent bond proceeds and the associated liability thereon
 - Gifts that have donor-imposed restrictions as to use or purpose
 - Permanent and term endowments

When permanent endowments are a component of restricted net assets, a distinction should be made between the restricted net assets that are expendable and those that are nonexpendable. Restricted expendable net assets are those restricted net assets that may be utilized for their intended purpose. Restricted nonexpendable net assets are those that are required to be retained in perpetuity. Restricted net assets may be segregated according to the type of restriction on the face of the Statement of Net Assets.

Statement No. 35 requires that public colleges and universities provide certain disclosures about donor-restricted endowments. The institution should disclose the amounts of net appreciation on investments of donor-restricted endowments

that the governing board can authorize for expenditure. In addition, the institution should disclose how the amounts are reported in net assets. Furthermore, the institution should disclose the appropriate state law regarding the ability to spend net appreciation as well as the policy for authorizing expenditures, such as a spending rate or a total return policy.

Board-designated endowments or quasi-endowments are generally not a component of restricted net assets as the constraints placed on those net assets are internally designated, and management has the ability to remove or modify them.

3. Unrestricted net assets consist of net assets that do not meet the definition of restricted or invested in capital assets, net of related debt (Statement No. 34, ¶ 36). Statement No. 35 does not allow the display of internal designations of unrestricted net assets on the face of the Statement of Net Assets. However, such designations may be disclosed in the notes to financial statements.

For the purposes of our discussion in the text that follows, it is assumed that a Statement of Net Assets is selected (see Exhibit 15.2 for a sample). However, a balance sheet is also presented (see Exhibit 15.3 for a sample). Either is acceptable under the GASB 35 reporting model.

(i) Capital Assets. Acquisitions of capital assets that meet an institution's capitalization policy are recorded as capital assets. Acquisitions that do not meet or exceed an institution's capitalization policy are recognized as expenses.

Accounting and reporting for collections varies among institutions, but in general, public colleges and universities should capitalize collections at historic cost, or fair value when donated. Statement No. 34 allows that collections that meet three conditions need not be capitalized, although capitalization is still encouraged. Some conditions need to be met:

- The collection is held for public exhibition, education, or research in furtherance of public service, rather than financial gain.
- It is protected, kept unencumbered, cared for, and preserved.
- It is subject to an organizational policy that requires the proceeds from sales of collection items to be used to acquire other items for collections.

If a collection is not capitalized, the institution should provide a description of the collection and the reasons that the collection is not capitalized. Also, if a collection is capitalized at June 30, 1999, then the collection and any additions to it cannot use this exemption from capitalization.

EXHIBIT 15.2

Sample Statement of Net Assets

WESTWOOD STATE COLLEGE	
STATEMENT OF NET ASSETS	
JUNE 30, 200X	
ASSETS	
Current Assets	
Cash and cash equivalents	\$ 4,300,000
Short-term investments	13,279,000
Accounts receivable, net	8,200,000
Inventories	400,000
Deposit with bond trustee	4,600,000
Notes and mortgages receivable, net	300,000
Other assets	<u>800,000</u>
Total current assets	31,879,000
Noncurrent Assets	
Restricted cash and cash equivalents	20,000
Deposit with bond trustees	2,000,000
Endowment investments	21,500,000
Notes and mortgages receivable, net	3,000,000
Investments in real estate	6,800,000
Capital assets, net	<u>145,000,000</u>
Total noncurrent assets	<u>178,320,000</u>
Total assets	<u><u>210,199,000</u></u>
LIABILITIES	
Current Liabilities	
Accounts payable and accrued liabilities	6,000,000
Compensated absences	500,000
Deferred revenue	2,500,000
Long-term liabilities—current portion	<u>4,000,000</u>
Total current liabilities	13,000,000
Noncurrent Liabilities	
Deposits	499,000
Deferred revenue	1,000,000
Compensated absences	2,000,000
Long-term liabilities	<u>18,700,000</u>
Total noncurrent liabilities	<u>22,199,000</u>
Total liabilities	<u><u>35,199,000</u></u>

15.6 BASIC FINANCIAL STATEMENTS

EXHIBIT 15.2 (CONTINUED)

Sample Statement of Net Assets

WESTWOOD STATE COLLEGE	
STATEMENT OF NET ASSETS	
JUNE 30, 200X	
NET ASSETS	
Invested in capital assets, net of related debt	123,000,000
Restricted for	
Nonexpendable	
Scholarships and fellowships	14,100,000
Research	4,000,000
Expendable	
Scholarships and fellowships	3,000,000
Research	6,000,000
Instructional department uses	1,000,000
Capital projects	8,500,000
Debt service	5,000,000
Other	400,000
Unrestricted	<u>10,000,000</u>
Total net assets	<u><u>\$175,000,000</u></u>

EXHIBIT 15.3

Sample Balance Sheet

WESTWOOD STATE COLLEGE	
BALANCE SHEET	
JUNE 30, 200X	
ASSETS	
Current Assets	
Cash and cash equivalents	\$ 4,300,000
Short-term investments	13,279,000
Accounts receivable, net	8,200,000
Inventories	400,000
Deposit with bond trustee	4,600,000
Notes and mortgages receivable, net	300,000
Other assets	<u>800,000</u>
Total current assets	31,879,000
Noncurrent Assets	
Restricted cash and cash equivalents	20,000
Deposit with bond trustees	2,000,000
Endowment investments	21,500,000
Notes and mortgages receivable, net	3,000,000
Investments in real estate	6,800,000
Capital assets, net	<u>145,000,000</u>
Total noncurrent assets	<u>178,320,000</u>
Total assets	<u><u>210,199,000</u></u>

EXHIBIT 15.3 (CONTINUED)

Sample Balance Sheet

WESTWOOD STATE COLLEGE	
BALANCE SHEET	
JUNE 30, 200X	
LIABILITIES	
Current Liabilities	
Accounts payable and accrued liabilities	6,000,000
Compensated absences	500,000
Deferred revenue	2,500,000
Long-term liabilities—current portion	<u>4,000,000</u>
Total current liabilities	13,000,000
Noncurrent Liabilities	
Deposits	499,000
Deferred revenue	1,000,000
Compensated absences	2,000,000
Long-term liabilities	<u>18,700,000</u>
Total noncurrent liabilities	<u>22,199,000</u>
Total liabilities	<u>35,199,000</u>
NET ASSETS	
Invested in capital assets, net of related debt	123,000,000
Restricted for	
Nonexpendable	
Scholarships and fellowships	14,100,000
Research	4,000,000
Expendable	
Scholarships and fellowships	3,000,000
Research	6,000,000
Instructional department uses	1,000,000
Capital projects	8,500,000
Debt service	5,000,000
Other	400,000
Unrestricted	<u>10,000,000</u>
Total net assets	<u>\$175,000,000</u>
Total liabilities and net assets	<u><u>\$210,199,000</u></u>

Experience shows that public colleges and universities normally do not have infrastructure assets. Infrastructure assets are large and complex networks or subsystems of capital assets that can be preserved for a significantly longer period of time than most fixed assets. Most public colleges and universities have large fixed assets such as computer networks,

athletic complexes and fields and facilities, research facilities, drainage systems, and so on. They also may have other complex networks or sub-systems such as campus roadways and sidewalks, telecommunications wiring and systems, and utility tunnels. Such assets, although large and, perhaps, complex, are typically ancillary to buildings or other capital assets and, therefore, are not accounted for as infrastructure.

(ii) Depreciation of Capital Assets. Capital assets should be reported in the statement of net assets at historical cost (or estimated fair value when they are received, if donated), net of accumulated depreciation. The amount capitalized should include interest and ancillary charges to place the asset into service.

Capital assets should be depreciated in the statement of revenues, expenses, and changes in net assets over the estimated useful life of the asset. Exceptions to the requirement to depreciate capital assets apply to the following:

- Infrastructure assets accounted for using the modified approach, as defined by the GASB
- Noncapitalized collections
- Inexhaustible capital assets, such as land and certain land improvements

Depreciation expense should be measured by allocating the net cost of capital assets (less estimated salvage value) over their estimated useful lives in a systematic and rational manner (e.g., straight line, sum of the years' digits, depletion). Statement No. 35 does not require depreciation expense to be calculated on an asset-by-asset basis but instead allows for depreciation to be calculated for a class of assets, a network of assets, or other aggregated groups of assets.

The accounting and reporting requirement of Statement Nos. 34 and 35 are fairly straightforward. However, as many public colleges and universities that have not recorded depreciation expense in the past will find out, implementing the provisions of this new standard can be very difficult and require a significant amount of time and resources.

(iii) Capital Asset Impairment. In November 2003, the GASB issued its Statement No. 42, Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries. Statement No. 42 establishes accounting and financial reporting standards for impairment of capital assets. A capital asset is considered impaired when its service utility has declined significantly and unexpectedly. Statement No. 42 also clarifies and establishes accounting requirements for insurance recoveries. Statement No. 42 is effective for periods beginning after December 15, 2004.

With the issuance of Statement No. 42, public colleges and universities (and all other governments) are now required to evaluate prominent events or changes in circumstances affecting capital assets to determine whether impairment of a capital asset has occurred. Such events or changes in circumstances that may be indicative of impairment include evidence of physical damage, enactment or approval of laws or regulations, or other changes in environmental factors, technological changes or evidence of obsolescence, changes in the manner or duration of use of a capital asset, and construction stoppage.

Impaired capital assets that will no longer be used by public colleges or universities should be reported at the lower of the carrying value or fair value. Impaired capital assets that will continue to be used by governments should be measured using the method that best reflects their diminished service utility. Statement No. 42 does not require a write down when the impairment of the assets is considered temporary, only permanent impairments are recognized. Impairment losses should be reported as a program expense, special item or extraordinary item per Statement No. 34. Statement No. 42 does not permit the reversal of impairments in future years.

(b) Statement of Revenues, Expenses, and Changes in Net Assets

The Statement of Revenues, Expenses, and Changes in Net Assets (SRECNA) should be prepared in a fully aggregated, single-column basis, with the sequencing of items in the all-inclusive format. The manner in which items are presented in the SRECNA (i.e., as operating or nonoperating) is often guided by how each item is classified in the Statement of Cash Flows, which is prepared in accordance with GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*.

Revenue should be reported by major source identifying revenues used as security for revenue bonds. Revenue should be reported net of nonexchange discounts and allowances, including tuition waivers, internally funded scholarships, and allowances in the form of institutionally funded financial aid. Revenues may be reported on the SRECNA net, with the amount of the discount or allowance reported parenthetically or in the footnotes to the financial statements. Alternatively, revenues on the SRECNA may be reported gross, with the related discounts or allowances reported directly beneath the revenue amount. The guidance on accounting for scholarships, discounts, allowances, and other types of aid is contained in the National Association of College and University Business Officers (NACUBO) Advisory Report 2000-5, *Accounting and*

Reporting Scholarship Discounts and Allowances to Tuition and Other Fee Revenues by Public Institutions of Higher Education.

Expenses can be reported by functional or natural classification. Public colleges and universities have traditionally reported expenses according to their functional classification. If expenses are presented by their functional classification, depreciation is not required to be allocated by category. However, if depreciation expense is allocated to the functional classes in the SRECNA, then total depreciation expense for the institution must be disclosed within the financial statements or in their respective footnotes.

It should be noted that regardless of whether the natural or functional classification of expenses is elected in the SRECNA, the program expenses still should be presented by function in MD&A.

Statement No. 35 requires that the SRECNA should distinguish between operating and nonoperating revenues and expenses. As mentioned earlier, when an institution elects BTA reporting, a consideration for defining operating revenue is how individual transactions are categorized for purposes of preparing a statement of cash flows using Statement No. 9, ¶ 21. Presented in Exhibit 15.4 is a summary of the general guidelines for the classification of various revenue items for a public college or university. See Exhibit 15.5 for a sample Consolidated Statement of Revenues, Expenses, and Changes in Net Assets.

(c) Statement of Cash Flows

The benefit of cash flow information is that it highlights the institution's ability to meet its obligations and it is a valuable tool for analyzing an institution's financial activities. Furthermore, cash flow information can be used to determine the institution's various external financing needs.

EXHIBIT 15.4

Guidelines for Classifying Revenues	
OPERATING REVENUE	NONOPERATING REVENUE
Tuition and fees	State appropriations (operating and capital)
Grants—exchange and “exchange-like” transactions	Grants—nonexchange transactions
Sales of services/auxiliaries	Gifts and contributions
Contracts	Investment income
Interest charged on student loans	Interest earned on investments

EXHIBIT 15.5

**Westwood State College: Consolidated Statement
of Revenues, Expenses, and Changes in Net Assets**

Year Ended June 30, 200X (In thousands)	
Operating revenues	
Student tuition and fees	\$ 650,000
Less: tuition discounts, waivers and scholarship allowances	<u>(90,000)</u>
Net student tuition and fees	560,000
Federal grants and contracts	300,000
State and local grants and contracts	2,000
Nongovernment-sponsored programs	85,000
Sales and services of educational departments	100,000
Auxiliary enterprises:	
Patient care revenues and managed care premiums	1,300,000
Other auxiliary enterprise revenues	98,000
Student residences (net of scholarship allowances of \$3,000)	45,000
Student loan interest income and fees	<u>2,000</u>
Total operating revenues	2,492,000
Operating expenses	
Compensation and benefits	1,700,000
Supplies and services	980,000
Depreciation	300,000
Scholarships and fellowships	<u>80,000</u>
Total operating expenses	<u>3,060,000</u>
Operating loss	<u>(568,000)</u>
Nonoperating revenues (expenses)	
State appropriations	475,000
Private gifts	50,000
Net investment	10,000
Interest expense	(25,000)
Net other nonoperating expenses	<u>(100)</u>
Net nonoperating revenues before capital and endowment additions	509,900
Capital state appropriations	34,000
Capital gifts and grants	8,000
Private gifts for endowment purposes	<u>50,000</u>
Nonoperating revenues	<u>601,900</u>
Increase in net assets	33,900
Net assets, beginning of year	<u>174,966,100</u>
Net assets, end of year	<u><u>\$175,000,000</u></u>

15.7 FOOTNOTE DISCLOSURES

GASB Statement No. 9, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, outlines the requirements for this financial statement. Highlights of Statement No. 9, particularly those that are applicable to public colleges and universities, follow:

- The statement of cash flows must be presented using the direct method of presenting cash flows from operating activities. The direct method presents major classes of operating cash receipts and cash payments. It requires adjusting revenues and expenses to reflect their cash impact. For example, tuition revenues would be adjusted to reflect only cash received from tuition by adjusting for the change in accounts receivable balance (including any adjustments that had been made for bad debts). A similar adjustment process would be carried out for each major class of revenues and expenses. Examples of major classes of revenues for institutions would be tuition and fees, grants and contracts, and auxiliary enterprises. Examples of major classes of expenses would be cash paid to employees, cash paid to suppliers of goods or services, and interest paid.
- In general, cash receipts and payments should be reported on a gross basis on the statement of cash flows. Certain financial items qualify for net treatment on the statement of cash flows; they are listed in Statement No. 9, paragraphs 13 and 14.
- Noncash transactions also must be presented on the statement of cash flows, either on the face of the statement or in a separate schedule. Noncash transactions are investing, capital, and financing activities that affect recognized assets or liabilities but do not result in cash receipts or cash payments (e.g., capital lease transactions, depreciation expense, write-off of uncollectible receivables).

See Exhibits 15.6 and 15.7 for sample Statements of Cash Flows.

15.7 FOOTNOTE DISCLOSURES

National Council on Governmental Accounting (NCGA) Interpretation 6, *Notes to the Financial Statements Disclosure*, as amended by GASB Statement No. 34, Statement No. 38, and other pronouncements, provides the requirements for a complete set of footnotes for state and local governments, including public colleges and universities.

EXHIBIT 15.6

Westwood State College: Statement of Cash Flows

WESTWOOD STATE COLLEGE	
STATEMENT OF CASH FLOWS	
YEAR ENDED JUNE 30, 200X	
(IN THOUSANDS)	
Cash flows from operating activities	
Student tuition and fees	\$ 513,900
Federal, state, and local grants and contracts	460,000
Nongovernment-sponsored programs	100,000
Sales and services of educational and other departmental activities	200,000
Patient care revenues and managed care premiums	1,500,000
Student residence fees	52,000
Payments to suppliers	(1,222,000)
Payments to employees	(1,300,000)
Payments for benefits	(400,000)
Payments for scholarships and fellowships	(60,000)
Student loans issued	(15,000)
Student loans collected	18,000
Student loan interest and fees collected	2,000
Other receipts, net	<u>100</u>
Net cash used in operating activities	<u>(151,000)</u>
Cash flows from investing activities	
Interest and dividends on investments, net	60,000
Proceeds from sales and maturities of investments	8,000,000
Purchase of investments	(8,200,000)
Net decrease (increase) in cash equivalents	
noncurrent investments	<u>190,000</u>
Net cash provided by investing activities	<u>50,000</u>
Cash flows from capital and related financing activities	
Proceeds from issuance of capital debt	100,000
State capital appropriations	30,000
Private gifts	8,000
Other receipts	1,000
Purchase of capital assets	(400,000)
Principal payments on capital debt	(95,000)
Interest payments on capital debt	<u>(28,000)</u>
Net cash used in capital and related financing activities	<u>(384,000)</u>

15.7 FOOTNOTE DISCLOSURES

EXHIBIT 15.6 (CONTINUED)

Westwood State College: Statement of Cash Flows

WESTWOOD STATE COLLEGE STATEMENT OF CASH FLOWS YEAR ENDED JUNE 30, 200X (IN THOUSANDS)	
Cash flows from noncapital financing activities	
State educational appropriations	400,000
Private gifts	125,000
Student direct lending receipts	121,000
Student direct lending disbursements	(125,000)
Amounts received for annuity and life income funds	5,000
Amounts paid to annuitants and life beneficiaries and related expenses	(2,000)
Deposits of affiliates	<u>1,000</u>
Net cash provided by noncapital financing activities	<u>525,000</u>
Net increase in cash and cash equivalents	40,000
Cash and cash equivalents, beginning of year	<u>4,260,000</u>
Cash and cash equivalents, end of year	<u><u>\$4,300,000</u></u>

EXHIBIT 15.7

Westwood State College: Consolidated Statement of Cash Flows

WESTWOOD STATE COLLEGE CONSOLIDATED STATEMENT OF CASH FLOWS YEAR ENDED JUNE 30, 200X (IN THOUSANDS)	
Reconciliation of operating loss to net cash used in operating activities:	
Operating loss	\$(568,000)
Adjustments to reconcile operating loss to net cash used in operating activities:	
Depreciation expense	300,000
Loss on disposal of capital assets	3,000
Changes in assets and liabilities:	
Accounts receivable, net	5,000
Prepaid expenses and other assets	(10,000)
Accrued compensation and other	60,000
Accounts payable	40,000
Deferred revenue	16,000
Deposits of affiliates, student organizations, and others	2,000
Insurance and benefits reserves	<u>1,000</u>
Net cash used in operating activities	<u><u>\$(151,000)</u></u>

GASB Statement No. 34, (as amended) discusses the disclosure requirements for state and local governments. In 2003, the GASB issued its Statement No. 40, *Deposit and Investment Risk Disclosures*, an amendment of GASB Statement No. 3, *Deposits with Financial Institutions, Investments and Reverse Repurchase Agreements*. With regard to public colleges and universities, these new pronouncements expand the disclosure requirements in the following areas:

- Capital assets
- Long-term liabilities
- Collections
- Donor-restricted endowments
- Priority of release of restricted funds
- Segment information
- Cash, deposit, and investment risks

The amended disclosure requirements for collections and donor-restricted endowments have already been discussed in Section 15.6 of this chapter. The following subsections are a brief overview of the more significant footnote disclosure requirements of GASB Statement No. 35, as amended and Statement No. 40.

(a) Capital Assets

Public colleges and universities are required to provide in-depth information about the changes in their long-term assets, particularly capital assets. Specifically, the beginning and ending balances of capital assets are required, as well as increases and decreases for the year for each major class of capital asset and the related accumulated depreciation thereon. An example of such a footnote appears in Exhibit 15.8.

If the institution reports any impairment losses in accordance with Statement No. 42, the amount and the financial statement classification should be disclosed if it is not evident from the financial statements.

EXHIBIT 15.8
Westwood State College Footnote to Financial Statements June 30, 200X

Capital Assets (in thousands)	Beginning Balance June 30, 2001	Additions and Transfers	Deletions and Transfers	Write-offs / Adjustments	Ending Balance June 30, 2002
Land and improvements	\$ 2,000				\$ 2,000
Buildings	\$133,600	\$2,000	(\$ 400)		\$135,200
Building improvements	\$ 13,000	\$5,000			\$ 18,000
Machinery and equipment	\$ 3,000	\$1,000	(\$ 800)	(\$ 200)	\$ 3,000
Construction in progress	<u>\$ 1,000</u>	<u>\$ 500</u>	<u>(\$ 700)</u>	<u>(\$ 400)</u>	<u>\$ 400</u>
	\$152,600	\$8,500	(\$1,900)	(\$ 600)	\$158,600
Less: Accumulated depreciation	<u>(\$ 10,000)</u>	<u>(\$3,000)</u>	\$ 400	<u>(\$1,000)</u>	<u>(\$13, 600)</u>
	<u>\$142,600</u>	<u>\$ 5,500</u>	<u>(\$1,500)</u>	<u>(\$1,600)</u>	<u>\$145,000</u>

(b) Priority of Release of Restricted Funds

Quite often, an institution will find that it has available both restricted and unrestricted funds that can be used to meet a particular expense or purpose. Statement No. 35 does not mandate the priority of release of restricted funds when both restricted and unrestricted resources are available to satisfy an expense. The GASB concluded that the decision whether to first apply restricted or unrestricted funds to specific expenses should be a management matter and, therefore, did not include a requirement similar to that in FASB SFAS 116, in which the FASB mandates that when restricted net assets are available to meet a particular expense or purpose, they will be used first before any unrestricted amounts are used. Under GASB Statement No. 35, the priority of release is based on the institution's policy governing the use of resources, and should be disclosed in the footnotes to the financial statements.

(c) Segment Information

As amended, GASB Statement No. 35 identifies a segment as an identifiable activity or group of activities. The activity or group of activities would be reported as or within an enterprise fund or as another stand-alone entity that has one or more bonds or other debt instruments outstanding, with a revenue stream pledged in support of that debt. In addition, the identifiable activities' revenues, expenses, gains and losses, assets, and liabilities are required to be accounted for separately. It is important to note that the requirement for separate accounting should be imposed by an external party. Bond indentures and similar financing documents are usually the best places to look to see whether an identifiable activity or segment is required to be separately accounted.

As an example, assume that a university issued one revenue bond for the construction of one residence hall. The revenues from that residence hall are pledged in support of the revenue bonds, and there are identifiable revenues, expenses, assets, and liabilities related to the segment that are required by an external party—in this case, the bond trustee—to be accounted for separately.

In this example, the university would have a segment and, therefore, would have to make the required disclosures. The disclosure requirements for each segment are met by identifying the types of goods and services provided and by presenting condensed financial information that is listed in detail in paragraph 122 of FASB Statement No. 34. However, if there were not a third-party requirement for the assets and liabilities to be accounted for separately, this activity would not be considered a segment.

The criteria for segment reporting are not overly difficult to understand. However, they can become difficult to apply when multiple series of revenue bonds are issued for multiple projects for which separately identifiable financial information is difficult to obtain.

(d) Deposit and Investment Risk

Certain deposit and investment risk disclosures were previously covered by GASB Nos. 3, 28, and 30; however, GASB Statement No. 40, *Deposit and Investment Risk Disclosures*—an amendment of GASB Statement No. 3, *Deposits with Financial Institutions, Investments and Reverse Repurchase Agreements*, issued in 2003 (effective for periods beginning after June 15, 2004)—modifies and updates many of these disclosures. This statement addresses the disclosures required for credit risk, interest rate risk and foreign currency risk as it relates to the institution's investment and deposit holdings.

15.8 MANAGEMENT'S DISCUSSION AND ANALYSIS

Statement No. 34 requires MD&A as an element of the required supplemental information. MD&A should provide an objective and easily readable analysis of the government's financial activities based on currently known facts, decisions, or conditions that management is aware of as of the date of the auditor's report. The financial managers of public colleges and universities are knowledgeable about the transactions, events, and conditions that are reflected in their financial report and of the fiscal policies that govern the operations of the institutions. MD&A provides financial managers with the opportunity to present both a short- and long-term analysis of the institution's activities (Statement No. 34, ¶ 8).

Even though MD&A precedes the financial statements, it is required supplemental information (RSI) and, accordingly, subject to auditor evaluation under Statement of Auditing Standards (SAS) No. 52, *Required Supplementary Information*, to ensure that the information included in it is consistent with the information in the financial statements and the criteria for RSI prescribed by the GASB. MD&A can include nonfinancial data; however, the nonfinancial data should be relevant to the requirements of MD&A that are supported by individual verifiable information. Only "required" information should be presented in MD&A. Other supplementary information, if any, should be presented elsewhere in the comprehensive annual financial report. Other requirements are listed in paragraphs 8 through 11 of Statement No. 34 and include the following:

THE EXTERNAL FINANCIAL STATEMENT REPORTING MODEL UNDER THE GASB

- A brief discussion of the basic financial statements, including how they relate to each other and the significant differences in the information they provide
- A comparative analysis of the condensed current year to the prior-year financial information based on institution-wide information. This comparative analysis should discuss the reasons for significant interperiod changes, financial trends, and economic factors that significantly affected current-year operations. This comparative analysis should put equal emphasis on both positive and negative trends at the institution. Comparative MD&A is not required in the year of adoption.
- An analysis of significant changes that occur in various funds and of significant variances between budgeted activities and actual results of activities
- A description of capital asset and long-term debt activity
- A description of currently known facts, decisions, or conditions that are expected to have a significant effect on financial position or results of operations (Statement No. 34, ¶¶ 8–11). MD&A does not expect the institution to present information that is not based on currently known facts or speculations.

15.9 OTHER NOT-FOR-PROFIT ORGANIZATIONS REPORTING UNDER THE GASB

In addition to public colleges and universities, certain not-for-profit organizations may be required to report under the GASB, rather than the FASB reporting standards. Such organizations are considered governmental, and therefore should present under the GASB, if they possess one or more of the following key characteristics:

- Popular election of officers or appointment (or approval) of a controlling majority of the members of the organization's governing body by officials of one or more state or local governments
- The potential for unilateral dissolution by a government with the net assets reverting to a government
- The power to enact or enforce a tax levy

There is also a presumption that if an entity has the ability to directly issue tax-exempt debt it is a governmental entity and should report under the GASB. That presumption, however, can be rebutted should the entity possess none of the other characteristics of a governmental entity, described above.

15.9 OTHER NOT-FOR-PROFIT ORGANIZATIONS REPORTING UNDER THE GASB

It should be noted that the entity's incorporation and tax status have no bearing on the determination of the accounting and reporting rules to be followed—the assessment should be made solely based on an application and assessment of the above criteria.

An example of a not-for-profit which may be required to report under the GASB is a public university foundation. Others may include school districts, hospitals or other health care organizations. In some cases, the determination of whether an entity is governmental or nongovernment is difficult to determine and may require consultation with the organization's board and legal counsel.

These organizations should use the external reporting format prescribed in GASB Statement No. 34 for proprietary funds, which is similar to that discussed in Section 15.6 of this chapter for enterprise funds.

CHAPTER SIXTEEN

Health Care Providers

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16.1 INTRODUCTION

One very important segment of not-for-profit business is the health care industry. Health care in the United States is provided by entities operating in all sectors of the economy. Some health care organizations are investor-owned, some are operated as not-for-profit organizations (either business-oriented or eleemosynary), and some are operated by federal, state, and local governments. There are many different types of health care organizations. Health care “provider” organizations include hospitals, subacute care facilities, nursing homes, continuing-care retirement communities (CCRCs), home health companies, clinics, physician practices, freestanding urgent care centers, rehabilitation facilities, surgery centers, and integrated delivery systems, to name but a few. Health plans such as health maintenance organizations (HMOs), which arrange for health care services to be provided to their members, are also considered health care organizations, as are organizations whose primary activity is the planning, organization, and oversight of health care providers (i.e., parent or holding companies).

If the financial statements of not-for-profit organizations were arrayed along a continuum based on complexity, the financial statements of most health care providers would be among the most complex. Although many receive support from religious and fraternal organizations, individuals, corporations, and other donors or grantors, most are essentially self-sustaining—that is, they finance their capital needs primarily from the proceeds of debt issues and their operating needs largely from revenues derived from health care services provided. As a result, accountability to capital markets is more of a driving force in matters pertaining to financial statement presentation and disclosure of health care providers than it is for not-for-profit organizations that rely primarily on contributions. Comparability with financial statements of providers in the governmental and investor-owned sectors is also important. As a result, health care entities follow a separate AICPA guide, *Health Care Organizations—AICPA Audit and Accounting Guide*, rather than the AICPA’s other guide, *Not-for-Profit Organizations*.

16.2 AUTHORITATIVE PRONOUNCEMENTS

(a) AICPA Audit Guide

The AICPA has been and continues to be the primary source of guidance relating to specific accounting principles for health care organizations.

Throughout this chapter, the principles outlined will be those contained in the AICPA audit and accounting guide *Health Care Organizations (HCO)*, which was issued by the Institute's Health Care Committee in 1996. *Health Care Organizations* applies to entities possessing both of the following characteristics:

- The principal operations involve providing health care services to individuals.
- It is basically self-sustaining from fees charged for services (as defined in CON 4).

Consequently, eleemosynary health care organizations, whose primary sources of income are contributions rather than fees for services provided (e.g., hospitals that are funded primarily by donations from the general public), are considered to be voluntary health and welfare organizations. They follow the guidance in the AICPA audit guide *Not-for-Profit Organizations*, rather than for *Health Care Organizations*.

The AICPA guidance for not-for-profit health care organizations contained in the audit guide for *Health Care Organizations* generally parallels that in the audit guide *Not-for-Profit Organizations*, except in areas where differences are justified for purposes of comparability among health care providers (for example, the requirement to prepare a Statement of Operations). Those differences are highlighted in this chapter.

(b) Securities and Exchange Commission (SEC)

Most not-for-profit health care organizations finance their capital needs through issuance of long-term debt, primarily tax-exempt municipal bonds. Tax-exempt debt frequently is issued by state and local governments on behalf of private sector organizations to foster private-sector participation in certain desirable community activities such as the provision of health care services. The most prevalent form of financing involves the use of a "conduit" municipal entity lending its authorization to issue special obligation bonds, whose payment is based solely on the hospital's financial strength.

By virtue of the large dollar volume of municipal securities issued and outstanding each year, such securities are a major factor in the U.S. economy and the national securities markets. As the agency charged with administering the federal securities laws and overseeing the securities markets, the SEC has an obligation to protect investors in the municipal markets from fraud, including misleading disclosures. In 1989, the SEC adopted Rule 15c2-12 under the Exchange Act to enhance the quality and timeliness of disclosure to investors in municipal securities in connection with the original issuance of securities. In 1995, the SEC amended Rule 15c2-12 to further deter fraud and manipulation in the

primary and secondary municipal securities markets by assuring that participants in the secondary market (i.e., markets where securities are bought and sold subsequent to original issuance) have current, relevant information about the creditworthiness of municipal securities issuers and obligors on which to base their investment decisions.

Because many not-for-profit health care organizations have tax-exempt municipal bonds outstanding, they should be aware of the SEC's oversight of the municipal securities market and how it affects their responsibilities with respect to financial reporting. These issues are discussed further in Section 16.5.

(c) HFMA Principles and Practices Board

In 1975, the Healthcare Financial Management Association (HFMA) founded a Principles and Practices Board (P&PB). This committee consists of distinguished individuals in the field of health care accounting and finance who set forth advisory recommendations on health care accounting and reporting issues which are not addressed in FASB statements or the AICPA's *Health Care Organizations*. Although the P&PB's statements have no authoritative status, they are valuable to the health care community because they disseminate well-thought-out opinions, along with views on the issues and relevant background information, regarding issues on which information would not otherwise be available. At the time of this writing, eight P&PB statements are issued and outstanding.

16.3 FINANCIAL STATEMENTS

Not-for-profit health care entities prepare the following basic financial statements:

- Balance Sheet
- Statement of Operations
- Statement of Changes in Net Assets
- Statement of Cash Flows

The audit guide for *Health Care Organizations* provides illustrative financial statements for six types of health care providers: a hospital, government hospital authority, nursing home, continuing-care retirement community, home health agency, health maintenance organization, and an ambulatory care facility. The sample financial statements illustrate how to apply the reporting practices contained in the audit guide for *Health Care Organizations*; however, they are not intended to represent the only types of disclosure or statement formats that are appropriate. Health care providers should use financial statement formats that are most informative

for their individual circumstances, provided the *HCO* guide's accounting and reporting guidelines are met.

(a) Interrelationship of SFAS 117 and *Health Care Organizations*

As discussed in previous chapters, SFAS 117 provides the broad standards of financial reporting with which all not-for-profit organizations must comply. However, health care providers must apply those standards in accordance with additional guidance contained in the audit guide for *Health Care Organizations*. A summary of areas where this additional guidance has been provided is shown in Exhibit 16.1.

The primary reason for these differences is that SFAS 117 would have allowed more flexibility in financial reporting than traditionally has existed within the health care industry. For example, it would have eliminated the longstanding requirement to present an income statement, which is important information from the standpoint of users of health care entities' financial statements.

(b) Balance Sheet

SFAS 117 requires that information about liquidity of assets and liabilities be provided in the balance sheet. Unlike many other types of not-for-profit organizations, most health care entities (with the exception of some CCRCs) traditionally have prepared a "classified" balance sheet—that is, one in which assets and liabilities are categorized as "current" or "noncurrent."

EXHIBIT 16.1

SFAS 117 and *HCO* Guidance Compared

SFAS 117 Guidance	Interpretive Guidance in <i>HCO</i>
Information about liquidity of assets and liabilities must be provided in some fashion within the balance sheet.	Providers must provide liquidity information through preparation of a classified balance sheet (e.g., segregation of assets and liabilities between current and noncurrent classifications).
Reporting the results of operations (i.e., net income) is allowed but not required.	Providers must prepare an income statement (Statement of Operations) that includes a ("performance indicator") subtotal (i.e., net income).
Nonprofit organizations must present a Statement of Activities.	In effect, <i>Health Care Organizations</i> subdivides the Statement of Activities into two statements: a Statement of Operations, which includes all changes in unrestricted net assets, including net income, and a Statement of Changes in Net Assets, which includes all changes in all classes of net assets.

The audit guide for *Health Care Organizations* requires all providers other than CCRCs to meet the liquidity requirements by preparing a classified Balance Sheet.

(c) Statement of Operations

Probably the most significant difference between the financial statements of health care providers and other not-for-profit organizations is that health care organizations are required to provide a Statement of Operations (which is a financial statement similar to the Statement of Comprehensive Income prepared by for-profit entities). The statement must include a subtotal that displays the net results of operations for the period as well as all other changes in *unrestricted net assets*.¹ The audit guide for *Health Care Organizations* refers to this subtotal as a “performance indicator.” In substance, it is analogous to the net income number in a for-profit organization; however, because the FASB has objected to the use of the term “net income” by not-for-profit organizations, providers generally use alternative terminology such as “excess of revenues over expenses,” “income from operations,” “operating income,” or similar descriptive captions.

Transactions accounted for as changes in unrestricted net assets which must be excluded from the performance indicator subtotal include:

- Equity transfers involving other entities that control the reporting entity, are controlled by the reporting entity, or are under common control with the reporting entity
- Receipt of restricted contributions (temporary and permanent)
- Contributions of (and assets released from donor restrictions related to) long-lived assets^{2,3}
- Investment return restricted by donors or by law
- Unrealized gains/losses on investments not restricted by donors or by law, other than trading securities

¹ Other changes in net assets (i.e., temporarily restricted and permanently restricted) may be presented separately, that is, in a statement of changes in net assets or in the Statement of Operations.

² Net assets released from restrictions other than those related to long-lived assets are included in the performance indicator.

³ Under SFAS 116, contributions of property, plant, and equipment generally are reported as increases in unrestricted net assets. A similar treatment is afforded donations received or pledged toward purchasing those assets, provided the stipulated asset is purchased and placed in service in the same period that the contribution is received. *Health Care Organizations* requires all such contributions to be reported below (i.e., excluded from) net income. This requirement is based on the traditional practice within the industry of flowing “capital” contributions through equity accounts.

- APB 30-type items (extraordinary items, discontinued operations, cumulative effect of a change in accounting principle)⁴
- Minimum pension liability under FASB SFAS 87
- Foreign currency translation adjustments
- The effective portion of the gain or loss on derivative instruments designated and qualifying as cash flow hedging instruments
- Other elements of “comprehensive income” as defined in SFAS 130

In December 2002, the AICPA’s Statement of Position (SOP) 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator*, was issued. SOP 02-2 amends *Health Care Organizations* to indicate that the performance indicator is analogous to income from continuing operations of a for-profit organization. It also clarifies that the items of “other comprehensive income” reported by for-profit enterprises under FASB SFAS 130, *Reporting Comprehensive Income*, should be reported below the performance indicator by not-for-profit health care organizations.

(i) Operating/Nonoperating Subtotal. Providers are not precluded from incorporating additional classifications within the performance indicator, if desired. Many have continued to follow a traditional industry practice of providing an intermediate measure of operations (i.e., segregating the results of operations into “operating” and “nonoperating” categories). Currently, there is no specific guidance in GAAP with respect to what constitutes operating versus nonoperating income/expense.

The AICPA health care audit guide that existed prior to the audit guide for *Health Care Organizations*⁵ provided some guidance based on FASB Concepts Statement No. 6. Although it was not carried forward into the audit guide for *Health Care Organizations*, it may nonetheless still be helpful to organizations that are attempting to make this distinction. The old guide stated that each provider must define its central mission and how that affects its reporting of revenues, expenses, gains, and losses. Each facility’s definitions of revenues, expenses, gains, and losses are tied to its interpretation of which of its activities are “ongoing, major, and central” and which are “peripheral and incidental” to providing health care services. Activities associated with the provision of health care services constitute the ongoing, major, or central operations of providers of health care services. *Revenues* and *expenses* arise from these activities, and generally are displayed as gross amounts. Transactions, which are peripheral or incidental to the provision of health care services, and from other events

⁴ As required by SFAS 117.

⁵ *Audits of Providers of Health Care Services*.

stemming from the environment that may be largely beyond the control of the entity and its management, result in *gains* and *losses*. These occur casually or incidentally in relation to the provider's ongoing activities, and generally are displayed as net amounts.

Because of the latitude inherent in the determination of "operating" and "nonoperating" income, if such subtotals are used, a note to the financial statements should describe the nature of the reported measure of operations or the items excluded from operations, if it is not apparent from the details provided on the face of the statement. This policy should be consistently applied from period to period.

(ii) Extraordinary Items, Discontinued Operations, and Effect of Changes in Accounting Principle. Extraordinary items, discontinued operations, and the cumulative effect of a change in accounting principle must be reported immediately prior to the change in unrestricted net assets, with a subtotal. This differs from the reporting of such items by for-profit entities (i.e., immediately prior to net income, with a subtotal).

(iii) Reporting Format for Expenses. SFAS 117 requires that expenses be reported by functional categories, either on the face of the statement of activities or in notes to the financial statements. The audit guide for *Health Care Organizations* encourages the use of "natural" expense classifications (e.g., salaries and wages, employee benefits, supplies) in the statement of operations, with disclosure of functional details in the notes. The audit guide also states that the extent of classification and sub-classification of expenses depends on many factors, such as the nature and complexity of the health care organization. Some may present only two categories: "health services" and "general and administrative." Others may present additional distinctions such as physician services, research, and teaching. Functional allocations should be based on full cost allocation.

The Statement of Operations has the potential to become an extremely detailed document. Some facilities present a great deal of detail; other present income statements that are highly condensed, providing only summary totals of major classifications of revenue and expense. Details, if desired, may also be presented in the accompanying notes or in supplemental schedules or statements. Each provider must determine the level of detail that it feels is most meaningful for full disclosure.

(d) Statement of Cash Flows

For the most part, not-for-profit health care providers follow the same principles for preparation of cash flow statements as do other not-for-profit

entities. However, there are some differences which are highlighted below.

- As discussed in Section 16.4(f) of this chapter, some health care organizations report cash and/or investments that are restricted or designated for long-term purposes in a noncurrent balance sheet caption called “assets whose use is limited.” For cash flow reporting purposes, assets whose use is limited should not be included in “cash and cash equivalents.”
- When using the indirect method:
 - Providers should reconcile the net cash flows from operating activities to the change in total net assets, as do other not-for-profit organizations. They should not reconcile to the performance indicator/net income subtotal, as is done by for-profit health care organizations.
 - In the reconciliation of cash flows provided by operations, providers should “gross up” cash flows by including the provision for bad debts as a separate line item.
 - Unrealized gains and losses on investments other than trading securities and contribution of long-lived assets will need to be adjusted out as noncash items.
- Equity transfers, restricted investment income, and restricted contributions (including contributions restricted for purchase of long-lived assets) will need to be “transferred” to the financing category by adjusting them out of operating cash flows and increasing (or decreasing, as appropriate) the financing category by that same amount.
- Purchases, sales, and maturities of trading securities should be classified as cash flows from operating activities; cash flows from purchases, sales, and maturities of other securities should be classified as cash flows from investing activities.

16.4 ACCOUNTING PRINCIPLES

(a) Parties to Health Care Transactions

One unique aspect of health care operations is that revenue transactions primarily involve more parties than the traditional “buyer” and “seller,” or “donor” and “donee.” As many as four parties may be involved in a revenue-generating transaction within a health care provider. These include: (1) the individual who receives the medical care; (2) the physician who orders the required services on behalf of the patient; (3) the health care entity that provides the setting or administers the treatment (e.g., hospital, home health company); and (4) the third-party payer that pays the health care provider(s) on behalf of the patient. In managed

care organizations, parties 2, 3, and/or 4 may all be part of the same organization.

(b) Revenue Recognition

(i) Health Care Providers. When a provider provides health care services, it may:

1. Collect the full amount of charges for the services provided (i.e., established rates—such situations will be rare).
2. Contract to accept less than full charges from third-party payers. Most provider revenue is earned as a result of negotiated contracts with third-party payers. Most third-party payers pay less than established rates because their economic power permits them to negotiate lower rates. These contracts fall broadly into two forms:
 - a. Some arrangements—called *capitation contracts*, or *prepaid health services contracts*—are similar to insurance contracts. In these arrangements, the provider and the health plan agree on a fixed amount (the “capitation fee”) that will be paid to the provider each month on behalf of all of the health plan’s members. In exchange for accepting that amount, the provider agrees to provide (or arrange for) all medical care that is required by the health plan’s members during that period of time. In theory, if no members presented themselves to the provider for treatment, the provider earns all of the fees and incurs no costs—a very lucrative deal! However, if the provider under-budgeted, and the plan’s members use far more services than the provider anticipated, the provider will lose money. These types of contracts often are called “risk contracts” because the provider is assuming the financial risk, if utilization exceeds anticipated levels.
 - b. Other contracts pay the provider based on the provision of services to a particular patient. There are many different payment arrangements, such as discounted fee for service (e.g., 75% of full charges), per diems (a set amount paid for each day of hospital care), resource-based relative value scale, and case rate (a set amount paid for a particular diagnosis).
3. Provide the services at no charge (or at reduced charges) to patients who cannot afford to pay (indigent care). Many health care organizations provide a considerable amount of such services at nominal rates or on a free (charity) basis.

4. Provide the services at reduced prices (or no charge) to employees, physicians, clergy, and others to whom it has a policy of extending "courtesy discounts."

With respect to revenue recognition, a provider can be thought of as similar to an airline or a hotel. Airlines may offer a variety of different ticket prices for passengers traveling on the same flight. Hotels may charge different rates for different guests occupying similar rooms. Likewise, providers may charge different prices to different patients that are receiving similar medical services.

How is this accounted for? With respect to the situations described in items 1, 2b, 3, and 4 of the previous list, for internal recordkeeping purposes, the revenue is recorded at the full rates, and a revenue deduction is recorded to adjust it to the amount actually expected to be received. Revenue deductions may include contractual allowances, charity care, or courtesy discounts. When the financial statements are prepared, the revenue deductions are offset against the gross revenues, and the net amount is reported in the financial statements as "net patient service revenue."

In the situation described in item 2a, the provider will receive monthly premium payments from the health plan, based on the number of covered members. These payments are reflected as income in the Statement of Operations as "capitation income" or "capitation fees earned." This raises the question, "Does the provider need to record charges for the services provided to patients under these agreements?" The answer is yes, because the provider must continue to have a basis for measuring consumption of resources between capitated and noncapitated patients. For most providers, gross charges will represent the only basis for comparing consumption of resources between payor classes. Therefore, charges must continue to be recorded in the provider's patient accounting system for capitated patients, even though these charges will not enter into the amount of revenue actually recognized by the provider. Instead, a revenue deduction is recorded which, when netted against the related charges, eliminates them entirely, leaving only the capitation income to be reported in the financial statements.

Certain health care providers that receive capitation payments must assess whether revenues and expenses from such activities should be presented gross in the Statement of Operations, or instead reflected in income as a net amount. EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*, provides guidance on this issue. EITF 99-19 concludes that the determination of gross versus net revenue reporting is a matter of judgment that depends on the relevant facts and circumstances, and that each organization's specific facts and circumstances should be evaluated against the following list of indicators that would point toward either gross or net reporting:

HEALTH CARE PROVIDERS

INDICATORS OF GROSS REVENUE REPORTING

- Organization is the primary obligor in the arrangement (i.e., responsible for fulfillment, including acceptability of the product or service provided)
- Organization has general inventory risk (for sales of products) or is obligated to compensate individual service providers for work performed (for sales of services)
- Organization has latitude in establishing price for the product or service
- Organization adds value by changing the nature of the product or by performing part of the service
- Organization has discretion in supplier selection
- Organization is involved in the determination of product or service specifications
- Organization has credit risk

INDICATORS OF NET REVENUE REPORTING

- Supplier (rather than the organization) is the primary obligor in the arrangement
- Amount the organization earns is a fixed portion of the overall transaction price (i.e., a set dollar amount per transaction; a stated percent of amount billed)
- Supplier (rather than the organization) has credit risk

The EITF observed that while some of these indicators are stronger than others, no single indicator would provide a presumption that gross or net treatment was appropriate. The relative strength of all indicators present should be considered.

(ii) HMOs. The primary source of income for HMOs is prepaid health care services contracts, similar to the arrangements discussed in item 2a in the list presented in subsection (i) Health Care Providers. However, the HMO receives premium payments directly from members (or in the case of a specialty HMO, from another HMO on behalf of those members). In HMO financial statements, the premiums are reported as “premium income.” The HMO then makes arrangements for the medical care that is required by the health plan member.

HMOs often purchase stop-loss insurance (also called “excess of loss reinsurance”) to protect themselves against the risk of loss incurred in the process of satisfying the claims of HMO subscribers. HMOs should report stop-loss insurance premiums as a health care cost, not as a reduction

of premium income. Stop-loss insurance recoveries should be reported as a reduction of the related premium expense; they should not be reported as revenue.

(iii) CCRCs. CCRC contracts may involve an up-front payment on the part of the resident (“advance fee” or “entrance fee”), part of which may be refundable, and a monthly fee. Although the nursing home component of a CCRC may record patient service revenue, these advance and monthly fees represent the primary source of revenue for most CCRCs.

Advance fees may be nonrefundable, partially refundable, or fully refundable if the resident dies or withdraws from the CCRC; as a result, they raise a number of accounting issues.

- The nonrefundable portion of advance fees represents payment for future services to be provided over the life of the resident (unless the contract terms state otherwise). Therefore, they should be accounted for as deferred revenue when received and amortized into income on a straight-line basis over each individual resident’s actuarially determined remaining life expectancy (or the contract term, if it is shorter).
- The refundable portion is a liability that is estimated each year and is measured at the amount that is expected to be refunded. The estimate is based on the facility’s own experience or, if not available, on the experience of comparable facilities. As time passes or other contract provisions cause the amount refundable to decrease, the portion that becomes nonrefundable should be reclassified to deferred revenue and amortized into income as described above.
- Some contracts provide that entrance fees will be refunded only when and if the contract holder’s unit is resold to a new resident. CCRCs generally structure contracts in this manner to recover the cost of the facilities over their economic lives; therefore, the portion of advance fees that is refundable upon re-occupancy should be reported as deferred revenue and amortized to income over the estimated useful life of the facility, consistent with the basis and method for calculating depreciation.

(c) Charity Care and Bad Debts

Charity care—the provision of services at no charge (or at significantly reduced rates) to patients who are financially unable to pay their medical bills—represents an important element of the services provided by many not-for-profit health care organizations, yet it doesn’t appear anywhere in the Statement of Operations. Accordingly, *Health Care Organizations* requires that specific disclosures regarding charity care be

included in the notes to the financial statements. A statement of management's policy with regard to providing charity care, and the fact that charity services do not result in the production of revenue, should be included in the entity's "summary of significant accounting policies." The level of charity care provided for each of the years covered by the financial statements must be disclosed in the notes to the financial statements. The level of care provided may be measured in a variety of ways, such as at established rates, costs, patient days, occasions of service, or other statistics. The method used to measure the charity care should also be disclosed.

Charity care should not be confused with bad debts, which arise when patients who are able to pay their medical bills fail to do so. When an account from a nonindigent patient is determined to be uncollectible, it is written off as a bad debt. Because bad debts represent an expense, not a revenue deduction, misclassifications between bad debts and charity care can result in a distortion of the health care provider's reported net patient service revenues.

As a practical matter, it can be difficult to distinguish charity care write-offs from bad debt write-offs. According to the audit guide for *Health Care Organizations*, charity care arises from an entity's policy to provide health care services free of charge to individuals who meet certain financial criteria. Therefore, the establishment of a formal management policy clearly defining charity care criteria should result in a reasonable determination.

(d) Government Contracting Considerations

The largest purchasers of health care services in the United States are the federal and state governments, which purchase services through the Medicare, Medicaid, CHAMPUS, and Federal Employee Health Benefit Administration (FEHBA) programs. Virtually all institutional health care providers (and an increasing number of managed care plans) serve Medicare and/or Medicaid beneficiaries, to some extent. Consequently, most health care providers are considered to be "governmental contractors"; as a result, they operate in a highly regulated environment.

The contractual relationship is defined by regulations written by the government and enforced by an elaborate oversight network of government auditors and contract administrators. (For example, Medicare administers its own contracts and subcontracts audits and claims processing functions to private sector "intermediaries," such as major Blue Cross plans.) The regulations, and the laws on which they are based, are inherently political and are subject to frequent change. As such, they give rise to unique contingent liabilities and other issues that accountants must consider (e.g., allowable costs and revenues that are subject to retroactive

adjustment as a result of examination by government intermediaries; the government's right to withhold or reduce contract payments for an extended period of time).

Additional risks may result from the applicability of certain laws that provide for potentially significant penalties to be assessed if the contractor violates them. For example, a provider that submits a false invoice or a false request for payment (that is, a "false claim") to the government may be subject to penalties ranging from a monetary penalty for each false claim submitted to suspension or debarment from the program.

(e) Settlements with Third-Party Payers

Payments under contracts with third-party payers such as Medicare, Medicaid, and HMOs are often based on estimates. In most cases, these payments are subject to adjustment either during the contract term or afterward, when the actual level of services provided under the contract is known. Oftentimes, final settlements are determined after the close of the fiscal period to which they apply. Such settlements have the potential to materially affect the health care entity's financial position and results of operations. The health care entity must make its best estimate of these adjustments on a current basis, and reflect these amounts in the Statement of Operations. To the extent that the subsequent actual adjustment is more or less than the estimate, such amounts should be reflected in the Statement of Operations for the period in which the final adjustment becomes known; it is not appropriate to reflect such amounts as prior period adjustments. The audit guide for *Health Care Organizations* requires that amounts receivable from or payable to third-party payers be set forth separately in the balance sheet, if material, and that significant changes in settlement estimates be disclosed.

Because third-party payment entails a number of uncertainties (for example, disallowed costs and cases, rate and volume adjustments, final settlement determinations, and government compliance reviews), most providers maintain a reserve against their third-party settlement receivable or payable for the effects of such uncertainties. These reserves should be specifically identifiable to uncertainties.

(f) Assets Whose Use Is Limited

As discussed earlier, unrestricted net assets represent the portion of total net assets that are free from any donor-imposed restrictions. They represent the net assets available for any purpose. This generally includes the provider's working capital, property and equipment, and long-term debt.

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Unrestricted net assets also include assets classified as “assets whose use is limited.”⁶ Many providers report certain of these noncurrent assets under the balance sheet caption “assets whose use is limited.” The caption includes assets whose use is contractually limited by outside parties, such as:

- Unexpended proceeds of debt issues (or other debt financing instruments) that are held by a trustee and that are limited to use in accordance with the requirements of the financing instrument
- Funds deposited with a trustee and limited to use in accordance with the requirements of an indenture or similar agreement, such as a bond sinking fund
- Other assets limited to use for identified purposes through an agreement with an outside party *other than* a donor or grantor—examples include debt service reserve funds required by bond indentures, malpractice self-insurance trust funds (revocable or irrevocable), and assets set aside to meet HMO statutory reserve requirements

The caption may also include assets that are “internally designated” by the governing board or management for identified purposes; for example, assets set aside that are designated for plant replacement or expansion (a long-standing industry practice referred to as “funded depreciation”). However, if such assets are reported under this caption, the audit guide for *Health Care Organizations* requires them to be distinguished from assets whose use is contractually limited by external parties. This distinction is considered important because the board or management retains control and may, at its discretion, subsequently use the funds for other purposes. This distinction may be accomplished through separate disclosure on the face of the balance sheet or in notes to the financial statements.

There are circumstances in which certain of the assets can be classified as current, rather than noncurrent. AICPA Accounting Research Bulletin (ARB) No. 43, Chapter 3A, footnote 1 states that where funds set aside for the liquidation of long-term debts, payments to sinking funds, or similar purposes are considered to offset maturing debt that has been

⁶ *Health Care Organizations* requires providers to exclude from current assets and report separately any cash or claims to cash that meet any of the following criteria, which are based on the guidance in Chapter 3 of AICPA Accounting Research Bulletin No. 43:

- Are restricted as to withdrawal or use for other than current operations
- Are designated for expenditures in the acquisition or construction of noncurrent assets
- Are required to be segregated for liquidation of long-term debt
- Are required by a donor-imposed restriction that limits their use to long-term purposes

properly set up as a current liability, they may be included within the current asset classification. Among health care entities, this is common practice with respect to bond sinking funds and self-insurance trusts.

A note generally is included in the summary of significant accounting policies (or separately) describing the purpose of the limited use assets.

(g) Agency Funds

Health care entities may act as agents for other parties; as such, they receive and hold assets that are owned by others. In accepting responsibility for these assets, the entity incurs a liability to the owner either to return them in the future or to disburse them as instructed by the owner. Transactions involving agency funds should not have any economic impact on the provider's operations. Consequently, they should not be included in the provider's Statement of Operations.

(h) Investments

(i) Marketable Securities. With respect to investments in debt securities and equity securities with readily determinable fair values, not-for-profit health care organizations are subject to the requirements of FASB SFAS 124, *Accounting for Certain Investments of Not-for-Profit Organizations*, plus interpretative guidance contained in the AICPA's *Health Care Organizations*. SFAS 124 did not address how its provisions should be applied by not-for-profit organizations that present a performance indicator. Since health care organizations are required to present a performance indicator, the audit guide for *Health Care Organizations* supplies the necessary interpretive guidance as shown in Exhibit 16.2.⁷ In general, it requires not-for-profit health care organizations to report unrestricted investment return using an income recognition approach similar to FASB SFAS 115. In other words, they should include investment income, realized gains and losses, unrealized gains and losses on trading securities, and other-than-temporary impairment losses in the performance indicator, and report unrealized gains and losses on other than trading securities below the performance indicator.

As a result, health care providers report investment return as shown in Exhibit 16.3.

⁷ Although technically the guidance in *Health Care Organizations* stands lower in the GAAP hierarchy than does the FASB standard, the FASB intended for not-for-profit health care providers to adopt FASB SFAS 124 in accordance with the implementing guidance contained in *Health Care Organizations*.

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EXHIBIT 16.2

SFAS 124 and HCO Guidance Compared

SFAS 124 Guidance	Interpretive Guidance in HCO
Does not require classification of investments into categories (i.e., “trading,” “available for sale”).	Providers must classify investments into “trading” or “other than trading” categories. ^a Trading securities should be included in current assets. Other securities should be reported either as current or noncurrent, as appropriate, under the provisions of ARB 43, chapter 3A.
Investment return is reported as a change in unrestricted, temporarily restricted, or permanently restricted net assets.	All <i>unrestricted</i> investment return (including holding gains and losses on trading securities) is included in the performance indicator.
No guidance pertaining to calculation of unrealized gains and losses.	Providers must calculate unrealized gains and losses in a manner consistent with that set forth in FASB SFAS. 115. Unrealized gains/losses on trading portfolios are reported as a component of net income (i.e., above the performance indicator); other unrealized gains/losses will be reported outside of (below) the performance indicator in the Statement of Operations.

^a The FASB specifically precludes the use of the “held-to-maturity” category by not-for-profit health care organizations.

EXHIBIT 16.3

Investment Return to Be Reported by Health Care Providers

<i>Type of Investment Return</i>	No Restrictions on Investment Return		Use of Investment Return Restricted by Donors or State Law
	Trading	Other than Trading	Trading/Other than trading
Holding gains and losses	Above performance indicator	Below performance indicator	Report as change in temporarily or permanently restricted net assets, as appropriate: when restriction expires, reclassify to unrestricted net asset as “net asset released from restriction”
Realized gains and losses	Above performance indicator	Below performance indicator	
Dividends/interest income	Above performance indicator	Below performance indicator	
<i>Classification of “net assets released from restriction”:</i>			
Restricted for long-lived assets	N/A	N/A	Below performance indicator
Restricted for other purposes	N/A	N/A	Below performance indicator

Although paragraph 4.07(a) of the audit guide for *Health Care Organizations* addresses how an other-than-temporary investment loss should be classified in the performance indicator, neither this guide nor FASB SFAS 124 provides any guidance on the need to assess whether an other-than-temporary impairment of securities has occurred. An AICPA Technical Practice Aid⁸ clarifies that not-for-profit health care organizations should follow an approach similar to that set forth in paragraph 16 of FASB SFAS 115. When a determination is made that an other-than-temporary impairment has occurred, the cost basis of the individual security should be written down to fair value as a new cost basis and the amount of the write-down should be included in the performance indicator (i.e., accounted for as a realized loss). An HFMA Principles and Practices Board monograph released in 2002, Issue Analysis 02-1, *Recognition of Other-Than-Temporary Decline in Investments for Tax-Exempt Organizations*, discusses these matters and provides practical assistance to not-for-profit health care organizations with respect to other-than-temporary impairment considerations.

EITF Issue No. 03-3, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*, requires certain quantitative and qualitative disclosures for debt and marketable equity securities that are impaired at the balance sheet date but for which an other-than-temporary impairment loss has not been recognized.

(ii) Other Investments. FASB SFAS 124 applies only to debt securities and to equity securities with readily determinable fair values. It does not apply to investments in equity securities that are accounted for under the equity method (described in AICPA APB 18), to investments in consolidated subsidiaries, or to certain other investments that are discussed below.

Some equity securities do not have readily determinable values; for example, certain limited partnerships, venture capital funds, hedge funds, and private equity funds do not have a fair value per unit that is currently available on a securities exchange or a fair value per share. EITF Topic D-46, *Accounting for Limited Partnership Investments*, provides guidance on the accounting for limited partnership investments. EITF Issue No. 03-16, *Accounting for Investments in Limited Liability Companies*, requires that a noncontrolling investment in a limited liability corporation (LLC) be accounted for using the equity method as described in APB 18 if that LLC maintains a “specific ownership account” for each investor—similar to a partnership capital account structure. However, if the organization’s interest is so minor that it has virtually no influence over the LLC’s operating and financial policies, the investment should be

⁸ AICPA, *Technical Practice Aid*, vol. 1, sec 6400-35.

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accounted for using the cost method. EITF Issue No. 03-3, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*, provides guidance for reporting equity securities that are reported at cost. It describes three steps an organization should take to assess whether a cost method investment is impaired and, if it is, whether an impairment loss should be recognized. EITF 03-1 also requires certain disclosures.

All other investments that are not financial instruments (such as real estate or certain oil and gas interests) are reported at amortized cost and are subject to impairment consideration consistent with SFAS 144. (This differs from the accounting prescribed for such investments for other types of nonprofit organizations.)

(i) Property and Equipment

If health care providers were ranked along a continuum of capital intensity, we would see a wide variation among the different types of providers. Some types of providers generally have little investment in capital assets (for example, physicians or home health companies). Others, such as acute-care hospitals, are extremely capital-intensive.

Property and equipment should be recorded at cost, or at fair market value if donated. Where historical cost records are not available, an appraisal at "historical cost" should be made and the amounts recorded in the provider's books. Depreciation expense should be shown separately (or combined with amortization of leased assets) in the Statement of Operations. The American Hospital Association's publication *Estimated Useful Lives of Depreciable Hospital Assets* provides guidelines that may be helpful in determining the estimated useful lives of fixed assets of health care providers.

Property that is not used for general operations (such as real estate held for future expansion or investment purposes) should be presented separately from property used in general operations.

(j) Contributions

As stated earlier, the audit guide for *Health Care Organizations* "scopes out" (e.g., excludes) health care providers whose primary source of revenue results from contributions from the general public and instead requires those organizations to follow the financial reporting requirements applicable to voluntary health and welfare organizations. Providers remaining within the scope of the *HCO* guide are those that do not rely on contributions as their primary source of income.

(i) Treatment in the Statement of Operations. FASB SFAS 116 provided broad standards with respect to accounting for contributions which

apply to *all* not-for-profit organizations. Health care entities must apply those standards in accordance with additional guidance contained in the audit guide for *Health Care Organizations*. The principal differences relate to the requirement that health care organizations report a performance indicator subtotal (i.e., net income) and therefore must determine the appropriate placement of various types of contributions in the Statement of Operations.

Unrestricted contributions are reported above (i.e., included in) the performance indicator. Restricted contributions are initially reported below the performance indicator (i.e., excluded from results of operations) when received, either as temporarily or permanently restricted. When the restriction is satisfied (e.g., the equipment has been purchased, the charity care has been provided), the contributions are reported as “net assets released from restriction” and classified as follows:

- *Donor restrictions related to capital contributions*⁹—report as “net assets released from restriction used for purchase of property and equipment” *below* the performance indicator (i.e., exclude from the performance indicator).
- *All other donor restrictions*—report as “net assets released from restriction” *above* the performance indicator (i.e., include in the performance indicator).

Actual donations of long-lived assets are reported as “donated property and equipment” and appear below the performance indicator.

The audit guide for *Health Care Organizations* also requires providers to recognize the expiration of donor restrictions related to capital contributions at the time the stipulated asset is placed in service. This is a narrowing of the options available to other types of not-for-profit organizations under SFAS 116.

Another important consideration with respect to capital contributions is the balance sheet treatment of the actual funds received. If cash contributions received for acquisition of property and equipment are included with other cash and cash equivalents in the balance sheet, the entity’s ability to repay debt (as indicated by compliance with any restrictive debt covenants) will be distorted. As a result, assets restricted by donors for acquisition of long-lived assets are differentiated from other cash and contributions receivable by reporting them in a separate category sequenced near the property and equipment section of the balance sheet.

⁹ Some health care providers are capital-intensive and have a significant investment in their property and equipment (e.g., hospitals); therefore, much of their fundraising may be directed toward capital projects. Contributions received or pledged toward upgrading, replacing, or expanding a provider’s land, buildings, and equipment (or actual contributions of land, buildings, or equipment) are referred to as “capital contributions.”

(ii) **Contributions Received by Affiliated Fundraising Foundations.** Many not-for-profit health care entities have created separate foundations to raise and hold funds for their benefit. The accounting for contributions received through these not-for-profit foundations depends on the nature of the relationship between the organizations and whether the health care entity is a not-for-profit or governmental organization. Reporting entity issues associated with related fundraising foundations are discussed in Subsection 16.4(l)(i) of this chapter.

When contributions are received by a fund-raising foundation affiliated with a health care provider, which entity should reflect the contribution income—the provider or the foundation?¹⁰ Is the foundation merely an “agent” in getting the contributions to the provider, or should it record the contribution income as its own? Guidance on these matters is found in SFAS 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*.

Financially Interrelated Organizations. Many provider-foundation relationships meet the definition of financially interrelated organizations provided in SFAS 136, paragraph 13. In such situations, the foundation should recognize contribution income for funds it receives on behalf of the provider. Because the financially interrelated provider is presumed to have an ongoing economic interest in the net assets of the foundation, the provider’s balance sheet should report an asset reflecting that interest, which should periodically be adjusted to reflect the changes in the net assets of the foundation. This accounting is similar to the equity method of accounting used by a parent to account for its investment in a subsidiary that is described in AICPA APB 18, *The Equity Method of Accounting for Investments in Common Stock*.

A series of AICPA Technical Practice Aids,¹¹ published in 2003, clarifies how the periodic adjustment of the provider’s asset (an amount analogous to the “equity pick-up” reported by a parent under equity method accounting) should impact the performance indicator reported in the provider’s Statement of Operations. Generally, a provider should segregate the equity pick-up into restricted and unrestricted portions. The unrestricted portion should be included in the performance indicator, and the restricted portion should be reported below the performance indicator, in accordance with the guidance provided in paragraph 10.18 of *Health Care Organizations* for reporting restricted and unrestricted activity.

¹⁰ If the provider and foundation belong to the same consolidated reporting entity, this question is relevant only when separately issued statements are prepared for the provider or foundation components. Otherwise the issue is moot, because the contribution income is attributed to the consolidated reporting entity rather than to the foundation or the provider individually.

¹¹ AICPA, *Technical Practice Aid*, vol. 1, sect 6400.36—6400.43.

How does a provider determine the apportionment between restricted and unrestricted?

- If the provider controls the foundation, the provider should apportion the change in interest in net assets based on the reporting of restricted and unrestricted activity in the foundation's Statement of Activities, because it can, in effect, access the foundation's assets at will. Therefore, the provider would report changes in its interest in the foundation's unrestricted assets as changes in unrestricted net assets that are included in the performance indicator in the Statement of Operations. Changes in the provider's interest in the foundation's restricted assets would be excluded from the performance indicator and reported as changes in restricted assets in the provider's Statement of Changes in Net Assets.
- If the provider does not control the foundation, and does not possess a relationship with the foundation that allows it to access the foundation's assets at will, there is an implied time restriction on the gifts held by the foundation for the provider's benefit. This is because the provider will not receive the funds until some future date when the foundation decides to make a distribution. In such situations, the provider would report the entire change in interest in net assets as restricted; that is, it would report "change in temporarily restricted interest in the Foundation's net assets" as an increase in temporarily restricted net assets (i.e., below the performance indicator). When distributions are received from the foundation, the implied time restriction would expire, and the provider would make a reclassification from temporarily restricted net assets to unrestricted net assets (assuming that those net assets are not subject to other purpose or time restrictions). The reclassification would be reported as "net assets released from restriction" and included in/excluded from the performance indicator in accordance with the treatment described in Section 16.4, (j)(i) of this chapter.
- In situations in which the provider does not control the foundation, yet possesses sufficient influence over the foundation to allow it to determine the timing and amount of distributions it receives, is it still appropriate to imply a time restriction on funds held by the foundation? The answer is no; in such situations, the provider should report the changes in net assets in a manner similar to the reporting used by providers with controlled foundations that is described in the first bullet. This situation is commonly encountered when the provider and foundation are under control of a common parent, and neither entity controls the other. However, it may also exist in situations where the foundation and provider are not part of the same consolidated reporting entity.

Organizations that are not financially interrelated. If a provider and its foundation do not meet the definition of *financially interrelated organizations*, then the foundation generally is presumed to be acting as an agent when it receives funds on behalf of the provider. When the foundation is presumed to be acting as an agent, the foundation debits cash (or another appropriate asset) and credits a liability account for amounts it receives on behalf of the provider; it does not recognize income. The provider debits a receivable and credits contribution income.

An exception is provided for situations in which the nonfinancially interrelated foundation possesses “variance power.” In those situations, the foundation debits cash (or a similar asset) and credits contribution income. The provider is not presumed to have any interest in the net assets held by the foundation; instead, it recognizes contribution income on a “cash basis” as distributions are received from the foundation.

(k) Malpractice Contingencies

The audit guide for *Health Care Organizations* states that the ultimate costs of malpractice claims should be accrued when the incidents occur, which give rise to the claims, if certain criteria are met. These criteria include a determination that a liability has been incurred and an ability to make a reasonable estimate of the amount of the loss. In particular, the audit guide for *Health Care Organizations* indicates clearly that health care providers that have not transferred to a third party all risk for medical malpractice claims arising out of occurrences prior to the financial statement date will probably be required to make an accrual. The audit guide for *Health Care Organizations* provides guidance in accounting for uninsured asserted and unasserted medical malpractice claims, claims insured by captive insurance companies, claims insured under retrospectively rated or claims-made insurance policies, and claims paid from self-insurance trust funds.

As indicated above, a key determinant of the amount of malpractice losses to be accepted by health care providers is the degree of risk the provider has transferred to an independent third party insurer vs. the risk of loss the organization has retained. A liability must be reported for all anticipated malpractice claims for which risk of loss has not been transferred as of the balance sheet date. This guidance (which, in essence, allows the offsetting of estimated insurance recoverables against the gross anticipated malpractice liability) conflicts with certain guidance contained in EITF 03-8, *Accounting for Claims-Made Insurance and Retroactive Insurance Contracts by the Insured Entity*. Among other things, EITF 03-8 concluded that the practice of offsetting prepaid insurance and receivables for expected recoveries from insurers against the gross anticipated amount of insurance liability is not appropriate. Because the guidance in

EITF consensus ranks below cleared AICPA audit guides in the GAAP hierarchy, the specialized industry guidance in the audit guide for *Health Care Organizations* was not impacted by the conflicting guidance in EITF 03-08. However, healthcare organizations are required to follow the provisions of Issue 03-8 that do not conflict with the audit guide for *Health Care Organizations* (for example, provisions which require an entity insured under a claims-made policy to determine if the policy is prospective, retroactive, or both).

(l) Related Organizations

In response to the massive changes that have taken place in the health care industry during the last two decades, there has been a widespread movement to diversify the activities of health care providers. This diversification has been reflected in the proliferation of complex multi-entity corporate structures, in numerous merger and acquisition (business combination) transactions, and in strategic alliances such as joint ventures and joint operating agreements. Such transactions usually are undertaken to enhance access to capital, respond to regulatory pressures, or help the entity to compete more effectively.

(i) Reporting Entity/Consolidation Issues. Chapter 11 of *Health Care Organizations* provides guidance for determining whether a not-for-profit health care entity must combine or consolidate its financials statements with those of related organizations. That guidance generally is similar to the guidance provided in Appendix B of Chapter 8 of the audit guide for *Not-for-Profit Organizations*. Readers should note that FASB SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, eliminated the “temporary control” exception to consolidation in FASB SFAS 94, *Consolidation of All Majority-Owned Subsidiaries*. Although the health-care-specific guidance in paragraphs 11.10 through 11.12 of *Health Care Organizations* is based largely on SFAS 94, it represents specialized industry guidance promulgated by the AICPA’s Accounting Standards Executive Committee (AcSEC). Consequently, the only aspect of the health-care guidance affected by the elimination of the temporary control exception relates to situations where consolidation is required due to the existence of a controlling financial interest (or its not-for-profit equivalent, sole corporate membership), as discussed in paragraph 11.10 of the audit guide for *Health Care Organizations*.

FASB Interpretation (FIN) No. 46R, *Consolidation of Variable Interest Entities*, addresses consolidation by business enterprises of certain “variable interest entities” (formerly referred to as “special purpose entities”). Generally, not-for-profit organizations (including not-for-profit health care organizations) are excluded from the scope of FIN 46R. The use of

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off-balance sheet structures and other special-purpose entities is not limited to the for-profit areas, however. Some not-for-profit health care organizations may contemplate using arrangements involving related entities in an effort to achieve off-balance sheet treatment. Historically, in assessing these structures for consolidation, some preparers and practitioners analogized to the guidance in EITFs and SEC staff announcements such as EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees, and Other Provisions in Leasing Transactions*, and Topic D-14, *Transactions Involving Special Purpose Entities*. (This guidance did not directly apply to not-for-profit organizations.) Although FIN 46 states that it nullifies the guidance in Issue No. 99-15 and Topic D-14, the FASB's *EITF Abstracts* volume clarifies that the FASB's intent was to only nullify that guidance for entities that are within the scope of FIN 46R. Because not-for-profit health care organizations are excluded from the scope of FIN 46R, the EITF guidance would still be applicable for not-for-profit health care organizations that apply this guidance by analogy to their structures involving special-purpose entities.

Some health care entities enter into long-term contractual agreements with management companies that, in substance, are similar to an acquisition of the health care company by the management company. Guidance with respect to such transactions is provided in EITF Issue 97-2, *Application of SASB 94 and APB 16 to Physician Practice Management Entities and Certain Other Management Entities with Similar Circumstances and Arrangements*. EITF 97-2 discusses conditions that must be present in order for consolidation to be required as a result of a long-term contractual management agreement. Although it specifically addresses the narrow issue of physician, dental, and veterinary practices entering into such arrangements, the EITF observed that use of the guidance in EITF 97-2 is also appropriate to other situations in which one entity manages another entity under circumstances similar to those described in EITF 97-2.

(ii) Business Combinations.

Note: In 2001, the FASB issued SFAS 141, *Business Combinations*, which supersedes several pronouncements, including AICPA APB 16, *Business Combinations*. However, SFAS 141 does not apply to combinations involving two or more not-for-profit organizations or the acquisition of a for-profit business entity by a not-for-profit organization. For those types of combinations, the FASB intends for the guidance in APB 16 to continue to apply, even though APB 16 technically has been superseded. Thus, not-for-profit health care organizations should continue to follow the guidance in HCO and in APB 16, as amended by pronouncements prior to the issuance of SFAS 141. Pronouncements that were amended by SFAS 141 should be applied as though that Statement had not amended them. In addition, in applying APB 16, not-for-profit health care organizations should continue to apply the amendments to that opinion that were included in FASB SFAS 121, *Accounting for*

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the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of, even though SFAS 121 was superseded by FASB SFAS 144. (SFAS 144 did not carry forward the amendments to APB 16 because APB 16 technically has been superseded).

Unlike other types of not-for-profit organizations, health care providers frequently are involved in business combination (i.e., merger and acquisition) transactions. The most prevalent form of transaction involves the merging of two health care entities to create a new entity without the exchange of consideration. The GAAP guidance applicable to such mergers is primarily conceptual in scope, with little guidance available with respect to the specifics of accounting for such transactions.

The audit guide for *Health Care Organizations* states that circumstances exist (e.g., two or more entities combine to form a new entity without exchange of consideration) under which reporting on the combination by the pooling-of-interests method better reflects the substance of the transaction than would reporting by the purchase method. An acceptable practice for reporting such business contributions is to report the assets, liabilities, and net asset balances of the combined entities as of the beginning of the year and disclose the information that would be required to be disclosed for a pooling-of-interests under APB 16, *Business Combinations*. (This is similar to the guidance provided in the audit guide for *Not-for-Profit Organizations* for other types of not-for-profit entities.)

The audit guide for *Health Care Organizations* states that APB 16 “may provide a useful framework” when evaluating business combinations entered into by not-for-profit health care organizations. However, the provisions of APB 16 cannot be applied literally to such transactions, since the entities involved do not issue common stock and there is no private ownership. Therefore, careful consideration must be given to the facts and circumstances of each transaction when interpreting the APB 16 pooling criteria in the context of not-for-profit organizations. The audit guide for *Health Care Organizations* provides factors to consider:

Circumstance	Accounting Guidance
Monetary consideration paid/received; change in legal title to assets and/or assumption of liabilities	<i>Similar to</i> a purchase under APB 16. Asset basis should be stepped up to reflect purchase price. Transaction is accounted for from date of acquisition.
Change in reporting entity characterized by change in control (e.g., change in sole corporate member)	<i>Similar to</i> a pooling-of-interests transaction under APB 16. No change in basis. Financial statements should be restated for all periods presented in accordance with APB 20 as a change in reporting entity.

“Similar to” is a key phrase. It recognizes that the facts and circumstances of each situation need to be evaluated very carefully in light of the not-for-profit environment. An inquiry published in the AICPA’s *Technical Practice Aids* (Section 6400.32) attempts to clarify that, generally, pooling accounting is used if consideration is not involved. HFMA Principles and Practices Board Statement No. 20, *Mergers, Acquisitions, and Affiliations Involving Not-for-Profit Health Care Entities*, also generally supports and illustrates the guidance contained in the audit guide for *Health Care Organizations*.

Although prevalent industry practice has been to account for transactions in which a new entity is created without the exchange of consideration as poolings, the valuation of long-lived assets—particularly in overvalued hospital facilities—sometimes is a concern. For example, as managed care penetrates a geographic market, the de-emphasis of inpatient hospital services can result in a significant drop in a hospital’s occupancy rate/utilization. As a result, the hospital may find that its fixed assets are salable for a fraction of their carrying value, particularly in locations that are overbedded. If a hospital in this situation is involved in a pooling transaction, the balance sheet of the new combined entity will be overstated (due to the carryover basis accounting accorded pooling transactions), as will the related depreciation charge reported in future income statements, unless these overvalued assets can be written down to their fair values. If certain specific criteria are met, SFAS 144, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, requires the write-down of impaired assets to their fair market values. However, the impaired assets may still be generating cash flows sufficient to preclude it from meeting the SFAS 144 criteria. In such situations, some entities have modified their pooling-type transactions to become purchase transactions, in order to reflect fair values on the new entity’s balance sheet going forward.

As discussed in the previous section, EITF 97-2 provides accounting guidance for situations in which health care entities enter into long-term contractual agreements with management companies that, in substance, result in acquisition of the health care company by the management company. EITF 97-2 discusses conditions that must be present in order for the execution of a long-term management agreement to be considered a business combination transaction. However, such business combinations cannot be accounted for using the pooling-of-interests method of accounting.

General information regarding SFAS 141, *Business Combinations*, SFAS 142, *Goodwill and Other Intangible Assets*, and the FASB project “Combinations of Not-for-Profit Organizations” is provided in Section 7.3 of Chapter 7 in this book, *Mergers of Not-for-Profit Organizations*. (As stated

previously, SFAS 141 and 142 do not apply to combinations involving two or more not-for-profit organizations or the acquisition of a for-profit business entity by a not-for-profit organization.) Because many not-for-profit health care organizations have one or more for-profit subsidiaries, a brief mention of how these standards and projects affect the accounting followed by those subsidiaries may be helpful.

Because transactions in which the acquirer is a for-profit entity are within the scope of SFAS 141, any acquisitions made by for-profit subsidiaries must be accounted for in accordance with SFAS 141. This may result in some inconsistencies in financial reporting. For example, an acquisition made by a not-for-profit health care system's parent entity would be excluded from the scope of SFAS 141; however, that same transaction would be subject to SFAS 141 if a for-profit subsidiary of the system made the acquisition. Similarly, the deferred effective date of SFAS 142 does not apply to for-profit subsidiaries of not-for-profit organizations. As a result, a portion of the goodwill and intangible assets reported in the financial statements of not-for-profit organizations with for-profit subsidiaries may continue to be amortized, while another portion ceases to be amortized. Once the FASB's not-for-profit combinations project has been completed, such inconsistencies should be eliminated.

(iii) Intangible Assets Associated with Business Combinations. Issues similar to those deliberated for business organizations in connection with SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Other Intangible Assets*, will be deliberated for not-for-profit organizations in the course of the FASB's not-for-profit combinations project. As a result, the provisions of SFAS 141 and 142 should not be applied by not-for-profit organizations until the FASB completes its not-for-profit combinations project. Instead, the guidance in APB 16 and 17 remains in effect for not-for-profit organizations, including continued amortization of goodwill. In addition, when applying APB 16 and 17, not-for-profit organizations should continue to apply the amendments to those opinions found in other literature, even though the other literature may have been superseded by SFAS 141 and 142.

Note, however, that the deferred effective date of SFAS 142 does not apply to for-profit subsidiaries of not-for-profit organizations. Such organizations must follow SFAS 142 by virtue of their status as for-profit organizations. When the subsidiary's financial statements are rolled up into the consolidated financial statements of the not-for-profit parent, SFAS 142's principles continue to apply. In other words, the subsidiary's financial statements should not be "converted" to the standards followed by the not-for-profit parent as a result of consolidation. Consequently, a portion of the consolidated entity's goodwill and identifiable intangible assets may continue to be amortized, while the remainder ceases to be amortized.

With for-profit entities, the general framework for evaluating impairment of goodwill and other intangible assets for impairment is provided by SFAS 142 (for goodwill and nonamortizable intangible assets) and SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (for amortizable intangible assets). Because the effective date of SFAS 142 is indefinitely deferred for not-for-profit organizations, those organizations must use a different framework for evaluating impairment of intangibles. Consequently, all goodwill of not-for-profit health care organizations should be tested for impairment under the provisions of APB 17, paragraph 31, and all other intangible assets should be tested for impairment under SFAS 144.

In the not-for-profit combinations project, the FASB will evaluate not-for-profit intangibles issues using a “differences-based” approach—that is, it will focus on whether the guidance contained in SFAS 141 and 142 with respect to intangibles make sense when applied to not-for-profit organizations. Any departures from the general framework established in those standards will have to be justified by clear differences in the nature of not-for-profit issues and transactions.

(iv) Joint Operating Agreements. It is common for two or more health care entities to enter into a joint operating agreement whereby all agree to jointly operate and control certain of their facilities while sharing in the operating results and residual interest upon dissolution, based upon an agreed-upon ratio. In these types of arrangements, none of the venturers receive cash or other monetary assets as part of entering into the agreement, and no separate legal entity is created (e.g., a corporation or partnership). They are similar to joint ventures; as such, they typically are characterized by factors such as:

- Common purpose (e.g., to share risks and rewards; to develop a new market, health service, or program; to pool resources)
- Joint funding (all parties contribute resources toward its accomplishment)
- Defined relationship (i.e., typically governed by an agreement)
- Joint control (control is not derived from holding a majority of the voting interest)

AICPA *Technical Practice Aids* (Section 6400.33) states that since there is joint control in this situation (i.e., no party controls the venture), consolidation would not be appropriate. Instead, such agreements should be accounted for similar to a corporate joint venture using the equity method of accounting. Since the transaction would not reflect the culmination of the earnings process, the venturers’ basis in the investment would be recorded at net book value.

(m) Accounting for Loss Contracts

(i) HMOs and Capitated Providers. If its premiums are set too low or if utilization by plan members is higher than expected, an HMO may sustain an economic loss in fulfilling a particular contract. Losses should be accrued when an HMO's projected health care costs and maintenance costs pertaining to a particular group of contracts exceed the anticipated premium revenues and stop-loss insurance recoveries under those contracts. To determine whether a loss accrual is necessary, an HMO will need to analyze its unexpired contracts in force at the end of each reporting period. Contracts should be grouped in the same manner the HMO uses for establishing its premium rates, and the aggregate health care costs, maintenance expenses, premium revenue, and stop-loss recoveries projected for the contracts in each group. The costs considered should include fixed costs as well as variable costs; in other words, the computation should include costs that would be incurred regardless of whether or not a particular contract is in force (such as staff physicians' salaries and costs attributable to facilities owned by the HMO). The costs considered should also include all direct costs of the contracts along with any indirect costs identifiable with or allocable to the contracts, as is customary in any type of contract accounting. Generally, this requires inclusion of all HMO costs other than general and administrative, selling, marketing, and interest. If the aggregate expenses for the contract period are expected to exceed the aggregate revenues for the contract period, the amount of the excess should be accrued as a loss on that group of contracts.

Similar provisions apply to providers that enter into capitation contracts—that is, the provider would record losses on risk contracts if future costs, including contract-related administrative costs (e.g., medical records, claims processing, billing) are expected to exceed future revenues and stop-loss recoveries from the contract.

(ii) CCRCs. If a CCRC contracts to provide lifetime services and the use of facilities to residents, then annually the CCRC needs to assess its contractual arrangements with existing residents to determine whether the expected future revenues from those contracts will be sufficient to cover the costs of providing services and use of facilities over the rest of the residents' lives. If the estimated costs of future services are determined to exceed anticipated revenues, the CCRC has entered into a loss contract. Losses resulting from such contracts should be recorded as a liability (the "obligation to provide future services and the use of facilities") in the period in which they are determined to exist, with a corresponding charge to income.

"Anticipated revenues" includes third-party payments (e.g., those from Blue Cross/Blue Shield), contractually or statutorily committed investment

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income from sources related to CCRC activities, contributions pledged by donors to support CCRC activities, periodic fees expected to be collected, and the balance of deferred nonrefundable advance fees. Examples of “estimated costs of future services” include costs of resident care, dietary costs, health care facility costs, general and administrative costs, interest expense, depreciation, and amortization costs.

In determining the present value of future net cash flows, “cash inflows” consist of revenue contractually committed to support the residents, and inflows resulting from monthly fees (including anticipated increases in accordance with contract terms). Cash outflows consist of operating expenses, including interest expense but excluding selling and general and administrative expenses. Cost increases resulting from inflation should be factored into the amount of operating expenses included in the computation.

(n) Risk Pools

Risk pools provide a vehicle for sharing favorable and unfavorable experiences among the participants in a risk contract by creating incentives for physicians and hospitals to control utilization of services. The type of incentive offered may be positive (“gain-sharing pool”) or negative (“loss-sharing pool”), or may combine both positive and negative incentives. Risk pool settlements retroactively determine the amount of fees a provider will ultimately be paid under a given risk contract; therefore, the settlements affect the amount of revenue that should be recognized in the provider’s financial statements and the amount of health care expense that should be recognized in the HMO’s financial statements. Risk pool settlements receivable or payable should be accrued based on relevant factors such as experience to date.

(o) Costs of Acquiring Initial Continuing Care Contracts

When a new CCRC is constructed, it will incur costs in obtaining contracts to initially fill the facility. These costs (termed “costs of acquiring initial continuing-care contracts”) are defined by the audit guide for *Health Care Organizations* as:

Costs incurred to originate a contract that result from and are essential to the acquisition of the initial contracts and are incurred through the date of substantial occupancy but no later than one year from the date of completion of construction. These costs include:

- a. The costs of processing the contract, such as evaluating the prospective resident’s financial condition; evaluating and recording guarantees, collateral, and other security arrangements; negotiating contract terms; preparing and processing contract documents; and closing the transaction.

- b. The costs from activities in connection with soliciting potential initial residents (such as model units and their furnishings, sales brochures, semi-permanent signs, tours, grand openings, and sales salaries). These costs do not include advertising, interest, administrative costs, rent, depreciation, or any other occupancy or equipment costs.
- c. The portion of an employee's compensation and benefits that relates to the initial contract acquisitions.

These costs represent an investment that will result in future revenues from amortization of nonrefundable advance fees (and future periodic fees, in some cases). The costs that are described in item b in the previous list and are expected to be recovered from future contract revenues should be capitalized in accordance with SFAS 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, and amortized to expense on a straight-line basis over the average expected remaining lives of the residents under the contract or the contract term, if shorter. Such costs incurred after a CCRC is substantially occupied or one year following completion should be expensed when incurred. The costs of acquiring initial continuing-care contracts that are described in items a and c should be accounted for in conformity with the guidance in AICPA SOP 98-5, *Reporting on the Costs of Start-Up Activities*.

(p) Derivatives

Derivatives are financial instruments. Although some derivative instruments may be considered investments, that is not always the case (for example, a provider with long-term debt outstanding may use interest rate swaps to synthetically modify the interest expense it pays). Consequently, derivatives are covered by their own financial reporting guidance; they are not subject to the guidance in SFAS 124.

The primary sources of accounting guidance for derivatives are SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and its related amendments, SFAS 137 and 138. These standards require derivatives to be reported at fair value in the balance sheet, and changes in fair value of derivatives (including unrealized gains and losses) to be recognized in the Statement of Operations. (For more information, see Chapter 6 of this book.)

The classification of derivative gains and losses in the Statement of Operations depends on whether the derivative qualifies for special hedge accounting treatment. If a derivative does not qualify for hedge accounting treatment, then all gains and losses associated with that derivative (including unrealized gains and losses) must be included in the performance indicator. More favorable accounting treatment is provided for derivatives that qualify as fair value, cash flow, or foreign-currency hedges.

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(i) **SOP 02-2.** In December 2002, the AcSEC issued SOP 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator*. SOP 02-2, resolves diversity in practice created by confusing wording in paragraph 43 of SFAS 133, which indicates that cash flow hedge accounting is not available to “an entity that does not report earnings as a separate caption in a statement of financial performance (for example, a not-for-profit organization ...).” Because a not-for-profit health care organization’s performance indicator generally is considered analogous to income from continuing operations of a business enterprise, the AcSEC concluded that it is appropriate for those organizations to use cash flow hedge accounting. Consequently, not-for-profit health care organizations should apply the provisions of FASB SFAS 133, including the cash flow hedge accounting provisions, in the same manner as for-profit enterprises. That is, any derivative gains or losses that affect a for-profit enterprise’s income from continuing operations should similarly affect a not-for-profit health care organization’s performance indicator, and derivative gains or losses that are excluded from a for-profit enterprise’s income from continuing operations (such as items reported in other comprehensive income) similarly should be excluded from a not-for-profit health care organization’s performance indicator. SOP 02-2 applies only to not-for-profit entities covered by *Health Care Organizations*. It does not apply to organizations within the scope of the AICPA’s audit guide for *Not-for-Profit Organizations*, or to governmental health care organizations.

Disclosures. SOP 02-2 requires not-for-profit health care organizations to provide all disclosures that are analogous to those required by paragraph 45 of SFAS 133 for for-profit enterprises, including disclosure of anticipated reclassifications into the performance indicator of gains and losses that have been excluded from that measure and reported in accumulated derivative gain or loss as of the reporting date. Although not-for-profit organizations are not subject to SFAS 130, *Reporting Comprehensive Income*, and, therefore, do not have the same requirement as for-profit organizations to report changes in the components of accumulated other comprehensive income, SOP 02-2 also requires not-for-profit health care organizations to separately disclose the beginning and ending accumulated derivative gain or loss that has been excluded from the performance indicator, the related net change associated with current period hedging transactions, and the net amount of any reclassifications into the performance indicator in a manner similar to that described in paragraph 47 of SFAS 133.

(ii) **Use of the Shortcut Method.** SFAS 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities (an amendment of SFAS 133)*,

limited application of the short-cut method to interest rate swaps that reference U.S. Treasury rates or LIBOR (London Interbank Offered Rate) as the underlying. Many not-for-profit health care organizations use swaps whose underlying index rate is the Bond Market Association Municipal Swap Index (sometimes referred to as the BMA Index). Under SFAS 138, the BMA Index does not constitute a benchmark interest rate for purposes of applying the shortcut method. Accordingly, if the variable leg of a swap is indexed to the Bond Market Association Municipal Swap Index (or any rate other than Treasuries or LIBOR), the hedging relationship does not qualify for the shortcut method.

(iii) Split-Interest Agreements. In April 2002, the FASB staff issued Derivatives Implementation Group (DIG) Issue B35, *Embedded Derivatives: Application of Statement 133 to a Not-for-Profit Organization's Obligation Arising from a Split-Interest Agreement*, which provides guidance on accounting for derivatives that are embedded in certain split-interest agreements. *Health Care Organizations*, in Chapter 10, "incorporates by reference"¹² the guidance in Chapter 6 of *Not-for-Profit Organizations* pertaining to accounting for split-interest agreements, which has been updated to address issuance of Issue B35. In a split-interest agreement, a donor enters into a trust or other arrangement under which a not-for-profit organization receives benefits that are shared with other beneficiaries. The amount of the benefit to each beneficiary will often be a function of the fair value of the donated assets over the term of the agreement. In situations where a not-for-profit organization controls the assets and consolidates the trust (e.g., it is the trustee), Chapter 6 of the audit guide for *Not-for-Profit Organizations* requires that a liability be recognized for the obligation to make future payments to the other beneficiaries of the trust based on the present value of the future expected payments to the beneficiaries. Although the liability may reflect the fair value of the obligation initially, it will not reflect fair value in future periods because the discount rate used in remeasuring the liability each period is not revised.

Issue B35 states that the obligation recognized under a split-interest agreement should be analyzed to determine whether there is an embedded derivative that warrants separate accounting. Generally, in circumstances where there is an obligation to make payments that vary based on the investment return from the contributed assets for a fixed period, bifurcation of an embedded derivative will be required. However, in situations where the payment is solely life contingent (i.e., it relates to payments that cease upon death of the donor or beneficiary), the split-interest

¹² Chapter 10 of *Health Care Organizations* refers users of that guide to Chapter 6 of *Not-for-Profit Organizations* for guidance on accounting for split-interest agreements.

agreement will qualify for the insurance scope exception in paragraph 10(c) of the audit guide for *Health Care Organizations*.

(q) Capitalizing Costs Associated with HIPAA Compliance

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) was enacted by the federal government with the intent to assure health insurance portability, improve the efficiency and effectiveness of the health care system, reduce health care fraud and abuse, help ensure security and privacy of health information, and enforce standards for transacting health information. Among other matters, HIPAA addresses issues of security and confidentiality in the transfer of electronic patient information and establishes standard data content and formats for submitting electronic claims and other administrative transactions. In January 2002, the AICPA Accounting Standards staff released a Technical Practice Aid Q&A (TPA)¹³ discussing whether computer systems costs incurred in conjunction with a health care entity's HIPAA compliance efforts could be capitalized.¹⁴ The TPA states that costs associated with upgrading and improving computer systems to comply with HIPAA should follow the guidance set forth in AICPA SOP 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use*. Unless the costs relate to changes that result in "additional functionality" (i.e., that allow the software to perform tasks that it previously could not perform), they should be expensed. Many of the costs associated with HIPAA relate to compliance with its act and do not result in additional functionality. For example, changes that merely reconfigure existing data to conform to the HIPAA standard and/or regulatory requirements do not result in the capability to perform additional tasks, nor do training costs, data conversion costs (except for costs to develop or obtain software that allows for access to or conversion of old data by new systems), and maintenance costs. However, changes that would increase the security of data from tampering or alteration, or that reduce the ability of unauthorized persons to gain access to the data, represent tasks that the software previously could not perform, and the associated qualifying costs of application development stage activities potentially are capitalizable.

(r) Physician Recruitment Arrangements

In order to attract physicians into a community to meet community needs, a hospital or health system may offer recruiting inducements.¹⁵

¹³ AICPA, *Technical Practice Aids*, vol. 1, sec. 6400.34.

¹⁴ TPA 6400.34, *Accounting for Computer Systems Costs Incurred in Connection with the Health Insurance Portability and Accountability Act of 1996*.

¹⁵ In such situations, the hospital is precluded by law from requiring the physician to refer patients to or treat patients at that facility, although the hospital hopes to be the primary referral location.

16.5 ADDITIONAL CONSIDERATIONS FOR TAX-EXEMPT DEBT ISSUERS

For example, a hospital may make loans to physicians to assist them in establishing their practices, or may offer to guarantee physicians' home mortgages (entitling the physician to reduced interest rates). The AICPA has issued guidance in the form of Technical Practice Aids¹⁶ that address whether these types of physician recruitment are within the scope of FASB FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others*. The TPAs indicate that physician loans would not be covered by FIN 45, nor would mortgage guarantees made to physicians that become hospital employees. However, if the physician is not employed by the hospital (which is the more common situation), then a mortgage guarantee would fall within the scope of FIN 45, and the hospital would be required to record a liability representing its commitment to stand ready to perform. This is because the liability typically would be reduced by a credit to earnings as the guarantor is released from risk under the guarantee. In the situation described previously, the hospital would reduce its liability as the physician's outstanding mortgage obligation is reduced.

16.5 ADDITIONAL CONSIDERATIONS FOR TAX-EXEMPT DEBT ISSUERS

The Security and Exchange Commission's mission to protect investor interests extends to securities issued by not-for-profit organizations as well as SEC registrants. Although tax-exempt entities aren't required to file 10-Ks or register their securities like the public companies, they are subject to the same antifraud provisions of the federal securities laws as the public companies. These provisions prohibit fraudulent and deceptive practices in the offer, purchase, and sale of securities (including municipal securities). An entity that makes any false or misleading statement of material fact, *or omits any material facts that cause such statements to be misleading in the context in which the statements are made*, violates the federal law. (Under the antifraud provisions, omissions of material fact could be either intentional or unintentional.) In other words, if the financial statements omit disclosures that the SEC believes would be relevant to investors, or contain significant departures from GAAP as a result of earnings management, the SEC would consider that to be fraudulent financial reporting. The SEC takes very seriously its obligation to protect investors in the municipal securities markets from fraud. In the last few years, there have been numerous instances in which the SEC's enforcement division has taken action with respect to municipal bond issues in which disclosure documents contained material misstatements or omissions of material facts.

¹⁶ AICPA *Technical Practice Aids* volume, Section 6400.45-.46.

(a) SEC's Views on Disclosure Requirements

In SEC Interpretive Release No. 33-7049, 34-33741 (March 1994), *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*,¹⁷ the SEC published its views with respect to the disclosure obligations of participants in the municipal securities markets under the antifraud provisions of the federal securities laws, both in connection with primary offerings and on a continuing basis with respect to the secondary market. The interpretive guidance is intended to assist municipal securities issuers, brokers, dealers, and municipal securities dealers in meeting their obligations under the antifraud provisions, in particular Rule 10b-5 of the Exchange Act (i.e., provide an interpretation of disclosure responsibilities under current law).

Annual and event reports required by Rule 15c2-12 create a contractual duty to make such disclosures, and it appears—and the SEC certainly asserts—that under accepted legal principles, such disclosures must therefore be accurate and not omit any material information needed to make the disclosures not misleading. Material misstatements or omissions in the annual or event reports may be the basis for claims of securities fraud under Rule 10b-5 (which applies to disclosures intended to influence securities markets) and other federal or state securities laws, action by the SEC or private plaintiffs (bondholders or other investors), with substantial potential liability for issuers or other obligated persons.

(b) Secondary Market Reporting/Disclosure Requirements

In response to concerns about the municipal securities markets, the SEC issued a final rule titled “Municipal Securities Disclosure” that became effective on July 3, 1995. The final rule amends Rule 15c2-12 under the 1934 act and attempts to deter fraud and manipulation in the municipal securities market by prohibiting the underwriting and subsequent recommendation of securities for which adequate information is not available. Under these rules, the underwriter’s agreement requires the issuer to provide specific financial information to a “repository” of municipal securities information. The repository makes the information available to bondholders and prospective bondholders (similar in some ways to the reporting required of SEC registrants).

To assure that participants in the secondary market base their investment decisions on current information, the rule requires the submission of periodic information along with timely disclosure of material events that materially reflect on the creditworthiness of municipal securities issuers and obligors and the terms of their securities.

¹⁷ Securities Act Release No. 7049 and Exchange Act Release No. 33,741, 7 *Fed. Sec. L. Rep.* (CCH) 72,442 (March 9, 1994).

- *What is “annual financial information”?*—The annual financial information to go in the annual report is to be financial information or operating data ... “of the type included in the final official statement with respect to such obligated person ...” Generally, this will be quantitative data derived from the obligated person’s records.

Annual financial information is both financial information and operating data and is the same type of information as is provided by the issuer in the official statement for a bond issue. If an issuer prepares audited financial statements, those statements also must be submitted annually. The SEC emphasizes in its explanation of the rule that operating information is intended to be quantitative in nature.

No specific date or time period after the close of the year is specified by the SEC for the provision of annual financial information. However, the issuer should specify in the undertaking and in the covenant the date when information will be provided. The SEC strongly recommends that the information be made available within six months after the close of the issuer’s fiscal year.

There is no requirement for the annual financial information to appear in a single document. Cross-referencing to other documents is specifically authorized as long as they are publicly available and subsequent official statements might satisfy the requirement in part. To satisfy this “public availability” requirement, the information must be deposited in the appropriate repositories.

- *Material events*—In addition to periodic information, to assure that participants in the secondary market base their investment decisions on current information, investors need timely disclosure of events that materially reflect on the creditworthiness of municipal securities issuers and obligors and the terms of their securities.

The rule requires the submission of notices of 11 events—i.e., an occurrence or a development relating to outstanding securities, the issuer of the securities, or an obligated person—if the events are material and applicable to the transaction. The rule also provides that issuers and their advisors may wish to identify material events in the undertaking other than those listed in the rule that could have a material effect on the holders of the bonds. Other types of events may be announced in the same way, such as whether a particular bond issue is affected by pending legislation, and it may be desirable for issuers or obligated persons to supply information to the market that is positive in nature (such as a favorable court decision). In general, the information should be specific to the issuer or issue.

Event disclosure is required only if the specified event is “material.” While there have been numerous definitions of materiality

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and much discussion of how the term relates to municipal issuers, the most common definitions center on any information that a reasonable investor might consider significant in an investment decision. It does not have to be an event that all investors would consider significant. In many cases, common sense is the best guide to the definition of “materiality.” The rule clearly leaves to municipal issuers the responsibility to determine materiality, although of course there may be consequences if their determination is later questioned.

The 11 material events that must be disclosed when they occur are:

- Principal and interest payment delinquencies
- Nonpayment related defaults
- Unscheduled draws on reserves
- Unscheduled draws on credit enhancements
- Substitution of credit or liquidity providers, or their failure to perform
- Adverse tax opinions or events affecting the tax-exempt status of the security
- Modifications to rights of security holders
- Optional or unscheduled bond calls
- Defeasances
- Matters affecting collateral (i.e., release, substitution, or sale of property securing repayment of the securities)
- Rating changes

If material events disclosure is not made by the issuer, the SEC could employ the enforcement action it has at its disposal.

- *How does this information reach the market?*—Issuers are required to send their annual financial information to all *nationally recognized municipal securities information repositories* (NRMSIRs) and to a *state information depository* (SID) if one exists in the issuer’s state. NRM-SIRs are private vendors who gather and disseminate information about municipal issuers to the primary and secondary markets. The NRMSIRs collect fees from the users of the information. Currently, three NRMSIRs exist.

Material event notices must be provided to all the NRMSIRs or the MSRB Continuing Disclosure Information (CDI) system and to a state information depository if one exists in the issuer’s state. For purposes of this section, NRMSIRs, SIDs, and CDI are referred to as “repositories.”

(c) Obligated Group Financial Statements

Some tax-exempt debt agreements may require preparation of combined financial statements of affiliated entities, the assets and revenues of which serve as collateral for the related debt (e.g., an “obligated group”). If debt or other agreements prescribe a financial presentation that varies from GAAP (for example, exclusion of entities otherwise required to be consolidated), the financial statements must be restricted for limited use. A problem may arise in some situations where the agreement with the underwriter was established prior to the issuance of HCO, and that agreement requires the health care organization to provide financial statements for the obligated group. A related issue is whether limited-use financial statements can be provided to municipal securities information repositories. Because it is a special purpose report, a limited-use type report on obligated group financial statements would not be appropriate to include in an official statement, nor to submit to a repository.

In such cases, there may need to be a modification of the agreement with the underwriters. However, quite often the underwriters will accept a consolidated audit report that includes a supplemental schedule showing the entities that add up to the obligated group, with an aggregate column for all other entities, coming up to the consolidated total (i.e., similar to the pro forma financials sometimes included in SEC filings). This should be acceptable to include in an official statement or to submit to a repository. Another approach being used in some cases is to provide two sets of financial statements: a set of audited consolidated financial statements and a set of unaudited financial statements that reconcile the obligated group to the audited consolidated numbers.

(d) Definition of “Public Company” in Application of FASB Standards

Several recent FASB standards have differentiated between “public” and “nonpublic” entities in the application of standards. The question has arisen as to whether the existence of debt obligations traded in the over-the-counter market and quoted only locally or regionally makes an entity “public.” Generally, the answer will depend on the facts and circumstances of the standard.

- SFAS 132, *Employers’ Disclosures About Pensions and Other Post-Retirement Benefits, an Amendment of FASB Statements 87, 88 and 106*. An argument can be made that an entity whose debt obligations are available to and traded by investors, regardless of how limited those obligations are in scope, should be considered a public entity for purposes of applying SFAS 132. The SFAS 132 definition of “public entity” includes entities whose “debt or equity securities trade in a public market either on a stock exchange (domestic or

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foreign) or in the over-the-counter market, including securities quoted only locally or regionally.” In SFAS 132, the FASB reduced disclosure requirements for nonpublic entities, because nonpublic financial-statement “users observed that they did not require the same level of precision in assessing benefits costs and net income” (SFAS 132, paragraph 57). However, such information would probably be of particular interest to an investor who is considering (or an analyst who is recommending) participation in an entity’s debt obligations.

- SFAS 131. Although SFAS 131 uses the same definition of “public entity” as does SFAS 132, it explicitly excludes not-for-profit organizations from its scope. Therefore, not-for-profit “public entities” would not be required to apply SFAS 131.
- SFAS 123. The definition of a nonpublic entity in SFAS 132 differs slightly from the definition in SFAS 123, “Accounting for Stock-Based Compensation.” The SFAS 123 definition includes entities whose “equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally”; it does not consider companies with only debt securities trading in a public market to be public companies.

CHAPTER SEVENTEEN

Accounting Standards for Other Not-for-Profit Organizations

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In 1978, AICPA issued SOP 78-10, *Accounting Principles and Reporting Practices for Certain Nonprofit Organizations*, applicable to all not-for-profit organizations that were not covered by one of the three previously issued Industry Audit Guides referred to in the three preceding chapters. In 1996, this SOP also was superseded by the AICPA audit guide, *Not-for-Profit Organizations*.

17.1 ACCOUNTING PRINCIPLES

(a) Accrual Basis of Reporting

Not-for-profit organizations must report on the accrual basis of accounting if they want their auditor to report that their financial statements are in accordance with generally accepted accounting principles (GAAP). As noted in Chapter 3, this is not the reporting practice of a large number of small- and medium-sized nonprofit organizations, which use cash basis accounting for purposes of reporting. This accrual-basis requirement specifically applies to financial reporting and does not necessarily apply to internal recordkeeping. Many not-for-profit organizations find it more practical to keep their records on a cash basis throughout the period and then prepare accrual basis financial statements through worksheet adjustments or formal journal entries.

(b) Fund Accounting

While the use of fund accounting (discussed in Chapter 4) for internal financial reporting purposes may be helpful, the net asset class format discussed in Chapter 12 is now mandatory for GAP basis financial statements.

(c) Gifts, Grants, and Bequests

Additional discussion of accounting for contributions is in Chapter 8 and in Chapters 5 and 6 of the audit guide for *Not-for-Profit Organizations*. All gifts, grants, and bequests, whether unrestricted or restricted, are to be recorded as income at the time received (see Section 8.3(b) in Chapter 8 of this book for a discussion of the timing of recording pledges, unrestricted gifts, and grants).

(d) Pledges (Unconditional Promises to Give)

Under SFAS 116, unconditional promises to give (usually called *pledges*) are to be recorded as an asset and reported at their estimated realizable value—that is, discounted to present value, and net of an appropriate allowance for estimated uncollectible amounts. Note that the requirement for recording pledges does not depend on the willingness or intention of the organization to actually take legal action to attempt to enforce an unpaid pledge. Few organizations would, in fact, ever take legal action. Rather, it is the ability to do so that mandates recording the pledge. Pledges to which unfulfilled conditions are attached can not be legally enforced until the conditions have been met, and should not be recorded until that time.

Those organizations wanting to avoid recording pledges can, therefore, include on their pledge card a condition which must be met, or an explicit statement to the effect that the pledgor can unilaterally withdraw the pledge at any time. As long as it is clear that the pledge is conditional upon some unfulfilled occurrence, or that the pledgor retains the right to cancel the pledge, the pledge would be unenforceable and therefore not recorded as an asset. This treatment also applies to unrestricted grants by foundations and others, which are payable over several years. These subjects are discussed in more detail in Chapter 8 of this book.

(e) Donated Services

The criteria for recording donated services are discussed on Chapter 8 of this book.

(f) Donated Materials

Donated materials, if significant in amount, should be recorded at their fair value at the date of receipt. The one proviso is that the organization must have a reasonable basis for valuation. Where the organization receives materials that are difficult to value, then no amount should be recorded. Examples of items that would be difficult to value include used clothing, furniture, and similar items. However, if a value can be reasonably determined, donated materials should be recorded. If the materials are sold soon after receipt (as in a thrift shop or bookstore) the sale price can be used as their value.

(g) Donated Facilities

Some not-for-profit organizations receive rent-free or reduced-rent offices, warehousing, and similar facilities. The fair value of such facilities should be recorded as a contribution and as an expense in the period utilized.

The value recorded should be based on the use actually being made of the facility. Accordingly, if a donor makes available high-cost office space, but the organization would normally rent low-cost office space, the organization should record as a contribution an amount representing the rent that the organization would pay if the donated facilities were not available. If the donation is in the form of reduced rent, only the excess of what the organization would normally pay over the reduced rent would be recorded.

Donated facilities should be recorded as income in the period the gift is made or promised. Accordingly, if a donor gives the organization a five-year, rent-free lease, the organization will record the full five-year rental as income in the year in which the donor gave the five-year lease.

(h) Investment Income, Including Gains and Losses

Additional discussion is in Chapter 6 of this book and in Chapter 8 of the audit guide for *Not-for-Profit Organizations*

(i) Membership and Subscription Income

Membership organizations receiving dues in advance of furnishing services to members should allocate the dues as revenue over the period of time in which the members will receive the services. This is a significant requirement. Until recognized as revenue, dues are reported as deferred revenue in the liability section of the balance sheet. Observe that under this requirement, dues are recognized as income over the period to which they relate, but not necessarily on a pro rata basis. If the organization can show that the services being rendered are not performed ratably over time, another basis of income recognition can be used.

Some organizations use the term “membership” as a fundraising device, and no real economic or other direct benefit accrues to the member by virtue of membership. Such “dues” should be treated as contribution income. Alternatively, if the membership dues are really a combination of dues and contribution, the payment should be appropriately allocated between these two categories. Appendix 17–A contains a checklist to help organizations distinguish between dues and contributions in practice. This subject is also discussed in Chapter 5 of the audit guide for *Not-for-Profit Organizations*. Subscription income should be prorated over the period to which the subscription applies. Where there are significant costs of obtaining the subscription, or renewal, only the net subscription income need be prorated.¹

(j) Life Membership and Initiation Fees

Some organizations offer life memberships, which represent a prepayment of dues. These life membership dues should also be recognized as income in the periods during which the member will receive services. If the number of life memberships is significant, the amortization would probably be based on the collective life expectancy of the members. Initiation fees that are not in fact a prepayment for services to be rendered in the future and that are not refundable should be reflected as income in the period in which the fees are payable. If the entire initiation fee is payable at the time a member joins, the entire fee would be recorded at that

¹ However, at a minimum, the deferred amount should at least equal the cost of fulfilling the subscription obligation. If the subscription is sold at a price insufficient to pay all costs, the subscription income that is deferred should be sufficient to cover the future period costs of fulfilling the subscription. The effect in this latter case will be to record a loss on subscriptions in the current period.

time. Some organizations provide for the payment of the initiation fee over a several-year period, in which case the fee should be recognized as it becomes due—that is, it should be spread over the several-year period corresponding to the payment schedule. The theory behind this deferral is that very few membership organizations will collect unpaid initiation fees if the member withdraws before the due date of the second or subsequent installments.

Where the initiation fee is a prepayment for services to be rendered in the future, it is essentially similar to life membership dues and should be amortized over the period in which the services are to be rendered. In some instances, an initiation fee is charged and, in addition, a fee will be assessed in future years to cover all or part of the cost of the services to be rendered. Where the future years' fee can reasonably be expected to cover the cost of such future years' services, then the initiation fee can be reflected as income currently; otherwise all or part of the initiation fee should be amortized as appropriate.

(k) Grants to Others

Some not-for-profit organizations (such as foundations) make grants to other organizations. Grantor organizations should record both as a liability and as an expense the amount of grants awarded at the time the grantee is "entitled" to the grant. Normally this is either at the time the board of trustees approves a specific grant or at the time the grantee is notified that it has been awarded the grant.

Some grants provide for payment over several years. Where the grantee will routinely receive such payments without the necessity of more than a cursory subsequent review by the grantor, the full amount of the grant, including the amounts payable in future years, should be recorded at the time of the initial award. (Amounts payable after one year should be discounted to present value, in the same manner as pledges receivable.) If, instead, the grantor indicates that the future payments are contingent upon an extensive review and formal decision process by the grantor prior to making payment, subsequent payments would not be recorded as a liability and expense until this subsequent decision process is completed. In these circumstances, each subsequent payment would effectively be treated as a new grant. (See Chapter 18 of this book and Chapter 10 of the audit guide for *Not-for-Profit Organizations* for a further discussion.)

(l) Reported Valuation of Investments

See the discussion in Chapter 6 of this book. Briefly, investments are to be reported at current fair market value under SFAS 124. However,

SFAS 124 covers only equity securities with a readily determinable fair value (except investments accounted for under the equity method, or investments in consolidated subsidiaries) and all debt securities. It does not set a standard for valuing other types of investments such as nonmarketable equity securities, real estate, partnerships, oil and gas interests, etc. The audit guide for *Not-for-Profit Organizations* states that these other investments should be reported in accordance with whichever one of the old audit guides were applicable to the type of organization concerned. Accordingly, other not-for-profit organizations should report such investments at either current fair market value or at the lower of cost (if purchased, or fair market value at the date of donation, if donated) or fair value. The same method must be used for all such investments. If investments are carried at other than current market value, and current market value is below cost, a provision for decline in value may need to be recorded if there has been a material decline which is considered other than temporary in nature.

(m) Fixed Assets

Fixed assets must be capitalized at cost or fair value at the date of donation (see Chapter 5 of this book). There is an exception, relating to reporting a value for museum and similar collections, if certain conditions are met. (This is discussed further in Chapter 18 of this book.)

(n) Depreciation Accounting

Refer to Chapter 5 of this book for a complete discussion of depreciation accounting.

(o) Life Income and Annuity Funds

The present value of the liability arising from life income and annuity gift contracts should be recorded as a liability at the time the gift is received. The excess of the gift over such liability is then recognized as income, also at the time the gift is received. Additional guidance is included in Chapter 6 of the audit guide for *Not-for-Profit Organizations* and Chapter 8 of this book.

(p) Expenses

The general rules for reporting expenses were discussed in Chapter 13 of this book. Fundraising costs must be reported as expenses in the period incurred. If fundraising is combined with a program function, such as educational literature that also solicits funds, the total cost should be allocated between the program and fundraising functions on the basis of

17.3 COMBINED FINANCIAL STATEMENTS

the use made of the literature, as determined from its content, reason for distribution, and audience, if the criteria of AICPA SOP 98-2, which is discussed in Chapter 13 of this book, are met.

(i) Membership Development Costs. This category is only for bona fide memberships and is not applicable for memberships that are in reality contributions (see the discussion of this topic above). Members must be receiving services commensurate with their dues. It is possible for membership dues to represent both a fee for services and a contribution. If so, membership development costs should be allocated between the fund-raising and membership development categories.

17.2 FINANCIAL STATEMENTS

As discussed in Chapter 12, the financial statement and disclosure requirements are now the same for all not-for-profit organizations. Rather than repeat the more extensive discussion and illustrations of financial statements in Chapter 13 (on voluntary health and welfare organizations), we refer readers to Chapter 13.

(a) Statement of Cash Flows (Formerly Changes in Financial Position)

Full discussion of this statement is included in SFAS 95. Chapter 12 of this book contains a practical guide for preparation of a statement of this statement.

17.3 COMBINED FINANCIAL STATEMENTS

AICPA SOP 94-3 discusses when it is appropriate to prepare combined (or consolidated) financial statements; the question of combined financial statements arises when the reporting organization is affiliated or has a close working relationship with other organizations. There are many types of affiliations between not-for-profit organizations, and the question of whether it is appropriate or necessary to present combined financial statements of legally separate organizations is a difficult one. The FASB is in the process of issuing new guidance on this subject. A full discussion of the current status of this subject is in Chapter 7 of this book.

(a) Funds Held in Trust by Others

Some organizations are beneficiaries under trusts or other arrangements where the organization itself does not have direct control over the assets. SOP 94-3 indicates that under these circumstances the assets should not be combined with those of the organization. The key is control. If the organization has no ability to control the investment of the

assets, the timing of income distribution, and the like, the combination of assets is not appropriate. However, if the organization is an irrevocable beneficiary of the trust, it would record the net present value of its interest in the trust as a receivable. This topic is the subject of further AICPA and FASB guidance. See Chapter 8 of this book for further discussion of this topic.

APPENDIX 17–A

Checklist: Factors to Be Considered in Deciding Whether a Payment Described as Membership Dues Is Properly Recorded by the Recipient as Dues or as a Contribution

Following is a list of factors which may be helpful to:

- *Organizations*, in deciding how to record “dues” receipts
- *Auditors*, in assessing the appropriateness of the client’s decision

No one of these factors is normally determinative by itself; all applicable factors should be considered together. Additional discussion of this distinction can be found in the instructions to IRS Form 990, line 3; and in IRS Regulation 1.509(a)-3(h).

Note: If the payment genuinely contains elements of both membership dues and contributions, it may be appropriate to allocate the payment between the two items, based on the relative proportions of each that are present. For example, a payment of \$100 which meets enough criteria to be considered a genuine dues payment, except that the value of the benefits received by the member is only \$65, might be recorded as dues of \$65, and a \$35 contribution.

Factors whose presence would indicate the payment should be recorded as membership dues

Factors whose presence would indicate the payment should be recorded as a contribution

Status and operation of the organization:

- | | |
|--|---|
| <p>1. The organization is tax-exempt under IRC Sec. 501(c)(5–8, or 10).¹</p> | <p>The organization is exempt under IRC Sec. 501(c)(3).¹</p> |
| <p>2. The stated purposes of the organization (as set forth in its IRS Form 1023 and/or 990, annual report, etc.) are mainly to serve members’ personal, social, or economic ends.</p> | <p>The stated purposes are mainly to serve public welfare purposes.</p> |
| <p>3. A “member” must meet specific criteria² to be permitted to join the organization.</p> | <p>Factor not present.</p> |

Characteristics of the solicitation:

- | | |
|--|---|
| <p>4. The solicitation refers specifically to membership dues.</p> | <p>The solicitation refers specifically to contributions, gifts, etc.</p> |
| <p>5. Factor not present.</p> | <p>The payment is described as an amount in addition to a basic dues payment, but there is no significant increase in the benefits available to the member.</p> |
| <p>6. The solicitation describes the use of the proceeds as to provide benefits to the member, or to other persons or organizations related to the member.</p> | <p>The solicitation describes the use of the proceeds as being for broad social, public, etc. purposes.</p> |

(continued)

ACCOUNTING STANDARDS FOR OTHER NOT-FOR-PROFIT ORGANIZATIONS

Factors whose presence would indicate the payment should be recorded as membership dues	Factors whose presence would indicate the payment should be recorded as a contribution
7. The payment is (partly) refundable in case of the member's withdrawal from membership.	The payment is not refundable to the payer.
<i>Benefits to "members":</i>	
8. Benefits vary with differing levels of payment.	Factor not present.
9. Benefits, whose values are objectively measurable, ³ have value approximately commensurate with the amount of the payment. (See also the note above.)	Benefits to the payer (or related parties) are negligible or not objectively measurable.
10. The payment confers benefits for a defined period, after which benefits cease unless another payment is made.	Although the payment may be stated as covering a certain period, benefits do not necessarily cease at the end of the period.
11. Benefits are directly related to matters which are central concerns of members' daily activities; e.g., one's employment or profession, place of residence, organized social and recreational activities, hobbies, religious practices, political views, etc.	Benefits are peripheral or unrelated to the central concerns of daily life.
12. The organization operates a facility, such as a clubhouse, regularly used by members.	Factor not present.
13. Membership in this organization is a prerequisite to receiving benefits from other entities (e.g., a lawyer must join a bar association before being licensed by the government to practice law).	Factor not present.

¹Having tax exemption under Sec. 501(c)(4) is not considered as a factor particularly indicative of either treatment.

²Types of membership criteria often found include:

- Age
- Present or former place of ownership of property, of residence, or of employment
- Professional qualifications (such as having certain levels of formal education, having passed an examination, having certain amounts and/or types of work experience, possessing a professional license)
- Having attended or graduated from a particular educational institution
- Having demonstrated certain academic, athletic, or other abilities
- Having been subjected to a formal initiation ritual (as with fraternities, sororities, and similar organizations)
- Professing formal allegiance to certain religious, political, or similar beliefs
- Having been formally approved by a membership committee or similar body (whether or not criteria similar to these are a factor in the approval process)

³Examples of objectively measurable benefits include:

- Receipt of magazines and other forms of communication with a significant amount of genuinely educational content
- The right to participate in substantive organized gatherings, open only to members, or available to members at a reduced fee, such as educational conferences, social activities, worship services, performances, etc.
- The right to purchase substantive goods or services from the organization, available only to members, or at a discount from the "non-member" price
- The right to use certain facilities such as those devoted to social or athletic purposes
- The right to receive (with or without additional payments) measurable benefits from other entities by virtue of being a member of the organization

APPENDIX 17-A

- The right to enter formal competitions for prizes awarded by the organization
- Examples of “benefits” which are not normally considered objectively measurable include:
- The right to vote for officers, or in other elections, or to hold office
 - The right to attend gatherings that are denoted as “membership meetings” but at which no substantive matters are decided by those present
 - Receipt of publications of little or no educational value
 - The privilege of listing one’s membership in the organization on one’s resume
 - The privilege of wearing or otherwise displaying the organization’s insignia
 - Having one’s name appear in a roster of the organization’s members
 - The possibility of receiving noncompetitive prizes or awards made only to members
 - Feelings of satisfaction from supporting a cause, or of enjoyment from associating with certain people or participating in informal social or recreational activities

CHAPTER EIGHTEEN

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In the preceding chapter we discussed in general not-for-profit organizations not discussed in Chapters 13 through 16. This chapter discusses some of the specialized accounting and reporting problems of specific types of organizations. It identifies unique accounting issues affecting these organizations and gives the authors' views on how professional literature applies. It also points out where SFAS 116 and 117 particularly affect these types of organizations.

This chapter does not attempt to examine in detail subjects covered earlier in the text. Accordingly, readers should also use this chapter as a reference to subjects that are more fully discussed in earlier chapters.

18.1 ASSOCIATIONS AND PROFESSIONAL SOCIETIES

Associations and professional societies are membership organizations that have been formed for other than a religious or social purpose. They include trade associations, engineering and academic societies, business leagues, and the like. Dues or other fees charged to the membership, revenue from trade shows, and subscriptions to publications of the organization are the main sources of revenue for these organizations.

(a) Reporting on a Functional Basis

Associations and professional societies can exist only so long as their membership is convinced that the services being rendered justify the dues and other payments being made. The members must see a benefit for their money. This means an association has a real need to communicate with its members. Functional reporting is one of the most effective ways of communicating since it requires the board to identify the association's programs and then to report the cost of each of these programs.

SFAS 117 requires functional reporting for external financial reports; the authors encourage it in internal reports as well. Although SFAS 117 permits the detail of expenses by function to be reported in a footnote (with the primary financial statement showing expenses by natural classification), the authors urge all not-for-profit organizations to present the functional expenses in the primary financial statement, where they will be more readily noticed by readers. Information by natural classification (salaries, rent, travel, etc.) can be shown in a footnote if desired.

(b) Reporting of Sections or Groups

Many national and regional professional societies establish separate sections, groups, chapters, or other form of local units that operate within certain geographical regions or within certain disciplines. These units often operate more or less autonomously, although they are legally part of the main organization. The board of directors of the main organization usually has final legal responsibility for both their activities and their financial affairs. The question often is asked: Should the financial affairs of these sections and groups be reported on a combined basis with those of the main organization? Generally such combination would *not* be required. The general subject of combination of affiliated organizations and AICPA SOP 94-3 are discussed in Chapter 7.

The most typical situation for associations and professional societies is when the section or group receives part of its funds from the national organization as a dues rebate and part from local assessments and fees for local events. Alternatively, the local organization may collect and process members' entire dues payments, and remit a portion up to the national organization. While technically the board of the national organization may have final legal responsibility with respect to this local section, the financial interrelationship is usually not analogous to that contemplated in SOP 94-3 as warranting consolidated financial statements. Accordingly, combination is not normally required. Some organizations are structured so that all of the activities of the local organization are financed entirely by the national organization, and on the surface it might appear that the financial interrelationship is such that combination is appropriate. Here is where the element of control becomes critical. If the local section is totally under control of the national organization, with its activities totally dependent on specific direction from the national organization, *and* if the activities being performed are a delegated function of the national organization, then—and only then—would combination be required.

To require a combination, the national organization must control and provide support to the local unit, and the local activities must be the responsibility of the national organization. Most local sections have their

own boards, with considerable flexibility as to program activities and emphasis, and therefore combinations are not typically required.

Nevertheless, there are some advantages in preparing combined financial statements, at least for internal use. Many associations have substantial activity at the local level and a reader at the national level can see the total picture only by looking at combined statements. The major problem with preparing combined financial statements relates to the cost and difficulties of getting the local units to prepare financial statements on a uniform and timely basis. One way to do this is to present the combined statements as an exhibit to the primary statements, which show only the parent organization.

(c) Use of Appropriation Accounting

For internal budgetary purposes, associations and professional societies often follow appropriation accounting techniques under which an expense is recorded at the time purchase orders are issued for goods or services to be received in future periods. This is not an acceptable method of accounting for external financial reporting purposes. Some associations and professional societies incorrectly use the term "appropriation" when they really mean "expense." The use of the term "appropriation" is easily misunderstood and should be avoided.

(d) Separate Charitable Organizations

Most associations are organized as noncharitable, tax-exempt organizations, usually under § 501(c)(6) of the Internal Revenue Code. As such, contributions received are not tax deductible by the donor (although dues may be deductible as a business expense). Often, an association will set up a second, separate "501(c)(3)" organization that is charitable in nature and can receive tax-deductible contributions. This charitable organization must then carefully conduct its affairs so that all of its activities are for purposes which qualify as charitable or educational. Usually, the boards of both organizations are substantially the same, and both organizations may occupy the same quarters (with appropriate interorganization expense charges).

The reporting question is: Should the financial statements of the two organizations be combined? The answer is almost always "yes" because the distinction between the two organizations is basically a legal and tax distinction, and effectively the combination of the two organizations is what most members think of when the association's name is mentioned. In fact, members will often be unaware that the second organization is a legally separate entity. Members have a right to see the total financial picture of both organizations.

18.2 CHURCHES

There are two ways to present the financial affairs in such circumstances. The most common is to use columnar statements with a separate column for each organization, with a total or consolidated column. The other approach is to combine the two organizations and present only the combined figures disclosing the existence of the charitable organization in the footnotes.

(e) Lobbying

Associations must comply with strict new rules surrounding their lobbying activities. These are discussed in detail in Chapter 28.

18.2 CHURCHES

In this section, we are discussing individual parishes, churches, mosques, or synagogues as distinct from religious organizations discussed later in this chapter. Virtually all revenue is typically received as contributions directly from the membership.

(a) Cash-Basis Accounting

Most churches keep their accounting records on a cash or modified cash basis of accounting, mainly for ease of recordkeeping. This is usually appropriate, at least for interim internal financial statement purposes. However, if there are any material amounts of unrecorded liabilities or assets at the end of the accounting period, these should be reflected on the financial statements. The key word is "material."

It is not suggested, for example, that uncollected dividends or interest on investments be recorded where such amounts are not in the aggregate significant. Perhaps the easiest way to determine whether accruals are needed is to ask whether the board might make different decisions about the governance or management of the organization if it saw financial statements in which all accruals were reported. If the answer is "yes," then they are material and should be recorded. Many churches will continue to present cash-basis reports, and there is no reason to change as long as the board recognizes the limitation of this type of reporting. If this is done, we recommend disclosing in a footnote the major items of unrecorded assets and liabilities at year end. At the same time, it is important to recognize that if the financial statements of the church are audited, the independent accountant will not be able to say that the financial statements have been prepared in accordance with generally accepted accounting principles if they are prepared on a cash basis.

(b) Fixed Assets and Depreciation

Fixed-asset and depreciation accounting is a difficult area for churches because of the complexity of the bookkeeping. Most churches do not

capitalize fixed assets and even fewer follow depreciation accounting practices. Nevertheless, the professional accounting literature requires that fixed assets be recorded as assets, and that depreciation accounting be followed.

(c) Adequacy of the Accounting Staff

Another problem is that churches often have bookkeeping difficulties. Typically, the treasurer of a small church will be the person actually keeping the records. The quality of the recordkeeping and financial statements is directly related to that individual's competency and availability of time. Also, treasurers come and go and some are more skilled than others. For that reason it is important that the system be kept simple or it is likely to fall apart at some time in the future.

18.3 CLUBS

Clubs include many types of organizations ranging from small social clubs that meet informally to much larger clubs that own buildings and property.¹ Country clubs and city "luncheon" clubs are typical of this latter category. Chapter 3 illustrates accrual bookkeeping using a country club as an example.

(a) Capital Shares and Initiation Fees

Most clubs charge a fee to new members—an initiation fee, payment for capital shares, or sometimes a combination of the two. Should such amounts be treated as revenue and reported as part of the excess of revenue over expenses for the period? The answer depends on the nature of the payment.

(i) Capital Shares. Clubs are normally the only type of not-for-profit organizations that have capital shares representing members' equity in the organization. Clubs usually provide for redemption of capital shares upon termination of membership, or the right of direct transfer of ownership of the shares to others. Therefore, payment for capital shares is not revenue and should be reported as an "other" addition to the net assets of the organization. This addition would be shown after a caption "Excess of revenue over expenses," and before the caption "Change in net assets." Because these payments are not *contributions* to the club, they cannot be shown in one of the restricted classes of net assets. Thus, by default, they must go in the unrestricted class, even though they are

¹ Additional guidance is in *Uniform System of Financial Reporting for Clubs*, published by the Club Managers Association of America, Inc.

rather in the nature of additions to the capital of the club. In the statement of cash flows, these cash flows would be financing cash flows.

(ii) Initiation Fees. Initiation fees are nonrefundable one-time charges that should be reported as revenue. Most clubs with significant turnover look upon initiation fees as additional, spendable income that should be reported as such. Initiation fees would be reported in the unrestricted class of net assets, even though, as is the practice with some clubs, initiation fees are explicitly understood by members to be restricted for capital acquisitions and improvements. In that case, the fees are still unrestricted (because they are not contributions) but should be segregated to indicate their intended purpose.

Some clubs provide for installment payment of initiation fees over a several-year period. A club should report initiation fees as the installment payments are due. It is not appropriate to record the entire initiation fee at the time the member joins the club since, in most instances, there is not a legal obligation and the club would not insist upon payment if the member resigns prior to the due date of the subsequent installments.

(b) Fixed-Asset Accounting

Clubs having buildings and other major fixed assets should capitalize these assets and follow depreciation accounting practices. This is appropriate since clubs need to know the cost of particular services being rendered to insure that the pricing structure recovers all costs. Fixed assets wear out and depreciation represents the process of allocating the costs of the assets over their useful lives. To do otherwise is to leave the club management and membership with an inadequate understanding of the costs of providing particular services, with a possible need for a special assessment at the time new fixed assets are purchased. Further, if non-members are served by the club, with resulting "unrelated business income," depreciation is an expense that is deductible when arriving at taxable income.

(c) Unrelated Business Income

Many clubs provide services not only to their membership but to guests of members, and in some instances to the public at large. If unrelated business income becomes sizable, it can jeopardize the club's tax exempt status, as well as create taxable income (see Chapter 28). Accordingly, it is very important that clubs keep track of revenue from non-members and applicable expenses. This usually involves a relatively elaborate reporting and bookkeeping system, and most clubs are well advised to get competent advice from a CPA.

18.4 LIBRARIES

Libraries, as contemplated, are all not-for-profit, nongovernmental libraries. Libraries run by a government usually follow the accounting principles established by the Government Accounting Standards Board (GASB), which differ from those promulgated by the FASB.

(a) Recording a Value for Books

Professional accounting literature does not contain an explicit requirement one way or the other about library books being recorded as an asset on the financial statements. Circulating and standard reference books would not meet the definition of a collection, as discussed in SFAS 116. Rather than track the actual cost or fair value of every individual book acquired, one way to simplify the recordkeeping process for library books is to use a standard amount as the value of each volume. Then the only data needed is the number of volumes, which is always known. In practice many organizations consider that individual books fall below the minimum threshold for asset capitalization, and expense them as acquired.

When library books are recorded as an asset, depreciation accounting practices are normally appropriate since most books are dated. While it is difficult to establish a composite life for all types of books, a three- to ten-year life is not unreasonable. Depreciation practices should not be followed for a collection or rare books, which is likely to maintain its value over a considerable period of time. Rare books that increase in value should continue to be recorded at the value on the original date of acquisition and not written up to a higher value.

18.5 MUSEUMS

Museums include all nongovernmental institutions that maintain a collection exhibited to the public, with or without an admission charge. Some museums that do not collect a mandatory admission charge do suggest that visitors make specified “contributions.”

(a) Valuing the Collection as an Asset

The most controversial question is whether it is meaningful and practical to include on the balance sheet of a museum or similar organization (zoo, arboretum, library, etc.) a value for its permanent collection. Organizations may choose to capitalize all of their collections or capitalize none of their collections. Capitalization of part of the collections (that is, *selective capitalization*) is prohibited. Practice varies—most museums do not include such an amount or use a nominal amount such as one dollar.

Those who favor such capitalization argue that the collection does meet the definition of an asset (in FASB Concepts Statement No. 6) and therefore should be presented so as not to omit significant valuable resources from the financial statements.

Those who oppose capitalization, including many in the museum community, make several arguments, as follows.

- Any value reported subsequent to initial acquisition has no meaning due to wide fluctuations in the markets for such items and the difficulty of disposing of some types of collection items at all.
- It would be virtually impossible for a museum of any size to perform the appraisal work that would be required to establish an initial value for its collection, if not previously capitalized (some museum collections number in the tens of millions of individual objects), nor to maintain the ongoing records that would result.
- Even if accurate values could be obtained, to include them on the balance sheet would be at best meaningless (because most collections cannot or would not ever be sold, nor do lenders look to collections as security for loans), or at worst detrimental (because financial statement readers would be diverted by the huge collection value from focusing on the real operating assets of the institution).

The FASB initially proposed to make capitalization mandatory, including retroactive capitalization of existing collections. Because this position met with so much opposition, SFAS 116 essentially continues the previously existing optional capitalization standard for collection items which meet certain criteria. For those that do not capitalize, purchased acquisitions would be shown as decreases in net assets, and donated items would *not* be reported as either increases or decreases in net assets. Certain disclosures about the collection would be required. This subject is discussed further in the AICPA audit guide for *Not-for-Profit Organizations*.

(b) Fixed-Asset Accounting

Except for collections, museums should capitalize and depreciate their fixed assets.

(c) Contributed Facilities

Museums receiving rent-free (or reduced-rent) facilities should reflect the value of such facilities both as a contribution and as an expense. This will be applicable to museums that occupy city-owned buildings, except that in some cases where the building is itself virtually a work of art, it may not be possible to objectively determine a rental value.

18.6 PERFORMING ARTS ORGANIZATIONS

Performing arts organizations include a wide variety of organizations including, but not limited to, theatrical groups, ballet and opera companies, and symphonies. In most instances, they rely on ticket sales as their primary source of revenue but are usually heavily dependent on public support as well. They range in size from all-volunteer companies to such professional groups as the Metropolitan Opera in New York and the Los Angeles Philharmonic.

(a) Recognition of Expenses

A basic reporting issue for performing arts organizations is the timing of expense recognition for particular productions that have not as yet been performed. Should a theatrical company that has incurred costs for the performance of a new play that will not be opening until the following period report such costs in the current period or should they be deferred until the following period? The general rule is that costs should be deferred so as to match the costs with revenues.

The annual reporting period for most performing arts organizations should conclude shortly after the close of the season, to minimize this kind of issue as well as a good number of bookkeeping problems. This deferral practice does not apply to advertising costs, however.

(b) Recognition of Ticket Revenue

A related question is when to recognize ticket revenue—when the tickets are sold or on the date of the performance? Ticket revenue income should be recorded when earned—that is, on the date of the performance. This is particularly important for organizations having advance ticket sales for the following season.

The revenue from sales of season tickets and subscriptions should be pro-rated over the performances covered by the subscription. Sometimes ticket prices for special events such as “opening night” or “gala” performances will be higher than normal and include what is in effect an element of contribution. Since the contribution element must be disclosed separately to patrons (for tax-deduction purposes), the organization should record this portion of the ticket price as a contribution, following the rules in SFAS 116.

(c) Recording Costumes and Stage Scenery as Fixed Assets

GAAP provides for recording fixed assets. Does this apply to costumes and scenery? In principle, the answer is “yes,” but in practice this is rarely done. Accounting literature does not specifically speak to this question

and it would appear in theory that such assets should be recorded. However, the implication in recording a fixed asset is that it does have a future value and that there will be revenue that will absorb the costs of such assets. This is probably fine where a performing arts company has a production that is given season after season; in this instance, the costumes and scenery should be recorded as an asset and depreciated over their expected useful life.

But most performing arts companies do not perform the same production on a regular schedule and effectively the costumes and scenery have assured value only for the initial season. If so, they should be expensed currently.

(d) Financial Statement Presentation

Since contributions are usually an essential part of their income, performing arts organizations should consider a statement format that emphasizes the role these gifts play toward keeping the organization solvent. A recommended format is to show first the loss from operations and then the contribution income. Here is an example in a very abbreviated form:

Ticket sales		\$500,000
Less—Expenses:		
Production costs	\$(600,000)	
Administration and general	<u>(50,000)</u>	<u>(650,000)</u>
Loss from operations		(150,000)
Contribution income	170,000	
Fundraising costs	<u>(10,000)</u>	<u>160,000</u>
Excess for the year		<u><u>\$ 10,000</u></u>

18.7 PRIVATE FOUNDATIONS

The term *private foundation* is used here as defined in the Tax Reform Act of 1969. The tax aspects of private foundations are discussed in detail in Chapter 28. Such organizations generally do not solicit funds from the public but are supported mainly by endowment income. Occasionally, private foundations receive new gifts but, by definition, these come from relatively few individuals.²

(a) Timing of Recording Liability for Grants Awarded to Others

While this is not unique to foundations, it is more of an issue to them than to most organizations. Many times foundations will make a grant award payable in installments, often over several years. Typically, subsequent

² Community foundations, another type of foundation, do receive gifts from the general public.

payments are dependent upon satisfactory performance or compliance with the original grant agreement, and as such, the "liability" for future payments is somewhat "conditional."

The accounting question relates to the timing of recording these grant liabilities and the related expense by the foundation. The foundation should record both as an expense and as a liability the full commitment at the time the grantee institution is informed of the foundation's intention to make specific payments.

The audit guide for *Not-for-Profit Organizations* provides:

Unconditional promises to give should be recognized at the time the donor has an obligation to transfer the promised assets in the future, which generally occurs when the donor approves a specific grant or when the recipient is notified. If a donor explicitly reserves the right to rescind an intention to contribute, or if a solicitation explicitly allows a donor to rescind the intention, a promise to give should not be recognized by the donor. If payments of the unconditional promise to give are to be made to a recipient over several fiscal periods and the recipient is subject only to routine performance requirements, a liability and an expense of the entire amount payable should be recognized. ... Conditional promises to give should not be recognized until the conditions are substantially met.

The real problem is determining when a grant is subject "... only to routine performance requirements ..."; in other words, not requiring subsequent review and approval. As noted, most multipayment grant awards contain language that requires certain interim reporting by the grantee and review by the foundation. When do these "routine performance requirements" stop being routine, and instead become a basis for reevaluation of the foundation's grant commitment every time it receives a report by the grantee?

There is no easy answer to this question, and it is necessary to examine very carefully the wording in the grant notification document. If from the terms of that document it is clear that the foundation has made the decision to make future years' payments conditional only upon the grantee institution doing what it says it will do, and it is reasonably clear that the grantee has the capacity to do so, then the grant is essentially unconditional and the full amount of future payments should be recorded. On the other hand, if the grant document merely indicates the foundation's general intent to consider favorably future requests, subject to a full review at that time, future payments would be conditional, and would not be recorded until the condition is met. This would not constitute the type of grant obligation which should be reported since the commitment is contingent on a future decision by the foundation. Footnote disclosure of significant unrecorded amounts should be made. Perhaps key to this discussion is the phrase "subject only to routine performance." All foundations reserve the right to revoke unpaid grants if the grantee institution fails to live up to its past performance, to submit routine financial reports

of the use of such funds and the like. Grants made subject to these routine performance requirements would not normally constitute language sufficiently restrictive to avoid the recording of the future grant payments. On the other hand, grants containing language such as the following would not be recorded:

The D. E. Martin Foundation Board of Trustees hereby grants to the Karen J. Sylvestre Home for Battered Women the sum of \$100,000 to establish a program for runaway teenage girls in the Detroit area. The staff of the Foundation will review carefully the uses made of this money during the first twelve months, and based upon their evaluation of the effectiveness of the program will consider additional annual requests for \$100,000 to fund the second and third years' programs.

It is clear that next year the foundation will investigate the uses made of the money and will then make a decision as to future support. Yet, on the basis of the foundation's intent, this organization can plan its program on the assumption that it is likely to get the additional support in the following two years. On the other hand, wording such as the following would appear to require recording in full:

The D. E. Martin Foundation Board of Trustees hereby grants \$300,000 to the Karen J. Sylvestre Home for Battered Women, payable \$100,000 by check herewith and additional payments of \$100,000 in each of the next two years. The payment of these future amounts is contingent upon receipt by the Foundation of a report by the Home which details the uses made of the monies received in the preceding year, an evaluation of the results of the program, and detailed budgets at the beginning of each program year.

In this instance, it appears fairly clear that the foundation has committed itself for a three-year period and that it should record the full \$300,000 (discounted to present value, as discussed in Chapter 8) both as an expense and as a liability at the time the grant is made. (The recipient would record a corresponding asset and revenue, also as discussed in Chapter 8.)

There are many gray-area grants where the answer will not be as clear as in these illustrations. The intent of SFAS 116 and the audit guide is for the foundation to record the grant if in all likelihood future payments will be routinely made. However, if the foundation has not made a final judgment on future payments, they should not be recorded. At the end of Chapter 8 are two checklists to help readers determine when, in fact, an unconditional pledge exists.

Some question why the obligation should be recorded both as a liability and as an expense in the current year. They point out that foundations derive their revenue primarily from endowment income, and that the future years' payments should be recorded as an expense at the time the income that will be used to pay the grant obligation is generated. The reason SFAS 116 takes the approach discussed above is that, historically, such amounts are in fact paid and are, therefore, obligations. If a foundation

that had committed itself to making future payments were not to record such amounts as an obligation, it would be presenting a rosier financial picture than is in fact the case. For example, one use of the financial statements is for the board to be aware of how much money is available for future grants. Amounts already committed, even if to be paid in future years, are clearly not available for new grants.

(b) Distinction between Principal and Income

One accounting distinction that private foundations often make is the distinction between principal and income in their net assets. Where such a distinction is made, the original principal and usually all capital gains thereon are accounted for separately from the accumulated, unspent income arising from investment of this principal. This distinction appears to be arbitrary and except where legal restrictions are involved usually serves no purpose to the readers of the financial statements.

This distinction between principal and income seems even less meaningful since the Tax Reform Act of 1969 and its requirement that minimum distributions be made (which will have the effect of dipping into capital gains and principal if dividends and income are not sufficient). In the absence of legal restrictions these two amounts be combined and reported simply as net assets. If an organization wishes to maintain the distinction, then the only place where the distinction should be made is in the net assets section of the balance sheet, as illustrated in the following abbreviated example:

Unrestricted Net Assets:	
Original donor contribution	\$1,000,000
Accumulated undistributed income	<u>200,000</u>
Total unrestricted net assets	<u><u>\$1,200,000</u></u>

(c) Community Foundations

Community foundations differ from private foundations mainly in that their source of contributions is the community at large rather than one person or family. This gives rise to certain tax and legal considerations that do not really affect financial accounting or reporting. Thus, all of the accounting and reporting principles discussed above and in Chapter 13 are applicable to community as well as private foundations.

18.8 RELIGIOUS ORGANIZATIONS OTHER THAN CHURCHES

The term "religious organization," as contemplated here, excludes individual churches that were discussed earlier in this chapter. Organizations that exist to service the particular needs of organized religion on a

regional or national basis are included, as are organizations involved in the national administration of churches or their domestic and foreign missionary activities. Some denominations have published accounting guidelines such as those by the U.S. Conference of Catholic Bishops.

(a) Combined Financial Statements

One of the difficult questions for a religious organization is to determine which entities are so financially interrelated that combined financial statements should be prepared as required by SOP 94-3.

The key to determining when combination would be appropriate under SOP 94-3 rests heavily on the financial interrelationship. There is no requirement for preparing combined financial statements unless substantially all of the funds collected by the secondary unit will be transferred to the reporting organization or used for its benefit. Thus, for example, a diocese may not be required to combine the financial statements of the individually incorporated church units within its jurisdiction for purposes of its reporting. While the individual church units may raise funds in the name of the church, such funds will largely be used for local purposes, and only a portion transmitted to the diocese.

(b) Allocations from Other Organizations

Religious organizations frequently receive allocations from affiliated local or regional organizations. Usually the allocation is established by the “parent” organization at the beginning of the fiscal year. An accounting question often arises as to the timing of income recognition. Should it be at the beginning of the year when the allocation is determined, at the time it is paid, or pro rata throughout the year?

Unless the amount to be paid by the parent organization qualifies as an unconditional pledge (as discussed in Chapter 8), recognition normally should be on a pro rata basis throughout the year since it is effectively payment for services which are presumably being rendered throughout the year. Where experience shows that the full allocation or assessment will not be paid, only the amount that can reasonably be expected to be paid should be recorded on this pro rata basis. Unpaid collections at the end of the year must be reviewed for collectibility. See also the discussion of pass-through gifts and SFAS 136 in Chapter 7.

18.9 RESEARCH AND SCIENTIFIC ORGANIZATIONS

Research and scientific organizations are those not-for-profit organizations existing primarily to do research in particular areas, usually under contract with government agencies, private foundations, or third parties.

(a) Timing of Recording Contract Revenue

The major question most research and scientific organizations have relates to the timing of recording contract revenue. Contract revenue should be recorded as revenue at the time the contract terms are met. In most instances, this is as expenses are incurred that can be charged against the contract. Some research and scientific organizations receive grants unrestricted as to use to assist the organizations in conducting their programs or meeting their general expenses. Usually these organizations submit budgets to the granting organization indicating the time frame and the type of activities that will be carried out with these unrestricted funds. When such grants are tantamount to a purchase of services by the grantor, recognition of such unrestricted grants should be on a timeframe basis; that is, as expenses are incurred over the period the grant specifies. If the grant amounts to an unconditional gift to the grantee, it should be recognized like all gifts; that is, immediately upon receipt of the gift or pledge. At the end of Chapter 8 is a checklist to help readers distinguish between contributions and purchases of services in practice.

The recognition of revenue is independent of the actual receipt of cash under the grant. In some instances, grantors pay the entire grant in advance, and in others, in arrears. When a grant which is a purchase of services is paid in advance, it would be reflected as "deferred grant revenue" on the balance sheet. If it is essentially a contribution, it is recorded as revenue immediately upon receipt. When the grant is paid in arrears, a receivable would be set up at the time of revenue recognition.

(b) Recording Future Grant Awards

A related question arises as to the appropriateness of recording both as a receivable and as deferred grant revenue the amounts which the organization has been told it will receive for future activities—either restricted or unrestricted. Should an organization reflect large future years' grants on the balance sheet?

This is a difficult question to answer, but the general answer is "no," unless the grant amounts to an unconditional pledge, discussed in Chapter 8, and the organization could enforce payment. If the grant has language in it such that the grantor can change its mind, with or without cause, such future grants are conditional and would not be recorded. Similarly, a "grant," which is a purchase-of-services contract is inherently conditional upon the grantee incurring qualifying expenses under the grant. On the other hand, where a grantor has made the grant unconditional and it is clear that the only condition is the passage of time, there is justification for recording the grant both as a receivable and revenue. The burden, however, is on showing that the grant is unconditional and could be legally enforced.

18.11 PUBLIC BROADCASTING STATIONS

In many ways, such future grants are effectively “pledges.” SFAS 116 provides that unconditional pledges should be recorded. The same applies to future grants. Note that this accounting principle is the same as that discussed previously for foundations making grants.

18.10 PRIVATE ELEMENTARY AND SECONDARY SCHOOLS

Private elementary and secondary schools are those institutions that provide education below the college level, and which are supported by tuition and contributions from private sources. Excluded from this category are government-supported school systems. For the most part these organizations follow accounting and reporting practices similar to those of colleges, discussed in Chapter 14.

(a) Accounting Manual

The National Association of Independent Schools has published *Business Management for Independent Schools*, which should be consulted for further guidance.

18.11 PUBLIC BROADCASTING STATIONS

Public broadcasting stations include noncommercial radio and television stations.

(a) Other Accounting Guidance

The Corporation for Public Broadcasting (CPB) has issued an accounting guide for public broadcasting stations. Copies are available from CPB (each station should already have a copy).

(b) Grants Received/Program Underwriting

Questions often arise as to whether a grant received to underwrite a particular program is a contribution or an exchange transaction. Promises to make a contribution may be either unconditional or conditional (“you will receive this grant only if you agree to produce this program,” and the station has not yet decided to produce the program, or production of the program is contingent on the ability of the station to attract enough additional funds to cover the anticipated production costs). Grants may be received from the Corporation for Public Broadcasting (CPB), other public broadcasting stations, business organizations, foundations, individuals, or governments. Some grants are intended to cover the costs of producing a program; others are simply to cover broadcast expenses of an existing program. “Community Service Grants” from the CPB are normally considered unrestricted contributions.

Guidance on the contribution versus exchange question can be found in the audit guide for *Not-for-Profit Organizations*, (paragraphs 5.03 and 5.04), and in Appendix 7–B of this book. We would anticipate that most grants to public broadcasters would be considered contributions, except in situations where the grantor retains future rights to control use of the finished program. The advertising value of having the underwriter's name associated with the ultimate broadcast of the program would likely be considered *de minimis* (as it must be under CPB rules). Guidance on the conditional versus unconditional question can be found in Appendix 8–F of this book. Each grant document must be read carefully to determine its substance.

(c) Donated Services of Volunteers

This subject takes on additional importance in the public broadcasting environment because the matching grant rules of the CPB allow stations to use the value of some volunteer services as part of the required matching amount for CPB grants. The normal rules in SFAS 116 apply.

(d) Program Production Costs

Not-for-profit broadcasters should follow the normal industry-oriented guidance in SFAS 63, with consideration given to possible impairment under SFAS 144.

(e) Fixed Assets

These should be accounted for in the usual manner. Donated assets, including free or reduced-rent use of facilities and equipment, should be accounted for in accordance with SFAS 116.

(f) Member Dues/Pledges

The amount in excess of any significant premium provided to the member is normally equivalent to a contribution, since "members" otherwise receive only very limited benefits (e.g., a program guide). Oral pledges received during on-the-air fundraising campaigns can qualify for recording under SFAS 116 if verifiable evidence of the pledge exists. The pledge cards filled out by the persons in the studio who receive the telephone calls would normally be considered adequate evidence to permit recording; however, the auditor must consider whether confirmation of selected unpaid pledges as of year-end would be required to obtain audit satisfaction as to the existence criterion. Since most such pledges are short-term, no discounting would be required, but an adequate allowance for uncollectibles should be established.

CHAPTER NINETEEN

The Financial Accounting Standards Board and Future Trends in Not-for-Profit Accounting

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So far the discussion of accounting principles and reporting practices has dealt with existing authoritative literature to which accountants and CPAs refer when determining appropriate treatment of accounting questions.

This chapter discusses the process by which accounting standards are created, as well as probable future developments. The chapter first discusses the impact on not-for-profit accounting of the activities of the Financial Accounting Standards Board (FASB). The later portion deals with some trends and developments the authors see as likely to take place during the next few years. It should be emphasized that much of the discussion in this chapter is conjecture based on the authors' close involvement with many of the recent developments in this field and reasonable expectations as to future developments. A great deal of the now-existing literature was first discussed in this chapter of earlier editions.

19.1 FINANCIAL ACCOUNTING STANDARDS BOARD

Since 1977, the FASB has been involved in rule-making for not-for-profit organizations. With the issuance in the 1990s of SFAS 116, 117, 124, and 136, discussed in earlier chapters of this book, the FASB has had a significant impact on not-for-profit accounting. To put this development into perspective, it is first necessary to describe the accounting profession's existing rule-making machinery, and detail its enforcement.

(a) Establishment of Accounting Rules

Until 1973, the senior rule-making body was the AICPA's Accounting Principles Board (APB). Accounting principles formally established by the Accounting Principles Board or its successor represent generally accepted accounting principles (GAAP), and CPAs reporting on financial statements of their clients cannot indicate that their clients are following generally accepted accounting principles unless they are, in fact, following the principles established by this board or its successor. CPAs, who report on a contrary treatment without appropriate indication in their opinion, can be disciplined by both the accounting profession and the state licensing boards, with a possible loss of their CPA certificates.

The APB never formally established accounting principles for not-for-profit organizations as such. However, the board did authorize publication of the industry audit guides. These guides, during the time periods

that they were in effect, had some authoritative status although they did *not* formally constitute GAAP. This means that accountants would not necessarily be disciplined for violating the principles in these guides. However, they could be called on to justify a departure from the guides, since they represented the most authoritative literature on the subjects covered. Embarrassing as this could be, seldom would it result in loss of a CPA certificate. However, all of the major accounting firms and most conscientious CPAs looked upon these guides as authoritative and were reluctant to violate them. (The above description applies only to audit guides and statements of position issued before 1992. Documents issued after 1992 carry a higher level of authority.)

There are two types of accounting rules: those rules that formally constitute generally accepted accounting principles from which departures are not permitted without CPAs qualifying their opinions on such financial statements, and those rules that represent the best thoughts of the accounting profession, from which departures can occur.

(i) Formation of FASB. In 1973, the APB turned over its rule-making authority to a new and totally independent organization—the FASB—and the APB was disbanded. Since then, only the FASB has been empowered to issue standards that constitute the highest level of generally accepted accounting principles. Prior to 1993, the FASB had issued only one accounting principle specifically addressed to the not-for-profit sector (SFAS 93, referred to in the next subsection).

(ii) AICPA's Statement of Position. At the time the FASB was established in 1973, the AICPA set up an ongoing committee to make recommendations to the FASB on accounting issues. This ongoing AICPA body is the Accounting Standards Executive Committee (AcSEC). Its recommendations are made in the form of "Statements of Position" addressed to the FASB for its consideration. These statements of position (SOP) are widely publicized. In the absence of FASB statements to the contrary, these SOPs represented the best thoughts of the accounting profession on a given subject.

Upon receipt of a proposed SOP, the FASB has two basic options. The FASB could conclude that the subject matter of the statement is sufficiently important that the FASB would place the subject on its agenda for future consideration. When this is done the SOP has little authority pending the FASB's resolution. Alternatively, the FASB could indicate that it does not intend to consider the matter covered in the SOP in the near future. When this happens the SOP became the "most authoritative" discussion of the accounting principles on that subject, and had much the same authority as the industry audit guides discussed above. As with the audit guides, a CPA not adhering to an SOP guidance would not necessarily

result in disciplinary action by the accounting profession or by state licensing boards. At the time of issuance of the SOP referred to in Chapter 17, the FASB had not yet placed on its agenda the consideration of formal accounting standards for not-for-profit entities. Accordingly, for a time, that SOP continued to be the most authoritative discussion of accounting principles for not-for-profit organizations not covered by one of the industry audit guides, except for those matters covered specifically by one of the Statements of Financial Accounting Standards described below. It continued to have this authority until the FASB issued further specific accounting standards for not-for-profit organizations, and until the AICPA issued the new audit guide described in the following subsection.

(b) FASB Conceptual Framework

In 1977, the FASB indicated that it was exploring the possibility of issuing a financial reporting “conceptual framework policy statement” applicable to not-for-profit organizations. A conceptual framework policy statement is a document that attempts to establish the framework on which individual, specific accounting principles (referred to by the FASB as “standards”) can be developed which will facilitate consistency among principles. The conceptual framework policy statement, however, would not represent detailed accounting standards as such; these would be adopted subsequently as a separate procedure. In an earlier document the FASB summarized the purposes of such a framework as follows.

- To establish the objectives and concepts that the Financial Accounting Standards Board will use in developing standards of financial accounting and reporting.
- To provide guidance in resolving problems of financial accounting and reporting that are not addressed in authoritative pronouncements.
- To enhance the assessment by users of the content and limitations of information provided by financial accounting and reporting and thereby further their ability to use that information effectively.

In 1985, the FASB published Concepts Statement No. 6, *Elements of Financial Statements*, containing further material relating to the FASB’s views on accounting and financial reporting by not-for-profit entities. It is important to note that, while these conceptual framework policy statements set the framework under which formal financial accounting standards are written, a conceptual framework policy statement itself is *not* a rule book. The development of specific financial accounting standards is a separate, formal process usually taking several years.

(c) FASB Not-for-Profit Projects

Originally the FASB identified five areas in which it intended to set accounting and reporting standards for not-for-profit entities. As of late 1999, the FASB has issued five accounting standards specifically applicable to not-for-profit organizations:

1. SFAS 93, *Recognition of Depreciation by Not-for-Profit Organizations*. This was discussed in Chapter 5.
2. SFAS 116, *Accounting for Contributions Received and Contributions Made*. This was discussed in Chapter 8.
3. SFAS 117, *Financial Statements of Not-for-Profit Organizations*. This was discussed in Chapter 12.
4. SFAS 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*. This was discussed in Chapter 26.
5. SFAS 136, *Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others*. This was discussed in Chapter 7.

One other not-for-profit project is under way which will have a major impact on the not-for-profit sector; combinations of not-for-profit organizations. Chapter 7 discusses this project in detail.

(d) AICPA Projects

After these statements were issued, large parts of the various AICPA audit guides and statements of position became obsolete. The AcSEC established a task force to update, revise, and combine the documents. (The *Health Care Audit Guide* will remain as a separate document, as much of its subject matter is peculiar to these types of organizations.) The new guide, *Not-for-Profit Organizations—AICPA Audit and Accounting Guide*, contains interpretive information about the new accounting and reporting standards, as well as guidance for auditors of financial statements in which the standards are applied. These provisions are discussed throughout this book.

Another AICPA SOP deals with joint costs of multipurpose activities, as discussed in Chapter 13. Accountants have tried to create rules that permit fair allocation but preclude improper allocation of these costs. The accounting rules contained in AICPA SOP 87-2, *Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal*, are replaced by new SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Governmental Entities That Include Fundraising*, which does not change the basic requirements. SOP 98-2 clarifies and amplifies some of the rules in SOP 87-2 and provides examples of recommended practices in this area.

The third project was one to issue guidance on combination of related entities when one is a not-for-profit organization. This subject is discussed in detail in Chapter 7. In September 1994, the AICPA issued a new statement of position, SOP. 94-3, that expands and clarifies guidance on this subject. This SOP will be superseded by the new FASB standard on this subject.

(e) Relationship of the AICPA to the FASB

This raises the obvious question of the relationship of the AICPA statements of position and the industry audit guides to the FASB and its conceptual framework policy statement and present and future accounting and reporting standards.

When formal accounting and reporting standards are issued by the FASB, they supersede any contrary provisions of the industry audit guides and SOPs. However, until superseded, the provisions of the industry audit guides and SOPs continue to represent the most authoritative pronouncements on the subject by the accounting profession. For this reason, they continue to have great impact. In 2003, the AICPA's Accounting Standards Team released several questions and answers (Q&A), commonly known as Technical Practice Aids (TPAs), that pertain to not-for-profit organizations. TPAs consist of responses to selected inquiries received by the AICPA. Note that TPAs are not sources of established accounting principles as described in Statement on Auditing Standards (SAS) No. 69, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles in the Independent Auditors Report*.

(f) Changes to the AICPA's and FASB's Rule-Making Process

The standard-setting process is changing—probably very significantly, although it will take time to accomplish the changes. In a 2001 survey, respondents were asked to prioritize FASB initiatives. Respondents ranked “standards overload” as a high priority. The accounting standards are too detailed and too complex, necessitating an increase in the amount of interpretive and implementation guidance.

In 2002, the FASB discussed adopting a “principles-based” approach to standard setting rather than a “rules-based” approach. It exposed for public comments its proposal, *Principles-Based Approach to U.S. Standard Setting*, in October 2002. In 2003, the FASB discussed the comments and took these steps:

- It directed staff to prepare for a limited-scope conceptual framework. The FASB will coordinate with the International Accounting Standards Board (IASB) and Canadian Institute of Chartered Accountants (CICA) that are working on similar projects.

19.1 FINANCIAL ACCOUNTING STANDARDS BOARD

- It established a near-term goal of using similar wording as that proposed by IASB.
- It initiated specific improvements, such as: (1) increasing the level of user involvement focused on the quality and timeliness of standards; (2) improving the process for providing interpretive and implementation guidance; and (3) improving accessibility of the accounting literature.

The Sarbanes–Oxley Act of 2002 (see Appendix 25–B to Chapter 25) required the U.S. Securities and Exchange Commission (SEC) to study the adoption of a principles-based or, as it preferred to state, an “objectives-oriented” approach and to report its findings to Congress by July 2003 (see Exhibit 19.1). The staff recommended principles-based approach that would, among other characteristics, be based on a clearly stated accounting objective and minimize exceptions from the standard.

EXHIBIT 19.1

SEC’s Timeframe for Adoption of a Principles-Based Accounting System

Action Items	Current Status	Time Horizon
Conceptual framework improvements project	FASB currently evaluating most efficient approach	Medium term
Move towards objectives-oriented <i>form</i> of standards	Recent standards (e.g., SFAS 141 and following) have included elements of objectives-oriented <i>form</i>	Immediate
Comprehensive review of current standards to identify and address those that are rules-based	SFAS 141 superseded Accounting Principles Board (APB) Opinion No. 16 (rules-based); accounting for stock-based compensation added to FASB agenda on March 12, 2003; staff and Board are evaluating existing standards for purposes of future agenda decisions	Underway
One standard setter	AcSEC will no longer be responsible for issuing “authoritative” standards, transition plan is in place; Emerging Issues Task Force (EITF) consensus now are subject to FASB approval	Underway
Redefine GAAP hierarchy	Conceptual framework improvements project to be completed first	Medium term
Convergence	In October 2002, FASB and IASB jointly announced intention to work towards convergence of international and domestic standards. Joint or cooperative projects underway include business combinations, measuring financial performance, stock-based compensation, revenue recognition, and short-term convergence	Underway; some standards expected to be issued within the next year, but effort will be long term

The report, Study Pursuant to Section 108(d) of the Sarbanes–Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, contained the following table that outlines key steps to move the standard-setting process to a more objectives-oriented approach. The report was prepared by the SEC’s staff. It is posted on the SEC’s website (www.sec.gov) and is in the “Special Studies” section.

Changing to a more objectives-oriented approach to standard setting would redefine the GAAP hierarchy. Currently, the hierarchy is as follows:

- Level A: FASB Statements, APB Opinions, and Accounting Research Bulletins (ARBs)
- Level B: FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides, and AICPA Statements of Position (SOPs)
- Level C: EITF Consensus and AICPA Practice Bulletins
- Level D: AICPA Accounting Interpretations, FASB staff Q&As, and industry practice

The new hierarchy would be something like the following:

- FASB conceptual framework documents
- FASB standards (SFASs, Interpretations, APB Opinions, ARBs)
- EITF consensus and FASB staff positions (FSPs)

Some changes have already been made. On November 5, 2002, the AICPA issued a press release saying that it had agreed to focus on industry-specific accounting and auditing guidance (i.e., its Audit and Accounting Guides). According to the *Wall Street Journal*, FASB Chairman Robert Herz announced that AcSEC will “cease issuing statements that create GAAP.”

The AICPA has been completing some of the projects that were in process in 2003. For example, AcSEC completed and issued the SOP 02-2, *Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations and Clarification of the Performance Indicator*. The AICPA transitioned other projects to the FASB.

19.2 TRENDS IN NOT-FOR-PROFIT ACCOUNTING

The balance of this chapter is devoted to discussing some of the reporting and accounting trends that the authors noted in earlier editions of this book and continue to see, with the hope that readers may find these observations useful as they explore ways to strengthen the reporting of organizations with which they are associated.

(a) The Organization as a Reporting Entity

Perhaps the most significant trend is toward reporting on the organization as a whole, and away from reporting on the individual funds of the organization. SFAS 117 and SOP 94-3 have accelerated this trend. For too long, organizations have been reporting on a fund-by-fund basis either in multicolumn format or on separate statements; confusion has resulted for most readers. In the future, the emphasis is placed on reporting on the organization as a single entity. The use of multicolumn, layered, or separate fund-by-fund financial statements is giving way to more reporting on a combined basis where the individual funds making up the entity are no longer separately shown in each financial statement.

This is not to suggest that monitoring the restrictions and limitations placed on resources by outside parties will not continue to be important. Of course it will. However, the use of fund accounting for bookkeeping purposes does not dictate the use of fund accounting for reporting purposes; this is the significance of the trend.

(i) Combining Affiliated Organizations. A related trend is that of requiring more combination of financial information of affiliated organizations for public reporting purposes. The theory here is also that readers should see the “big picture” rather than just a part or a collection of parts. In recent years, the FASB has required business entities to combine more of their affiliates into the parent company’s financial statements. It is reasonable, and desirable, to expect the same for not-for-profit entities. This topic is discussed further in Chapter 7.

(b) Reporting Certain Assets at Current Value

Recent years have seen a trend in accounting for all entities (not just not-for-profit organizations) toward more reporting of assets at current fair value (market value when determinable, and best estimates of fair value where market values are not available), rather than just at historical cost. The FASB issued SFAS 124, *Investments Held by Not-for-Profit Organization*. This standard requires market value accounting for most investments.

(c) Use of a Bottom Line

Another trend is toward reporting an operating measure or “bottom line”—that is, reporting the excess of revenue and support over expenses, or change in net assets. This is not required by SFAS 117. Some not-for-profit organizations have resisted this, believing that there is no significance to the fact or size of such an excess. However, boards and other readers are recognizing with increasing frequency that an important indicator of financial health is the bottom line. The axiom that over time you can’t

spend more than you receive applies to all organizations, including not-for-profit organizations.

Further, many readers find they are able to get a better overall understanding of the organization's financial statements if they first see a clearly labeled bottom line. The bottom line pulls together financial details and helps the reader to focus on the overall results of activities. It is similar in effect to the perspective astronauts achieve when looking at the North American continent from space. Once the overview is comprehended it is much easier to focus on the specifics.

(d) Similarity to Profit-Oriented Reporting

Another related trend is that not-for-profit reporting has become more similar in appearance to reporting by profit-oriented entities. This is not to suggest that there are not transactions unique to not-for-profit organizations; rather, it reflects the fact that readers of financial statements of not-for-profit-oriented entities feel more comfortable—that is, more confident in their interpretive ability—with reporting formats that closely parallel those of profit-oriented entities. As a result, except where unique transactions suggest contrary treatment, the trend is toward profit-oriented reporting.

(e) Emphasis on Functional Reporting

Consistent with SFAS 117 and the earlier accounting pronouncements, reporting for not-for-profit organizations will continue to emphasize program or functional reporting. Not-for-profit organizations exist to perform services, not to pay salaries. Thus, there will be greater emphasis on appropriately reporting the cost of services being rendered. Cost accounting techniques will become a standard tool in not-for-profit accounting.

(f) A Single Set of Accounting Principles for All Not-for-Profit Organizations

With the entry of the FASB and increased awareness on the part of CPAs of the awkwardness of applying different principles to the same transaction for different types of organizations, we are seeing a gradual reconciliation of existing accounting pronouncements and the evolution of a single set of basic underlying accounting principles and reporting practices for all not-for-profit organizations. The statements listed so far in this chapter are part of this trend.

This does not mean that there will be a single reporting format applicable for all nonprofit organizations. This is neither practical nor appropriate, and it can reasonably be expected that there will continue to be

many different reporting formats. But there will be greater uniformity in the basic information disclosed in the statements.

(g) Development of “Industry” Accounting Manuals

The development of a single set of accounting principles does not decrease the need for individual manuals for each of the various types of not-for-profit organizations; rather, it increases the need. Just as the development of accounting principles in the not-for-profit sector was initiated by industry groups, so too it can be expected that the various industry associations of different types of not-for-profit organizations will continue to develop detailed accounting manuals to assist their own membership. Recent examples such as *Museum Accounting Guidelines*, developed for museums, and *Accounting and Financial Reporting Guide for Christian Ministries*, for religious organizations, will be emulated by other industry groups.¹

(h) Uniform State Reporting

As is more fully discussed in Chapter 28, many states have reporting requirements for charitable organizations soliciting funds within their jurisdiction. Unfortunately, the reporting requirements differ from state to state, as have some of the reporting formats that must be used. This constituted a great expense for a national charity that may have had to file different reports in each of the various states. It was also awkward since the accounting principles applicable in one state often differed from those of another state.

As a result of efforts on the part of the Internal Revenue Service, state regulators, charities, the accounting profession, and others, starting in 1982, almost all the states agreed to accept a copy of IRS Form 990 in satisfaction of the basic financial statement reporting requirements. Most states require additional schedules and some an auditor’s opinion; but using a single set of financial statements is a cost saving for national charities.

(i) Unified Chart of Accounts

Related to, and partly driven by, the preceding trend is the development of a unified reporting framework for not-for-profit organizations. The unified reporting framework fulfills the varied reporting requirements under GAAP; rules promulgated by federal and state government oversight agencies; various funding entities such as numerous federal, state,

¹ Interested readers may order a copy of the *Accounting and Financial Reporting Guide for Christian Ministries* at <http://www.cccc.org/>.

and private grant makers; United Way and other private funders; and others who require or request financial information from not-for-profits. The idea is to reduce the administrative burden on organizations of providing financial information to their various constituents.

In fall 2000, *Unified Financial Reporting System for Not-for-Profit Organizations—A Comprehensive Guide to Unifying GAAP, IRS Form 990, and Other Financial Reports Using a Unified Chart of Accounts* by Sumariwalla and Levis (San Francisco: Jossey-Bass, 2000) was published to help organizations meet their obligations in this area. It includes the chart of accounts itself, together with guidance for using it to design a system to prepare the various internal and external financial reports. It also includes a discussion of the reporting process and the various different reporting methods in common use, guidance in preparing IRS Form 990, discussion of expense allocation procedures, sample recordkeeping and reporting forms, and other helpful information. There is, of course, no requirement to use the unified chart of accounts. It is just another tool available to assist in the process of accountability.

(j) Federal Reporting Requirements

As discussed in Chapter 28, present federal reporting requirements relate to filing information with the IRS to enable it to determine the tax status of activities of not-for-profit organizations and for federal granting agencies to determine compliance with the terms of grants. With the increased emphasis on full disclosure and accountability in recent years and an occasional newspaper headline about a charity that has abused its public trust, legislation has been introduced at various times in Congress which would, if adopted, require additional reporting by charitable organizations soliciting funds from the public. The legislation proposed has fallen basically into two alternative categories: regulatory and disclosure. Since each is distinctively different they are discussed separately below.

(i) Regulatory-Type Legislation. The regulatory-type legislation basically provides for filing financial statements and other information with a regulatory body to allow that body to determine the organization's conformity to certain standards established either by the legislation or by the regulatory body. Typically, the regulatory body is given authority to discipline the organization if transgressions occur that are deemed to be not in the public interest. The financial statements filed with the regulatory agency are usually open for public inspection, although often only at the offices of either the charity or the regulatory agency, with the result that they are not easily available to many people. Congress recently required not-for-profits to send a copy of their IRS reporting form (Form 990) to anyone who requests it.

(ii) **Disclosure-Type Legislation.** This alternative type of legislation basically provides that certain information be disclosed on the face of all fundraising literature, including a statement that financial statements will be sent directly to the contributor upon request. Typically such legislation does not require the routine filing of a financial statement with a regulatory body, or the passing of judgment on these statements or on the charity by a regulatory body. The presumption is that, with access to financial information, the contributor can make a wiser decision than a regulatory body on which charity to support. As can be seen, these two approaches are quite different. In the one, the presumption is that a regulatory body can better make the judgment as to the worthiness of an organization. In the other, the presumption is that the contributor can make the better judgment.

The authors believe that the disclosure approach would eliminate 95 percent of the credibility problems currently experienced by charitable organizations simply because charities will know that their financial affairs will routinely become public. Few will abuse public trust if they know with certainty they will be found out. In addition, the authors endorse recognition of the individual contributor, equipped with adequate information, as the best arbiter of worthiness among organizations competing for funds. The authors expect that in the current Sarbanes–Oxley-Act-driven environment, both federal and state lawmakers are paying close attention to charitable organizations and their reporting practices, and that legislation is being passed in several states to regulate it.

19.3 NEW FASB STATEMENTS OF FINANCIAL ACCOUNTING STANDARDS THAT AFFECT NOT-FOR-PROFIT ORGANIZATIONS

The FASB has issued six new standards since April 2002:

- SFAS 145, *Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections*. SFAS 145 was issued in April 2002. It rescinds SFAS 4, *Reporting Gains and Losses from Extinguishment of Debt*, SFAS 64, *Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements* (SFAS 64 had amended SFAS 4), and SFAS *Accounting for the Intangible Assets of Motor Carriers*. Among other amendments, SFAS 145 amends SFAS 13, *Accounting for Leases*.

In rescinding SFAS 4 and 64, SFAS 145 eliminates the requirement that gains and losses from the extinguishment of debt be aggregated and, if material, classified as an extraordinary item, net of the related income tax effect. However, pursuant to SFAS 145, an entity would not be prohibited from classifying such gains and losses as

extraordinary items, provided they meet the criteria in paragraph 20 of APB Opinion No. 30 (APB 30), *Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions*.

Further, SFAS 145 amends paragraph 14(a) of SFAS 13, *Accounting for Leases*, to eliminate an inconsistency between the accounting for sale-leaseback transactions and certain lease modifications that have economic effects that are similar to sale-leaseback transactions. The amendment requires that a lease modification: (1) result in recognition of a gain or loss in the financial statements; (2) be subject to SFAS 66, *Accounting for Sales of Real Estate*, if the leased asset is real estate (including integral equipment); and (3) be subject (in its entirety) to the sale-leaseback rules of SFAS 98, *Accounting for Leases: Sale-Leaseback Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases*.

Also, SFAS 145 makes several other technical corrections to existing pronouncements that may change accounting practice. Generally, SFAS 145 is effective for transactions occurring after May 15, 2002.

This pronouncement may affect not-for-profit organizations that have included extraordinary gains and losses from extinguishment of debt in the Statement of Activities. Pursuant to SFAS 145, such previously reported extraordinary gains or losses would need to be reclassified to the nonoperating section on the Statement of Activities for organizations that have a measure of operations. The amendment to SFAS 13 is not anticipated to affect not-for-profit organizations, as sale-leaseback transactions are rare in the nonprofit sector.

- SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*. SFAS 146 was issued in June 2002. It addresses significant issues relating to the recognition, measurement, and reporting of costs associated with exit and disposal activities, including restructuring activities, and nullifies the guidance in Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*.

SFAS 146 applies to costs associated with an exit or disposal activity of a business enterprise or a not-for-profit organization. SFAS 146 does not apply to: (1) costs associated with the restructuring of an entity newly acquired in a business combination, which will continue to be accounted for under EITF Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination*; (2) termination benefits that are provided to employees under

the terms of an ongoing benefit arrangement (or enhancements to an ongoing benefit arrangement) or an individual deferred compensation contract covered by other accounting pronouncements; (3) costs to terminate a capital lease that continue to be accounted for in accordance with SFAS 13, *Accounting for Leases*; or (4) a disposal activity covered by SFAS 144. SFAS 146 does the following:

- It requires that the initial liability for costs associated with exit and disposal activities be measured at fair value.
- It prohibits the recognition of a liability based solely on an entity's commitment to a plan, which, in turn, nullifies EITF Issue 94-3.
- It requires that the liability for costs associated with exit and disposal activities be evaluated each reporting period and subsequent changes in the fair value of the liability be measured using an interest allocation approach.
- It provides a definition of a one-time benefit arrangement that is more stringent than in EITF Issue 94-3.
- It provides a model for the accounting for one-time termination benefits. This model is based on whether the benefit arrangement requires employees to render future service (as defined in SFAS 146) beyond a minimum retention period after the communication date.
- It requires establishing a liability for costs to terminate an operating lease or other contract. The following two items should be included in the liability measured at fair value: (1) costs to terminate a contract before the end of its term when the entity terminates the contract in accordance with the contract terms; and (2) costs that will continue to be incurred under the contract for its remaining term without economic benefit when the entity ceases using the rights conveyed by the contract.
- It nullifies EITF Issue No. 88-10, *Costs Associated with Lease Modification or Termination*. It does so by requiring that the fair value of the liability for costs associated with an operating lease that is not terminated be measured at the "cease-use" date based on the remaining lease rentals, reduced by the estimated sublease rentals that could be reasonably obtained for the property (even if there is no intent to sublease).
- It requires that all other costs associated with an exit or disposal activity be expensed as incurred, even if those costs are incremental to other operating costs and will be incurred as a direct result of the plan.

The provisions of SFAS 146 are effective for exit or disposal activities initiated after December 31, 2002. Earlier application is encouraged. Retroactive application of SFAS 146 is prohibited and, accordingly, liabilities recognized prior to the initial application of SFAS 146 should continue to be accounted for in accordance with EITF Issue 94-3 or other applicable preexisting guidance.

SFAS 146 will affect not-for-profit organizations that engage in activities to exit or dispose of any activity. One example may be a university's decision to discontinue its distance learning program. This pronouncement also will pertain to employees who are involuntarily terminated.

- SFAS 147, *Acquisitions of Certain Financial Institutions*—an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9. SFAS 147 was issued in October 2002. It is not likely to affect not-for-profit organizations.
- SFAS 148, *Accounting for Stock-Based Compensation—Transition and Disclosure*—an amendment of FASB Statement No. 123. SFAS 148 was issued in December 2002. It is not likely to affect not-for-profit organizations.
- SFAS 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. SFAS 149 was issued in April 2003. We briefly discuss FASB No. 149 in Chapter 8.
- SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. SFAS 150 was issued in May 2003. It establishes standards about how organizations should classify and measure certain financial instruments with characteristics of both liabilities and equity.

19.4 OTHER FASB PRONOUNCEMENTS AND PROJECTS

(a) FIN 45

In November 2002, FASB issued FASB Interpretation No. 45 (FIN 45), *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, an Interpretation of FASB Statements No. 5, 57, and 107 and Rescission of FASB Interpretation No. 34*. It relates to the accounting for and disclosure of guarantees and addresses: (1) an obligation to stand ready to perform over the term of the guarantee in the event that the specified triggering events or conditions occur; and (2) a contingent obligation to make future payments if those triggering events or conditions occur.

FIN 45 elaborates on the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees that it

has issued. It also clarifies that a guarantor is required to recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. FIN 45 does not prescribe a specific approach for subsequently measuring the guarantor's recognized liability over the term of the related guarantee. This Interpretation also incorporates, without change, the guidance in FIN 34, *Disclosure of Indirect Guarantees of Indebtedness of Others*, which is being superseded.

FIN 45 requires that upon issuance of a guarantee, the entity (i.e., the guarantor) must recognize a liability for the fair value of the obligation it assumes under that guarantee. Many guarantees are embedded in purchase or sales agreements, service contracts, joint venture agreements, or other commercial agreements and the guarantor in many such arrangements does not receive a separately identifiable upfront payment for issuing the guarantee. FIN 45 requires identical accounting for guarantees issued with or without a separately identified premium.

The provisions related to recognizing a liability at inception for the fair value of the guarantor's obligation do not apply to the following:

- Product warranties
- Guarantees that are accounted for as derivatives
- Guarantees that represent contingent consideration in a business combination
- Guarantees for which the guarantor's obligations would be reported as an equity item (rather than a liability)
- An original lessee's guarantee of lease payments when that lessee remains secondarily liable under a conjunction with being relieved from being the primary obligor (i.e., the principal debtor) under a lease restructuring
- Guarantees issued between either parents and their subsidiaries or corporations under common control
- A parent's guarantee of a subsidiary's debt to a third party, and a subsidiary's guarantee of the debt owed to a third party, either by its parent or another subsidiary of that parent

However, the guarantees described in items (a) through (g) of FIN 45 are subject to the disclosure requirements of this interpretation.

The initial recognition and initial measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor's fiscal year-end. The disclosure requirements in this Interpretation are effective for financial statements of annual periods ending after December 15, 2002. The interpretative guidance incorporated without change from FIN 34 continues

to be required for financial statements for fiscal years ending after June 15, 1981—the effective date of FIN 34.

FIN 45 may not affect many not-for-profit organizations because the literature specifically excludes certain transactions that are prevalent in the nonprofit sector. These transactions are related to guarantees issued between parents and subsidiaries, and a parent's guarantee of a subsidiary's debt (items (f) and (g) of FIN 45). These transactions would be scoped out of FIN 45. One exception would be not-for-profit organizations that guarantee loans. These organizations would be required to adhere to FIN 45 for those transactions.

Even though we believe that the provisions of FIN 45 will not affect many not-for-profit organizations, it is important to thoroughly review FIN 45 to help ensure that all guarantees included in the literature are properly accounted for and disclosed in the annual financial statements.

(b) FIN 46

The FASB published its Interpretation No. 46, *Consolidation of Variable Interest Entities*, in January 2003. It interprets ARB Opinion No. 51, *Consolidated Financial Statements*, to address consolidation by business enterprises of variable interest entities. FIN 46 contains the following scope exception:

Not-for-profit organizations subject to the consolidation requirements of AICPA Statement of Position (SOP) 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, are not subject to this Interpretation, except that they may be related parties for purposes of applying paragraphs 16 and 17 of this Interpretation. In addition, if a not-for-profit entity is used by business enterprises in a manner similar to a variable interest entity in an effort to circumvent the provisions of this Interpretation, that not-for-profit entity shall be subject to this Interpretation.

The lack of clarity of this guidance raised several implementation issues for not-for-profit entities.

The FASB issued a Final Staff Opinion (FSP) 46-7 in late November 2003.² Among its conclusions, the FASB modified FIN 46, *Consolidation of Variable Interest Entities*, to clarify that the scope exception provided in paragraph 4(a) of FIN 46 applies to all entities that meet the definition of not-for-profit organizations in SFAS 117, *Financial Statements of Not-for-Profit Organizations*, which includes not-for-profit health care organizations.

(c) EITF Issue 01-8, Determining Whether an Arrangement Is a Lease

At its May 15, 2003, meeting, an EITF Task Force reached consensus on guidance to use when determining whether an arrangement should be considered a lease subject to the requirements of SFAS 13, *Accounting for*

² Beginning in 2003, the FASB introduced the FASB Staff Position (FSP) to issue application guidance.

19.5 CONCLUSION

Leases. Under the EITF's agreed-upon model, purchasers (lessees) should consider the facts and circumstances of the arrangement, including whether the purchaser (lessee) has the ability to operate the *property, plant and equipment* (PP&E), control physical access to the PP&E, or take substantially all of the output of the PP&E. The detailed conclusions that the EITF Task Force reached can be found in the minutes of the May 15 meeting. The conclusions are generally applied.

(d) Pension Plans

In December 2003, the FASB issued a revised SFAS 132, *Employers' Disclosures about Pensions and Other Postretirement Benefits, an Amendment of FASB Statements No. 87, 88 and 106*. As revised, SFAS 132 does not change the measurement or the recognition of such plans. It also retains the disclosure provisions of the unrevised SFAS 132. However, this revised statement requires additional disclosures, including information about the types of plan assets, investment strategy, measurement date(s), plan obligations, cash flows, and components of net periodic benefit cost recognized during interim periods. The revised statement also retains reduced disclosure requirements for nonpublic entities, including not-for-profit organizations.

19.5 CONCLUSION

With the introduction of the Financial Accounting Standards Board into the not-for-profit accounting sector, and with increased attention directed at all of our public institutions, it appears that financial reporting by not-for-profit organizations is bound to undergo increasing scrutiny. Perhaps foremost among the changes that have emerged recently is a reassessment of the appropriateness of different accounting treatments for the same transaction by different types of organizations. This trend toward greater openness and accountability is desirable and will continue in the coming years. Financial statements will increasingly report on the organization as a whole rather than on a fund-by-fund basis. Our not-for-profit institutions will increasingly find themselves in the "sunshine" environment of the post-Sarbanes-Oxley era, and will increasingly recognize their responsibility to provide the public with meaningful financial information.

P A R T F O U R

**Controlling the Not-for-Profit
Organization**

CHAPTER TWENTY

The Importance of Budgeting

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A budget, like motherhood, is something very few would argue against. Yet, the art of preparing *and using* budgets in a meaningful manner is completely foreign to many not-for-profit organizations. It is not that the treasurer or board is unaware of their importance, but more that they are uncertain of their skills in budgeting techniques, and often are reluctant to use a budget as a tool to *control* the financial activities. This chapter discusses the *importance* of budgeting, preparing a useful budget, and equally important, *using* the budget to control.

20.1 THE BUDGET: A PLAN OF ACTION

A budget is a plan of action. It represents the organization's blueprint for the coming months, or years, expressed in monetary terms. This means the organization must have specific goals before it can prepare a budget. If it does not know where it is going, it is going to be very difficult for the

THE IMPORTANCE OF BUDGETING

organization to do any meaningful planning. All too often the process is reversed and it is in the process of preparing the budget that the goals are determined.

The first function of a budget is to record, in monetary terms, what the realistic goals or objectives of the organization are for the coming year (or years). The budget is the financial plan of action that results from the board's decisions as to the program for the future. The second function of a budget is to provide a tool to monitor the financial activities throughout the year. Properly used, the budget can provide a benchmark or comparison point that will be an early warning to the board that their financial goals may not be met. For a budget to provide this type of information and control, four elements must be present;

1. The budget must be well-conceived and have been prepared or approved by the board.
2. The budget must be broken down into periods corresponding to the periodic financial statements.
3. Financial statements must be prepared on a timely basis throughout the year and a comparison made to the budget with explanations of significant deviations (or lack of deviation where one might be expected).
4. The board must be prepared to take action where the comparison in Step 3 indicates a problem.

Each of these four elements are discussed in this chapter.

(a) Steps for Preparation

A budget should represent the end result of a periodic review by the board or by the membership of the organization's objectives or goals, expressed in monetary terms. Often the budget process is a routine "chore" handled by the treasurer to satisfy the board that the organization has a budget, which the board, in turn, routinely ratifies. Frequently, such budgets are not looked at again until the following year, when the next year's budget is prepared. This type of budgeting serves little purpose. A budget, to be effective, must be a joint effort of many people. It must be a working document that forms the basis for action. Here are the basic steps that, in one form or another, should be followed by an organization to prepare a well-conceived budget:

1. A list of objectives or goals of the organization for the following year should be prepared. For many organizations, this process will be essentially a reevaluation of the relative priority of the existing programs. Care should be taken, however, to avoid concluding too hastily that an existing program should continue unchanged. Our society

is not static and the organization that does not constantly reevaluate and update its programs is in danger of being left behind.

2. The cost of each objective or goal listed should be estimated. For continuing programs, the actual expense and budget for the previous year, as well as the current year's budget and estimated actual expenses, will be a helpful starting point in estimating this cost.¹ For new programs or modifications of existing programs, a substantial amount of work may be necessary to accurately estimate the costs involved. This estimating process should be done in detail because elements of a particular goal or objective may involve many categories of salaries and other expenses. Input from the operating staff of the organization is necessary for this step.
3. The expected income of the organization should be estimated. With many organizations, contributions from members or the general public will be a principal source of income and careful consideration must be given to the expected economic climate in the community. A year when unemployment is high or the stock market is down is a poor year to expect increased contributions. With other organizations, the amount of income will be dependent on how successful they are in selling their program. Possibly some of the programs can be expanded if they are financially viable, or contracted if they are not. Organizations are often overly optimistic in estimating income. This can prove to be the organization's downfall if there is no margin for error; realism must be used or the budget will have little meaning. The persons preparing a budget should *never* "plug" a predicted deficit by assuming that contributions will somehow be found to cover the shortfall. This is a certain recipe for financial disaster.
4. The total expected income should be compared to the expense of achieving the objectives or goals. At this point in the process, usually the expected expenses will exceed income, and this is where some value judgments will have to take place. What programs are most important? What expected costs can be reduced? Can some additional income be found? This process of reconciling expected income and expenses is probably the most important step taken during the year because it is here that the program's blueprint for the coming year is fixed. It is important that consideration be given to the reliability of the estimated income and expense figures. Is it possible that expenses have been underestimated or that income

¹ Note that the expenses for the current year are described as "estimated actual." This is because the preparation of the budget for the next year should be taking place well before the end of the current year—before the current year's final actual data is known.

has been overestimated? If expenses have been underestimated by 15 percent and income has been overestimated by 10 percent, there will be a deficit of 25 percent, and unless the organization has substantial available liquid reserves it will likely be in serious difficulty before the year is out. If the organization has small cash reserves or has little likelihood of getting additional resources quickly, then a realistic safety margin should be built into the budget.

5. The final proposed budget should be submitted to the appropriate body for ratification. This may be the finance committee of the board, the full board or it may be the entire membership. This should not be just a formality but should be carefully presented to the ratifying body so that, once ratified, all persons will be firmly committed to the resulting plan of action.

The steps listed may seem so elementary that there is no need to emphasize them here. But elementary as they are, they are often not followed and the resulting budget is of very little value to the organization.

(b) Levels of Reserves

Step 4 in (a) Steps for Preparation referred to cash or liquid reserves. What is the appropriate level of liquid reserves to maintain? Most people understand the need to be able to respond to an unexpected, or expected, downturn in the organization's financial situation, or for an unanticipated, or anticipated, opportunity to expand services. However, there is little guidance available about how large such reserves should be. Although it would be nice to have enough in the bank to cover any possible problem or opportunity, this is rarely possible—and it is not necessarily desirable. Every dollar held back in reserve is a dollar that is not being used to provide program services to the organization's constituency. If no amounts were held back, more meals could be served to the homeless, more concerts given by the orchestra, more work done to find a cure for cancer—at least in the short run. Without reserves, however, the organization might not survive for the long run, and then there will eventually be no meals, concerts, or cancer research. Somewhere in between is the happy medium, but where? Reserve levels are a matter of judgment. The following factors should be considered in making that judgment for a particular organization.

- How predictable are the organization's revenues? How likely is it that there might be a sudden and significant shortfall that could hurt the organization's ability to continue its programs?
- How predictable are the organization's expenses? How likely is it that there might be a sudden and significant need to spend resources beyond those planned for in the budget? Such a need

could result from either an unexpected increase in the cost of doing what has been planned (such as a wage increase won by a labor union, or an increase in the price of some commodity purchased); from the need to respond to a natural or man-made disaster such as a fire, flood, or earthquake; or from an unexpected opportunity to meet a new community need by expanding the organization's program activities into new areas.

- If one (or both) of the preceding two scenarios occurs, how certain are management and the board of their ability to tap new or increased sources of financial resources quickly? Are there existing donors who would readily respond to an emergency appeal for support? Are there other donors, maybe a local foundation, a United Way, or a governmental unit, who would help? Could revenues from sales of goods or services (if such exists) be rapidly expanded? Would creditors be willing to postpone debt payments? Are there other assets that could be sold for cash on short notice? Are there lenders (either individual or commercial) who would make a loan to the organization? Does the organization already have an available line of credit with its bank? (If not, why not?)
- Could planned expenditures be reduced or deferred, at least for a while, without long-term harm to the organization's programs? Many not-for-profits are quite labor-intensive. Payroll expenses are often not easy to reduce, and payroll taxes have to be paid timely to the government.
- How risk averse is the organization's management? How willing is it to "run close to the edge" and count on its ability to deal with problems or opportunities as they arise without having much in the way of ready reserves to draw on? None of this has directly answered the question of reserve size. Unfortunately, there is no answer that works for all organizations all of the time. Each organization has to make its own determination based on its own circumstances. Some people use as a rule of thumb somewhere between three and six months' expenditures as a desirable reserve level. Consider *all aspects* of your particular situation before making this determination.

An example of an organization that must be prepared to respond very quickly to large, unpredictable demands on its resources is the American Red Cross. When disaster strikes, they must be ready to help—immediately. They cannot sit back and wait, and then go out and raise some extra money after the disaster happens. Thus, for them a desirable level of reserves is much larger (perhaps as much as two years' normal budget) than for most organizations. Donors can be presumed to understand this, and not be reluctant to contribute.

Similarly, a museum that wishes to be able to acquire new items for its collection must have the financial resources available when the opportunity arises. If a desirable painting is coming up at auction next week, and the museum cannot afford to bid on the painting, it will be unable to acquire it for the collection.

In contrast, a local day-care center, with very predictable expenses and a long-term contract for funding from a reliable revenue source, does not normally need as much in the way of reserves. Once the decision is made regarding the desired size, the actual reserve can be handled in several different ways. One way is to do nothing beyond monitoring the level of unrestricted net assets for conformity with the established reserve level. Some organizations like to place an amount of cash or other liquid assets equal to the reserve amount in a separate bank or investment account. This may serve as a form of self-discipline by making it less easy to spend the reserve assets. A more formal procedure is to have the board vote to designate an amount of the unrestricted net assets as an operating reserve on the balance sheet.

A final question that sometimes comes up is whether there is some upper level of reserves which, if exceeded, will attract unwelcome attention from the Internal Revenue Service. The answer is almost always, no. The tax laws tell the IRS to be concerned with how an organization uses its resources to further its tax-exempt purpose, but do not mention any limits on how much the organization may accumulate (unless you are a "private foundation", which is further discussed in the tax chapter). Some major universities and foundations have assets in the billions of dollars, without raising any concern. The point is that these organizations are using these assets, in many cases to generate annual income which is used for the organizations' purposes. Only if an organization were not using the investment income from its assets, or were holding large amounts of non-income-producing and otherwise unused assets, would the IRS ask questions about reserve levels.

Questions about apparently high levels of reserves are far more likely to come from those who support the organization financially: donors, members, students, or others. A donor who is asked to contribute to an organization that appears to already have sufficient resources for its needs might ask why further contributions are still being sought. Members may question dues levels; students may ask why tuition is so high. Organizations must be prepared to respond to such questions in a way that will convince the questioner that there is truly a need for additional resources.

(c) Responsibility for Budget Preparation

The next concern is who should follow these steps in preparing the budget? The preparation of a budget involves policy decisions. The treasurer

20.2 MONTHLY AND QUARTERLY BUDGETS

may be the person best qualified to handle the figures, but is usually not the person to make policy decisions. For this reason, a “budget committee” should consist of persons responsible for policy decisions. Usually this means that either the board should itself act as the budget committee, or it should appoint a committee of board members to do so. The treasurer may be a member of this committee, but generally speaking, members of management should not be voting members of board committees.

This does not mean that the detailed estimated cost studies and revenue estimates for various activities cannot be delegated to staff members. In fact, they normally should be. The final decisions, however, as to what are the goals and their relative priority has to be a board-level function. Take, for example, a private independent school. At first glance, there might not appear to be many board-level decisions to make. The purpose of a school is to teach, and it might seem that the budget would be a most routine matter. There are, nevertheless, many decisions that have to be made—for example:

- Should more emphasis be placed on science courses?
- Should the school purchase more sophisticated equipment to help teach computer science?
- Should the school hire a foreign language teacher for grades 2–4?
- Should the school increase salaries in the coming year and try to upgrade the staff?
- Should the athletic field be resodded this year?
- Should a professional fundraiser be hired?
- Should the extracurricular music program be expanded?
- Must tuition be increased? If so, how much?

These questions and many more face the board. Undoubtedly they may rely on the paid staff to make recommendations, but the board is responsible for policy and the budget represents “policy.” This responsibility cannot be delegated.

20.2 MONTHLY AND QUARTERLY BUDGETS

After the organization has prepared an annual budget, the budget must be divided into meaningful segments that can be compared to interim financial statements prepared on a monthly or quarterly basis. Some organizations attempt to do this by dividing the total budget by 12 and showing the resulting amounts as a monthly budget, which is then compared to actual monthly income and expenses. While this is better than not making any budget comparison, it can produce misleading results when the income or expenses do not occur on a uniform basis throughout

THE IMPORTANCE OF BUDGETING

the year, as is usually the case. Consider the following abbreviated statement of a small church:

	Annual Budget	Three Months Ending March 31	
		Annual Budget ÷ 4	Actual
Contributions	\$ 120,000	\$ 30,000	\$ 35,000
Less Expenses	(120,000)	(30,000)	(30,000)
Excess	—	—	\$ 5,000

The logical conclusion that might be drawn is that the church will have a surplus at the end of 12 months of approximately \$20,000: four times the quarterly excess of \$5,000. If this conclusion were reached, the temptation would be to slacken off on unpaid pledge collection efforts and to be a little less careful in making purchases. This would be a very serious mistake if, in fact, the normal pattern of pledge collections were such that \$40,000 should have been collected in the first quarter instead of the \$35,000 actually received. A monthly or quarterly budget can produce misleading conclusions unless considerable care is taken in preparing it.

(a) Allocating an Annual Budget to Monthly or Quarterly Periods

One of the best and easiest ways to allocate an annual budget into shorter periods is to first analyze the actual income and expense for the prior year, and then allocate this year's budget based on last year's actual expenses.

To illustrate, assume the church's income last year was \$100,000 but is expected to be \$120,000 this year. A budget for the new year could be prepared as follows:

	Actual Last Year	Percent of Last Year's Total	New Budget
Income:			
First quarter	\$ 30,000	30%	\$ 36,000
Second quarter	25,000	25%	30,000
Third quarter	25,000	25%	30,000
Fourth quarter	20,000	20%	24,000
	\$100,000	100%	\$120,000

In this illustration, we have assumed that the increase in income of \$20,000 will be received in the same pattern as the prior year's income was received. If this assumption is not correct, then an adjustment must

20.2 MONTHLY AND QUARTERLY BUDGETS

be made for the anticipated income that will depart from past experience. For example, if it is anticipated that a single gift of \$10,000 will be received in the first quarter and the other \$10,000 will be received in about the same pattern as last year's income, the calculations to arrive at a new budget would be somewhat different, as shown:

	Actual Last Year	Percent of Last Year's Total	New Budget Other Than Special	Special Gifts	Total Budget
First quarter	\$ 30,000	30%	\$ 33,000	\$10,000	\$ 43,000
Second quarter	25,000	25%	27,500	—	27,500
Third quarter	25,000	25%	27,500	—	27,500
Fourth quarter	20,000	20%	22,000	—	27,500
	<u>\$100,000</u>	<u>100%</u>	<u>\$110,000</u>	<u>\$10,000</u>	<u>\$120,000</u>

If at the end of the first quarter, income of only \$35,000 had been received compared to a budget of \$43,000, it would be apparent that steps should be taken to increase contributions or the church will fall short of meeting its budget for the year.

The expense side of the budget should be handled in the same way. Generally, expenses tend to occur at a more uniform rate, although it really depends on the nature of the organization. In many ways the expense side of the budget is more important than the income side since it may be easier to control how and when costs are incurred than to raise additional contributions. If the budget is regularly compared to actual expenditures for deviations, it can be an effective tool to highlight unbudgeted expenditures.

The more frequently year-to-date actual information is compared with the budget for the same period, the better able management and the board will be to respond to changing circumstances before small problems become big ones. If possible, the budget, and actual data, should be prepared on a monthly basis. If this proves to be too cumbersome, consideration could be given to quarterly or bimonthly budgets and statements. However, if the organization's cash position is tight, monthly statements become almost a necessity.

(b) Illustrative Expense Budget

The Valley Country Club is a good example of an organization that has to be very careful to budget its income and expenses. While the club has a beautiful clubhouse and a fine golf course, most of its resources are tied up in these fixed assets and there is no spare cash to cover a deficit.

Accordingly, each fall when the board starts to wrestle with the budget for the following year, it is aware that it cannot afford the luxury of a deficit. Because the budget is so important, the entire board may decide to sit as a budget committee to work out the plans for the following year. The club manager, with the help of the treasurer, prepares a worksheet in advance of the budget meeting. This worksheet indicates the actual expenses for the current year to date, the estimate of the final figures for the year, and the current year's budget to show how close the club will come. The board through discussion and debate attempts to work out a budget for the coming year. Exhibit 20.1 shows the worksheet for the expense budget.

In looking at this worksheet, notice first that the expenses are grouped by major function so that the board can focus attention on the activities of the club. The alternative presentation would have been to list expenses by type—salaries, supplies, food—but this does not tell the board how much each of the major activities is costing. Knowledge of the cost of each activity is needed to know whether the club is making or losing money on them, so that intelligent decisions can be made about levels of charges to be assessed to members for participation. There are three columns for the proposed budget: the minimum, the maximum, and the final amount. As the board considers each item, it records both the minimum and the maximum it feels is appropriate. No attempt is made at the beginning to fix a "final" budget amount. Instead, all budget items are considered, listed as to the minimum and maximum cost, and totals arrived at. It is only after all items have been considered, and only after a preliminary review of potential income has been made, that the board is in a position to make judgments. After the board has completed this worksheet showing final figures for the year, the next step is to break down the budget into monthly pieces. As with many organizations, the Valley Country Club's expenses (and income) are seasonal. In this case, the budget is broken down into monthly segments assuming that the expenses will be incurred in the same pattern as expected for the current year, in the manner discussed earlier.

20.3 TIMELY INTERIM STATEMENTS

The most carefully thought-out budget will be of little value if it is not compared throughout the year with the actual results of operations. This means that the interim financial statements must be prepared on a timely basis.

What is timely? This depends on the organization and how much "slippage" or deviation from budget the organization can be afforded before serious consequences take place. If the cash balance is very low, an organization cannot afford the luxury of not knowing where it stands on

EXHIBIT 20.1

Worksheet Used in Preparing an Expense Budget for a Country Club

THE VALLEY COUNTRY CLUB									
WORKSHEET FOR PREPARING 20X1 EXPENSE BUDGET									
(IN THOUSANDS)									
	Actual Current Year			Budget Current Year			Budget for New Year		
	To Date (10 Months)	Estimate Balance of Year	Estimate for Year	Budget Current Year	Proposed Minimum	Proposed Maximum	Proposed Minimum	Proposed Maximum	Final
Maintenance of greens and grounds:									
Salaries and wages	\$ 47	\$ 3	\$ 50	\$ 46	\$ 50	\$ 65	\$ 50	\$ 65	\$ 55
Seeds, fertilizer, and supplies	14		14	13	14	14	14	14	14
Repairs, maintenance, and other	12	2	14	10	10	15	10	15	15
Maintenance of clubhouse:									
Salaries and wages	20	4	24	23	24	28	24	28	26
Supplies, maintenance, and repair	10	1	11	12	11	11	11	11	11
Golf activities:									
Salaries and wages	10		10	11	12	20	12	20	20
Tournament costs	14		14	15	15	15	15	15	15
Golf cart maintenance	8		8	5	5	5	5	5	5

THE VALLEY COUNTRY CLUB
WORKSHEET FOR PREPARING 20X1 EXPENSE BUDGET
 (IN THOUSANDS)

	Actual Current Year		Budget Current Year	Budget for New Year		
	To Date (10 Months)	Estimate Balance of Year		Estimate for Year	Proposed Minimum	Proposed Maximum
Swimming pool expenses:						
Salaries and wages	4	4	4	5	10	5
Supplies and maintenance	2	2	1	2	2	2
General and administrative salaries	35	6	41	44	51	44
Property taxes	33	7	40	42	42	42
Other expenses	<u>41</u>	<u>7</u>	<u>48</u>	<u>40</u>	<u>50</u>	<u>50</u>
Total, excluding restaurant	<u>250</u>	<u>30</u>	<u>280</u>	<u>274</u>	<u>328</u>	<u>304</u>
Restaurant expenses:						
Food and beverages	96	13	109	110	150	130
Salaries and wages:						
Kitchen	32	6	38	45	60	50
Dining room	20	4	24	26	39	32
Bartender	11	2	13	14	19	16
Supplies, repairs, and maintenance	13	4	17	15	25	18
Total restaurant	<u>172</u>	<u>29</u>	<u>201</u>	<u>210</u>	<u>293</u>	<u>246</u>
Total Expenses	<u>\$422</u>	<u>\$59</u>	<u>\$481</u>	<u>\$484</u>	<u>\$621</u>	<u>\$550</u>

a very timely basis. Guidelines are dangerous, but if an organization is unable to produce some form of abbreviated monthly or quarterly financial statement within 20 days of the end of the period, the likelihood is that the information is “stale” by the time it is received by those who depend on it for decision-making. If 20 days is the length of time it takes, then the board should plan to meet shortly after the 20th of the month so as to be able to act on deviations while there is still time to act. This is not to suggest that monthly financial statements are always necessary for all not-for-profit organizations. However, even if prepared on a bimonthly or quarterly basis, they should still be prepared on a timely basis.

(a) Importance of Budget Comparison

The internal financial statement should also show the budget, and for the same period of time. Interim figures for the three months cannot easily be compared to budget figures for 12 months. The budget must also be for three months. Last year’s actual figures for the same period, and the current full-year’s budget, may also be shown if that is considered helpful. However, the more information a reader of a financial report has to absorb, the greater the chance that added information could detract from rather than help the reader’s understanding of the information presented.

Exhibit 20.2 shows the Valley Country Club Statement of Income and Expenses for both the month of June and for the six months, with budget comparisons to highlight deviations from the budget. This financial statement gives the reader a great deal of information about the club’s activities for the two periods. It should have the effect of alerting the reader to the fact that unless something happens, there may be a deficit for the year. Instead of having a small excess for June, there was a deficit of \$6,240, and instead of having an excess of \$7,500 for the six months, there was a deficit of almost \$5,000. The board member reading the statement should be concerned about these deviations from the budget. This form of presentation makes it easy to see deviations. Unfavorable deviations can be quickly pinpointed and the reasons for them can be explored to determine the action that must be taken to “make up” (if possible) for their effects and to prevent their recurrence.

Notice that both the current month and the year-to-date figures are shown on this statement. Both are important. The monthly figures give a current picture of what is happening, which cannot be learned from the six-month figures. If only the six-month figures were shown, the reader would have to refer to the previous month’s statements showing the first five months to see what happened in June. Likewise, to show only the month, with no year-to-date figures, puts a burden on the reader. Some calculating using previous monthly statements would be required to get a

EXHIBIT 20.2

Statement of Income and Expenses, Showing a Comparison with Budget

		6 Months		
		Month		Deviation Favorable (Unfavorable)
	Actual	Budget	Actual	Budget
VALLEY COUNTRY CLUB				
STATEMENT OF INCOME AND EXPENSES, AND COMPARISON WITH BUDGET				
FOR THE MONTH OF JUNE AND THE 6 MONTHS ENDED JUNE 30, 20X1				
			Actual	Budget
			Deviation Favorable (Unfavorable)	Deviation Favorable (Unfavorable)
Income:				
Annual dues	\$ 15,650	\$ 17,000	\$ 81,900	\$ 90,000
Initiation fees	2,100	2,000	6,600	4,500
Greens fees	4,750	4,000	11,000	8,000
Swimming	3,300	3,000	2,300	2,000
Other	6,710	8,000	18,250	14,000
	<u>32,510</u>	<u>34,000</u>	<u>120,050</u>	<u>118,500</u>
Total, excluding restaurant	37,850	34,000	168,500	180,000
Restaurant	<u>70,360</u>	<u>68,000</u>	<u>288,550</u>	<u>298,500</u>
Expenses:				
Maintenance of greens and grounds	14,650	12,000	37,650	36,000
Maintenance of clubhouse	3,450	3,000	18,100	19,000
Golf activities	13,500	10,000	19,500	16,000
Swimming pool	3,400	3,000	5,100	4,000
General and administrative	4,200	3,700	24,150	22,000
Payroll taxes	3,700	3,500	23,500	21,000
Other expenses	4,150	5,000	19,560	20,000
	<u>47,050</u>	<u>40,200</u>	<u>147,560</u>	<u>138,000</u>
Total, excluding restaurant	29,550	27,000	145,650	153,000
Restaurant	<u>76,600</u>	<u>67,200</u>	<u>293,210</u>	<u>291,000</u>
	<u>(\$ 6,240)</u>	<u>\$ 800</u>	<u>(\$ 4,660)</u>	<u>\$ 7,500</u>
Excess of income over (under) expenses			<u>(\$ 4,660)</u>	<u>(\$12,160)</u>

total and see where the club stood cumulatively. Year-to-date budget comparisons are often more revealing than monthly comparisons because minor fluctuations in income and expenses tend to offset over a period of months. These fluctuations can appear rather large in any one month.

(b) Restaurant Operation

Restaurant income and expenses have been shown “gross” in the statements. It would be equally proper for the club to show net income for the club before the restaurant operation was considered. Here is how this would look:

Income (excluding restaurant)	\$ 120,050
Expenses (excluding restaurant)	<u>147,560</u>
Excess of expenses over income excluding restaurant	<u>(27,510)</u>
Restaurant	
Gross income	168,500
Expenses	<u>(145,650)</u>
Net restaurant income	<u>22,850</u>
Excess of expenses over income	<u><u>\$ (4,660)</u></u>

Another possibility is to show only the net income of the restaurant in the statements, perhaps in the income section. In condensed form, here is how the statements would look: Either presentation, or the one in Exhibit 20.2, is acceptable. The appropriate presentation depends on the importance of highlighting the restaurant activities.

Income	
Other than restaurant	\$ 120,050
Restaurant net income	<u>22,850</u>
Total income	142,900
Expenses (other than restaurant)	(147,560)
Excess of expenses over income	<u><u>\$ (4,660)</u></u>

(c) Variable Budget

One technique that is often used in budgeting an operation where costs increase as the volume of activity increases is to relate the budgeted costs to income. For example, the final expense budget (Exhibit 20.1) and the relationship to budgeted income for the restaurant operation is as follows:

THE IMPORTANCE OF BUDGETING

	Amount	Percent of Income
Income	\$290,000	100%
Food and beverages	\$130,000	45%
Salaries and wages		
Kitchen	50,000	17
Dining room	32,000	11
Bartender	16,000	6
Supplies, repairs, and maintenance	18,000	6
	\$246,000	85%

If all costs increase proportionately as income increases, it is a simple matter to create new budget figures each month based on actual income. Using the six-month figures shown in Exhibit 20.2, our budget comparison for the restaurant activity for the six-month period would look like this:

	Actual	Variable Budget	Deviation from Variable Budget	Deviation from Original Budget Shown in Exhibit 20.2
Income	\$168,500	\$180,000 ^a	\$ (11,500)	\$(11,500)
Expenses (in total)	145,650	143,225 ^b	(2,425)	7,350
Net	\$ 22,850	\$ 36,775	\$ (13,925)	\$ (4,150)

^a Original budget for six months.

^b 85% of actual income for the six months, based on the relationship of budgeted expenses to budgeted income as shown above.

The significant observation here is that while the original budget comparison in Exhibit 20.2 showed an unfavorable deviation from budget of only \$4,150, the unfavorable deviation using this variable budget is significantly higher, at \$13,925. If the variable budget is accurate, the club manager has not been watching costs carefully enough.

The financial statements would show only the variable expense budget. The original expense budget would not be used. This kind of budget is more difficult to work with because each month the treasurer or bookkeeper has to recalculate the expense figures to be used based on actual income. At the same time, by doing so, a more meaningful budget comparison can then be made. It would be very difficult otherwise for the board to judge the restaurant's results.

One final observation about this variable budget: Certain costs are not proportional to income. For example, the club cannot have less than

one bartender or one chef. Accordingly, in preparing a variable budget sometimes the relationships that are developed will not be simple percentage relationships. For example, perhaps the relationship of bartender salary will be, say, \$5,000 plus 5 percent of total income over \$75,000. If so, then if restaurant income is \$350,000, the budget will be \$18,750 (\$5,000 + 5 percent of \$275,000).

(d) Narrative Report on Deviations from Budget

Much of the detail shown in the budget (Exhibit 20.1) has not been shown on the interim financial statement (Exhibit 20.2). If the board felt it appropriate, supporting schedules could be prepared giving as much detail as desired. Care should be taken, however, not to request details that will not be used since it takes time and costs money to prepare detailed supporting schedules, even when the mechanics of preparation are done by computer.

It may be that a more meaningful supporting schedule would be a narrative summary of the reasons for the deviations from budget for the major income and expense categories. In the case of the Valley Country Club, the club manager would probably be the one to prepare this summary. It should then be reviewed by the treasurer prior to the full board meeting so that questions that are likely to be asked in that meeting can be anticipated and answers obtained. The amount of detail and description that might be put in this summary would vary from account to account. The report should discuss only reasons for the major deviations. This report should accompany the financial statements so that questions raised by the statement are answered immediately. Exhibit 20.3 is an example of the type of summary that might be prepared to explain the expense deviations from budget (in part).

This type of report can be as informal as you want to make it as long as it conveys why there have been deviations from the original budget. But it should be in writing, both to ensure that the board knows the reasons and to force the club manager to face squarely the responsibility of meeting the projected budget. This report is a form of discipline for the manager.

(e) Action by the Board

The best-prepared budget serves little purpose if the board is unwilling to take action once it becomes apparent that expenses are exceeding budget or that income has not been as high as anticipated. To be useful, the budget must be a planning device that *everyone* takes seriously. There must be follow-up action.

EXHIBIT 20.3

Example of a Narrative Report Prepared by the Manager of a Country Club Explaining Why Certain Major Deviations Have Occurred from Budget

**VALLEY COUNTRY CLUB
CLUB MANAGER'S REPORT TO THE BOARD
EXPENSE DEVIATIONS FROM BUDGET, JUNE 20X1**

Maintenance of Greens and Grounds (\$2,650)

As you will recall, April and May were fairly wet months. This, coupled with other unfavorable soil conditions, required that we treat about 25% of the course with a fungicide that had not been budgeted (\$1,850). We also had some unexpected repairs to the sprinkler system (\$1,500). For the six months to date we have exceeded budget by only \$1,650 and I am confident that our annual budget will not be exceeded.

Maintenance of Clubhouse (\$450)

We had scheduled painting the clubhouse for May but because of the rains were not able to get it done until this month. Year-to-date expenses are \$900 under budget.

Golf Activities (\$3,500)

After the budget had been approved, the board decided to have an open tournament with a view toward attracting new membership. With promotion and prizes, this came to \$2,850. So far the membership committee has received thirteen new applications for membership.

The type of reporting discussed in this chapter will give the board information on where the plan is not being followed. However, the board must be prepared to take action when the deviations indicate the existence of serious problems. Perhaps all that will be necessary is for the board to discuss the budget deviations with the club manager. A club manager who knows that the board fully expects performance within the budget will take appropriate action. If some matters are beyond the control of the manager, he or she may suggest alternatives to the board for its action.

The board must be prepared to take action to modify its plans if it becomes apparent that the budget cannot be met. If the organization has substantial resources to fall back on, it can afford to accept some deviations from the original budget without serious financial consequences. For most organizations, this is not the case. The board must be willing to face unpleasant facts once it becomes apparent from interim financial statements that corrective action must be taken. Many budgets fail, not because there is not enough information available to the board, but because the board fails to take aggressive, corrective action. In these instances, the board is not fulfilling its responsibilities and the budget is a meaningless formality.

20.4 A FIVE-YEAR MASTER PLAN

So far our discussion has centered on budgeting techniques for the current year. Almost as important are the techniques for planning even further into the future than the 12-month period most budgets show. As will be discussed more fully in the next chapter, organizations must be constantly alert to changing conditions that may alter their goals or objectives and thus their sources of income. Otherwise, they may find themselves in unexpected financial difficulty. One of the more effective ways organizations can avoid the unexpected is to prepare, and periodically update, a five-year master plan. The purpose of this five-year plan is to force the board to look ahead and anticipate not only problems but goals and objectives that it wants to work toward achieving.

The development of a five-year plan requires considerable effort. The treasurer can be the person who initiates and pushes the board toward developing such a plan but cannot single-handedly prepare it. As discussed earlier, to be effective any plan of action involving the organization's program and allocation of resources must be developed by all of the people who will have to live with the resulting plan. To unilaterally prepare a five-year plan risks the strong possibility that the treasurer's conceptions of the important objectives are not consistent with those of the conceptions of the rest of the board or the membership.

(a) Suggested Procedures

There is no "standard" way to go about preparing a five-year plan. Probably the best way to start is to set up a committee. The people chosen for this five-year planning committee should be people who are in policy-making roles within the organization. There is little point in putting a person on this committee who is not both knowledgeable and influential within the organization. Otherwise the resulting document will be of relatively little value to the organization.

(i) **Setting Goals.** Before meeting as a committee, each member should be instructed to list all of the goals or objectives that are considered important for each of the next five years. The list can be specific or general. The important thing is to get down some thoughts as to what the organization should be doing during each year, particularly as they might be different from what is being done currently. No consideration should be given at this point to dollar costs—only goals or objectives.

Once each member of the committee has independently prepared this conception of the future goals or objectives of the organization, the committee should meet and discuss these projections jointly. There may or may not be initial agreement among the committee members, and if not,

there should be extended discussions to try to establish a plan of objectives that all members can agree on as being reasonable. If, after extended discussions, the committee cannot agree on these broad objectives, they should go back to the board for direction. All of this is *before* any figures have been associated with each specific objective or goal. The organization must decide what its goals or objectives are before it starts worrying about costs.

(ii) Estimating Costs. Once the committee has agreed upon objectives for each of the five years, then it is appropriate to start to estimate the costs involved in reaching each of these goals. This can be difficult because there are always many unknowns and uncertainties as to the details of how each goal will be accomplished. Nevertheless, it is important that the best estimate be made by the committee. The treasurer and club manager are key people in this estimating process. Among other things, it is up to the treasurer to try to factor inflation and realism as to costs into these figures.

After the committee has associated dollar costs with each objective for the five years, the next step is to add up the total to see how much income will have to be raised. Notice that until this point, no real consideration has been given to how the goals will be financed. This is important because in long-range planning an organization should set its objectives and then look for the means to reach them. If the objectives are good ones which the membership or supporters will agree should be accomplished, the financial support should follow. An organization gets into difficulty when it does not periodically reevaluate its direction and thus finds itself out of step with those who support the organization financially and in other ways. The procedure to follow is first to define the objectives and goals, then to associate dollar amounts with each, and finally to determine how to raise the necessary income.

(iii) Plan for Income. This final step of determining how the income will be raised is usually not as difficult as it may sound provided the goals and objectives are ones that the board and the membership believe are sound. It is possible that as a result of this five-year plan new sources of income may be required. Perhaps a foundation will be approached, or perhaps a major capital improvement fund drive will be started. There are many possibilities. The important thing is that the organization has no right to exist except as it serves societal or members' interests. So if the organization keeps up with the times, it should be able to get sufficient support to achieve its objectives; if it does not, this is clear evidence that the objectives or goals are not sufficiently important to justify support. At that point the organization should either change its goals or should seriously consider the desirability of discontinuing its existence.

(b) Illustrative Master Plan

The result of this whole process is a master plan that should guide the board in its planning. It should be reviewed at least every year or two and should be updated and extended so that it represents, at all times, a five-year plan for the future. Exhibit 20.4 shows an example of a simple master plan for the Center for the Development of Human Resources. The Center for the Development of Human Resources exists to help individuals “grow” through interaction in study groups. The center has a professional staff organizing and running programs, which are held in a rented building.

Note that on this master plan the center has indicated future expenses not in terms of the type of expenses (salaries, rent, supplies, etc.) but in terms of the goals or objectives of the organization. This distinction is important because the center pays its expenses only to further some goal or objective. Thus, in a master plan it is entirely appropriate to associate costs with each goal or objective. This means that a certain amount of allocation of salaries and other costs between goals will be necessary.

Another observation is that the format of this master plan did not start off with the traditional approach of showing income and then deducting expenses. Instead, the goals or objectives were stated first, and only after the organization agreed on what it wanted to do did it start to work on how to raise the necessary income. This point has been emphasized because the organization does not exist to raise money and pay expenses; it exists to accomplish certain objectives, and unless these are spelled out clearly and are constantly kept in mind, the organization may lose sight of the reason for its existence.

No attempt was made in this master plan to balance the amounts of income and expense except in a general way. In each year, there is an indicated surplus. This recognizes that while the board has made its best guess as to how it will raise its income, there are a great many unknowns when working with a five-year budget. As each year passes and this five-year plan is updated (and extended), the sources of income will become more certain, as will costs, and these figures will be refined and adjusted. The important thing, however, is that the board has set down what it plans to do in the future, and how it now expects to be able to finance such plans.

20.5 CONCLUSION

A budget can be an extremely important and effective tool for the board in managing the affairs of the organization. However, to prepare a meaningful budget the organization must know where it is heading and what its goals and objectives will be. Priorities change, and this means that

EXHIBIT 20.4

Example of a Five-Year Master Plan that Emphasizes the Objectives and Goals of the Organization

CENTER FOR THE DEVELOPMENT OF HUMAN RESOURCES					
MASTER PLAN, 20X2 THROUGH 20X6					
	20X2	20X3	20X4	20X5	20X6
Goals or objectives:					
Develop and run management program	\$ 17,000	\$ 22,000	\$ 25,000	\$ 27,000	\$ 30,000
Reprogram receptive listening program	12,000	—	—	—	—
Continue receptive listening program	35,000	35,000	45,000	45,000	45,000
Work with other centers across country	—	12,000	15,000	15,000	15,000
Develop and run child day care training center	8,000	15,000	20,000	20,000	20,000
Explore Project "A"	20,000	10,000	—	—	—
Run other programs	40,000	45,000	50,000	55,000	55,000
Purchase building for center	—	150,000	—	—	—
Total	<u>132,000</u>	<u>289,000</u>	<u>155,000</u>	<u>162,000</u>	<u>165,000</u>
Sources of income:					
Contributions from members	60,000	45,000	60,000	60,000	60,000
Special gifts and legacies	10,000	10,000	—	—	—
Building fund drive	—	100,000	—	—	—
Program fees:					
Management	10,000	15,000	18,000	20,000	22,000
Receptive listening	30,000	35,000	45,000	45,000	45,000
Child care	—	5,000	10,000	10,000	10,000
Other	38,000	40,000	45,000	45,000	45,000
Foundation grants:					
Child care	10,000	—	—	—	—
Building fund	—	50,000	—	—	—
Total	<u>158,000</u>	<u>300,000</u>	<u>178,000</u>	<u>180,000</u>	<u>182,000</u>
Projected surplus	<u>\$ 26,000</u>	<u>\$ 11,000</u>	<u>\$ 23,000</u>	<u>\$ 18,000</u>	<u>\$ 17,000</u>

20.5 CONCLUSION

many people should be involved in the budget preparation and approval process to insure the resulting budget is fully supported. Once prepared, the budget must be compared to actual results on a timely basis throughout the year to insure that the board knows where deviations are occurring. Equally important, the board must promptly take corrective action if problems are discovered. The foundations of a sound financial structure are a well-conceived budget, a timely reporting system, and a willingness by the board to take corrective action. The importance of planning into the future cannot be overemphasized. In this fast-moving age, worthy not-for-profit organizations can quickly get out of step with the times, and when this happens contributions and other income quickly disappear. A five-year master plan is one technique to help ensure this will not happen.

Avoiding Bankruptcy

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"Bankruptcy? It can't happen to us!" Of course it can; don't think that your organization is immune. Whether the organization is a commercial or a not-for-profit one, insolvency will be the fate of some organizations that are today vigorous and healthy. An organization's importance and reputation will not protect it. Avoiding bankruptcy takes effort and real skill.

21.1 EARLY RECOGNITION OF PROBLEMS

While the final responsibility for the financial health of the organization is the board's, the treasurer is the person charged with watching both the day-to-day and long-term financial picture. One of the most important functions of the treasurer is to recognize potential problems while there is still time to act. While it might seem like a simple task to recognize that the organization is in, or is headed for, financial trouble, the fact is that many people fail to recognize the symptoms at a time when they might still be able to do something.

Recognizing on a timely basis that there is a problem is important because most not-for-profit organizations have so little cash. They cannot

AVOIDING BANKRUPTCY

afford the luxury of waiting until after the problem has fully manifested itself. If they do, they may run out of cash. If there are substantial reserves in the bank, an organization can afford several years of deficits before it really has to become concerned about the future. Nevertheless, few organizations have this comfortable level of cash reserves. Organizations usually have enough cash for only three or four months' operations if all income were to cease.

A balanced budget, based on conservative revenue estimates, is an effective means to avoid financial calamity. A balanced budget requires that difficult decisions, such as program curtailment or elimination, be made during each budget cycle, rather than deferring them until a future date, at which time a genuine crisis may have developed and the future of the organization itself may be imperiled. There is no perpetual life for not-for-profit organizations. Not-for-profit organizations have a privileged place in our society. Most have been granted certain tax privileges, which means that society as a whole has a right to demand that they perform their function in the public interest. If the organization fails to be responsive, no matter how "worthwhile" its program may be when viewed objectively from afar, the organization will have a short life. This is as true of churches and religious organizations as it is of other types. The organization must be responsive, and the contributor is the final judge of whether it is or not. This means the treasurer must be alert to indications that the health of the organization may be declining either as shown in historical financial statements, or as projected into the future.

(a) Historical Statements as a Guide

Many look upon past financial statements only as a historical bookkeeping record that has little significance for the future. This is a mistake. Often, there is a clear indication in these statements of potential problems for the future. This can often be seen by comparing several years' statements, because relationships may become obvious that were not apparent when looking at only one year's statements. An example can best illustrate this point. The five-year operating statement of the Center for World Peace is shown in Exhibit 21.1. This statement offers a great deal of information to the observant treasurer and should help in anticipating problems. The obvious and most serious problem revealed is that there has been a large deficit in 20X5 which, if repeated, would wipe out the organization. Beyond this obvious observation, however, a number of other important clues can be seen. Note first the relationship between expenses and program fees over the years. From 20X1 to 20X5, expenses have gone up almost 40 percent, but program fees have gone up only 13 percent. Either the organization is not charging enough for its programs, or the programs are not responsive to the membership and therefore

EXHIBIT 21.1

Example of a Five-Year Statement of Income, Expenses, and Cash Balances that Can Assist the Reader in Spotting Trends

CENTER FOR WORLD PEACE					
SUMMARY OF INCOME, EXPENSES, AND CASH BALANCES RESULTING FROM CASH TRANSACTIONS					
FOR THE FIVE YEARS ENDED DECEMBER 31, 20X5					
	<u>20X1</u>	<u>20X2</u>	<u>20X3</u>	<u>20X4</u>	<u>20X5</u>
Income:					
Contributions	\$ 53,000	\$ 65,000	\$ 56,000	\$ 66,000	\$ 49,000
Program fees	46,000	48,000	48,000	50,000	52,000
Other	<u>3,000</u>	<u>3,000</u>	<u>2,000</u>	<u>3,000</u>	<u>2,000</u>
Total income	<u>102,000</u>	<u>116,000</u>	<u>106,000</u>	<u>119,000</u>	<u>103,000</u>
Expenses:					
Salaries	68,000	72,000	76,000	78,000	80,000
Rent	14,000	16,000	18,000	20,000	24,000
Supplies	9,000	10,000	14,000	18,000	22,000
Other	<u>3,000</u>	<u>3,000</u>	<u>4,000</u>	<u>5,000</u>	<u>6,000</u>
Total expenses	<u>94,000</u>	<u>101,000</u>	<u>112,000</u>	<u>121,000</u>	<u>132,000</u>
Excess of income over (under) expenses	8,000	15,000	(6,000)	(2,000)	(29,000)
Cash balance, beginning of the year	<u>34,000</u>	<u>42,000</u>	<u>57,000</u>	<u>51,000</u>	<u>49,000</u>
Cash balance, end of year	<u>\$ 42,000</u>	<u>\$ 57,000</u>	<u>\$ 51,000</u>	<u>\$ 49,000</u>	<u>\$ 20,000</u>

AVOIDING BANKRUPTCY

attendance is down. Then again, perhaps the center has gotten too sophisticated in its programming, with too many paid staff for the size of fees that can be charged. These are the kinds of questions that have to be asked.

Another question that should concern the treasurer is why contributions have fluctuated so much from year to year. Is there significance in the decline in contributions received, from \$66,000 in 20X4 to \$49,000 in 20X5? Does this represent a strong “vote” by the membership that they are not interested in the programs of the center or that something is wrong? This question concerned the treasurer and after some digging, these facts were found:

Year	Recurring Contributions	Special or One-Time Gifts	Total
20X1	\$43,000	\$10,000	\$53,000
20X2	45,000	20,000	65,000
20X3	47,000	9,000	56,000
20X4	55,000	11,000	66,000
20X5	49,000	—	49,000

From this analysis it is easy to see what happened. The center had been living off special or one-time gifts and no such gifts were received in 20X5. Most of the special gifts had come from half a dozen people, some now deceased. The earlier five-year summary did not tell the whole story, and the treasurer recast this statement showing these special gifts separately. Exhibit 21.2 shows these revised statements in condensed form.

From Exhibit 21.2, it was easy for the treasurer and the board to see that they had been living off special gifts in every year except 20X5. Hard decisions had to be made as to whether the center should count on receiving such special gifts in the future and, if not, how expenses could be cut or additional income gained.

(b) Analysis of Interim Statements

It is not necessary (or wise) to wait for the completion of a full year’s activities before starting to draw conclusions from the trends that should be obvious to the careful analyst. Exhibit 21.3 is a worksheet showing a comparison of actual with budget for three months, and a projection for the entire year based on the assumption that the experience for the first three months compared to budget is a good indication of what can be expected for the next nine months.

Based on this worksheet, unless something happens to change the pattern, instead of being ahead of budget the center is headed for a deficit of

21.1 EARLY RECOGNITION OF PROBLEMS

EXHIBIT 21.2

Five-Year Statement of Income and Expenses in Which Nonrecurring Special Gifts Are Shown Separately to Highlight Continuing Income

CENTER FOR WORLD PEACE					
SUMMARY OF INCOME AND EXPENSES					
FOR THE FIVE YEARS ENDED DECEMBER 31, 20X5					
	20X1	20X2	20X3	20X4	20X5
Recurring income:					
Contributions	\$43,000	\$ 45,000	\$ 47,000	\$ 55,000	\$ 49,000
Program fees	46,000	48,000	48,000	50,000	52,000
Other	3,000	3,000	2,000	3,000	2,000
Total	<u>92,000</u>	<u>96,000</u>	<u>97,000</u>	<u>108,000</u>	<u>103,000</u>
Expenses (total)	<u>94,000</u>	<u>101,000</u>	<u>112,000</u>	<u>121,000</u>	<u>132,000</u>
Excess of expenses over recurring income	(2,000)	(5,000)	(15,000)	(13,000)	(29,000)
Special nonrecurring gifts	<u>10,000</u>	<u>20,000</u>	<u>9,000</u>	<u>11,000</u>	<u>—</u>
Excess of income over (under) expenses	<u>\$ 8,000</u>	<u>\$ 15,000</u>	<u>(\$ 6,000)</u>	<u>(\$ 2,000)</u>	<u>(\$ 29,000)</u>

\$23,000. Notice that the center had only \$20,000 in cash at the beginning of the year and cannot afford to have a deficit of \$23,000. The board can hardly spend money it does not have, and yet it appears that some time during the fourth quarter this is exactly what is going to happen.

The point should be obvious: If the treasurer does not stay on top of the finances of an organization, serious trouble may be discovered only after it is too late to do anything about it.

The checklist shown in Exhibit 21.4 may be helpful in identifying financial problems before they endanger the organization.

(c) Treasurer's Duty to Sound the Alarm

With all of these warning signs, the treasurer must call for help—loudly! The treasurer's job is to call the situation to the attention of the board. The real responsibility for solving the problem, however, is the board's. The treasurer may be able to offer recommendations on how to solve the problem—as the person closest to the finances, the treasurer will probably have some sound ideas—but under the laws of most states, it is the full board that is responsible for the continuation of the organization.

EXHIBIT 21.3

Example of a Worksheet Projecting Income and Expenses for the Year Based on Only the First Three Months' Actual Experience

	CENTER FOR WORLD PEACE						
	WORKSHEET SHOWING CALCULATION OF PROJECTED INCOME AND EXPENSES						
	3 Months to March 31		9 Months April to December		12 Months		
	Actual	Budget	Percentage Actual to Budget	Budget	Projected on Actual ^a	Budget	Projected
Recurring income:							
Contributions	\$18,000	\$20,000	90%	\$38,000	\$ 34,200	\$ 58,000	\$ 52,200
Program fees	17,000	18,000	95%	42,000	39,900	60,000	56,900
Other	500	500	100%	1,500	1,500	2,000	2,000
Total	<u>35,500</u>	<u>38,500</u>	<u>92%</u>	<u>81,500</u>	<u>75,600</u>	<u>120,000</u>	<u>111,100</u>
Expenses:							
Salaries	22,000	21,000	105%	63,000	66,100	84,000	88,100
Rent	6,000	6,000	100%	18,000	18,000	24,000	24,000
Supplies	4,500	2,500	180%	7,500	13,500	10,000	18,000
Other	1,000	500	200%	1,500	3,000	2,000	4,000
Total	<u>33,500</u>	<u>30,000</u>	<u>111%</u>	<u>90,000</u>	<u>100,600</u>	<u>120,000</u>	<u>134,100</u>
Excess of income over (under) expenses	<u>\$ 2,000</u>	<u>\$ 8,500</u>		<u>(\$ 8,500)</u>	<u>(\$ 25,000)</u>	<u>—</u>	<u>(\$ 23,000)</u>

^a i.e.: percentage actual to budget for three months times budget for nine months (90%×38,000 = \$34,200).

21.1 EARLY RECOGNITION OF PROBLEMS

EXHIBIT 21.4

Signs that May Indicate Financial Trouble for Not-for-Profit Organizations

COMMUNITY SUPPORT

- Decline in utilization of organization's services by the local community (fewer students, patients, visitors, members, or other users)
- Decline in real dollar support through gifts, bequests, and membership dues
- Decline in hours of time made available by volunteers
- Increasing incidence of turndown of grant requests
- Criticism of the organization or its programs by public figures or media

FINANCIAL INDEPENDENCE

- A growing percentage of expenditures for basic operations financed by restricted grants
- A growing percentage of own-source unrestricted revenues committed to meet matching requirements, or needed to supplement restricted revenues for special projects
- Increasing reliance on very few different sources of support
- A growing debt burden
- Rapid increases in fixed cash costs (salaries and fringes, rent, debt service, and the like)
- Continuing decline or deficit in operating income or unrestricted net assets
- Continuing decline or overdraft in cash and equivalents

PRODUCTIVITY

- Cost per unit of service rising rapidly
- Number of employees per unit of service rising rapidly
- User fee rates rising rapidly (unless resulting from a deliberate management decision to reduce the amount by which such fees are subsidized from other revenue sources)

DEFERRED CURRENT COSTS

- Proceeds of long-term debt or sales of long-term investments being used for current purposes
- Deferring needed maintenance of capital assets
- Low or declining funding of replacement of capital assets near the end of their useful life
- Default on debts (bonds, notes, mortgages, interest)
- Failure to pay payroll or other taxes when due
- Inability to pay salaries or other current expenses when due, or borrowing to cover such amounts shortly before payment
- Borrowing of cash or other assets from restricted funds or other diversion of restricted resources to inappropriate purposes

MANAGEMENT PRACTICES

- A pattern of budget cost overruns, either overall or in specific programs/departments
- Increasing incidence of revenue shortfalls
- Earnings on investments declining disproportionately to general trends of investment yields

Signs that May Indicate Financial Trouble for Not-for-Profit Organizations

- Interest rates charged by lenders increasing disproportionately to general trends of interest rates, unwillingness of lenders to lend to organization, or insistence by lenders on burdensome debt covenants
- Levels of receivables, inventory, or prepaid expenses increasing faster than related activity would dictate
- Increasing incidence of funding source challenge or disallowance of expenses
- Financial and operating data being provided to board members and management is delayed, unclear, or incomplete; explanations of key items and variances are unavailable or of doubtful validity
- Failure on the part of board members or management to understand and accept the seriousness of the financial situation

There is another very practical reason for calling for help as loudly as possible: Sometimes calling attention to a problem is all that is really necessary to start the wheels in motion to solve it. Perhaps some of the members who have been lax in making contributions or attending programs will start doing so.

21.2 REMEDIAL ACTION

Once the board has been forced to recognize the problem, what are the alternatives or courses of action that can be taken? There are perhaps six or seven, some of which may not be available to all organizations.

(a) Increasing Contributions

The most obvious solution to many organizations' financial problems is to raise additional contributions. However, this is usually much easier said than done. If contributions are received mainly in small amounts from many donors, it is not realistic to expect that the organization will be able to increase contributions by a very large amount. Unless the organization really motivates its donors, contributions tend to remain fairly constant from year to year except for small increases attributable to general cost-of-living increases, increased personal income, and so on.

This is not as true with donors making large contributions. If the organization can sell its program (called "making its case" in fundraising parlance), often these larger donors will make additional special contributions. The key is that the organization must convince these large donors that the extra amount it needs to solve this year's crisis will not be needed again next year, and the year after, and so on. This means that in presenting its case, the organization must be able to show how it can and will avoid a similar difficulty

next year. Otherwise, to the donor it will appear that a contribution is not really helping to solve the problem but only postponing it.

Credibility is an important aspect of the ability to raise additional funds. The board will have a greater chance of success if over the years it has presented meaningful financial statements to all donors and has not created doubts about the true financial condition. Even with good statements, however, an organization that is in serious difficulty will probably find that the first place to look is not at contributions. Contributions can be increased, but usually the response rate is too slow and the amounts too modest.

(b) Increasing Fees

Another source of increased income is raising fees charged for services being rendered. Modest increases usually can be “sold” if there has not been a recent increase. Most people recognize the effect of inflation. At the same time, increasing fees may decrease the number of persons using the services.

For example, in the case of the Center for World Peace, if the board were to increase charges by only 10 percent effective April 1, almost \$4,000 would be added to income assuming nobody dropped out as a result of the increase. This represents almost 20 percent of the projected deficit for the year. If the programs are worthwhile, the board should be able to convince the membership that the alternative to increasing fees is discontinuing the organization’s activities. If the board is unable to “sell” this, then perhaps it should question the need for these programs.

(c) Cutting Expenses

If it appears that there will be a deficit, and this deficit cannot be covered by increasing income, then most likely it will be necessary to reduce expenses. This is always difficult for the board of a not-for-profit organization to accept. A board often finds it difficult to accept the fact that sometimes an organization cannot do all that it wants to do, no matter how worthy.

Whatever the reason, not-for-profit organizations seem to have particular difficulty in recognizing that as with any individual, they must spend within their means. This is one reason why the treasurer can offer only suggestions and should not attempt to dictate solutions. The board has to wrestle with the policy question of which programs are in fact most “indispensable.” The treasurer may have suggestions, but if these are forced on the organization without the board’s full concurrence, the suggestions either will not “stick” or the treasurer’s efforts will be sabotaged. Remember that not-for-profit organizations, unlike commercial

ones, are heavily dependent on volunteer help and these volunteers must be in agreement with what is going on or they will stop volunteering their time and effort.

The conclusion is obvious. When the organization is threatened with insolvency, the board must either raise income or cut expenses. Cutting expenses, however unpleasant, is often the only practical solution to an immediate crisis.

(d) Borrowing

One source of emergency funds that many organizations use is the bank. They will borrow to cover short-term emergency needs, particularly when they have fluctuations in their income. Short-term borrowing is fine if used only to cover fluctuating income, and if the treasurer is sure that there will be income from which to pay these monies back. On the other hand, what should not be done without some serious thought is to mortgage the organization's physical property to raise money to pay for current operations. It is one thing to borrow money for capital additions but it is an entirely different thing to borrow money that will be used for the day-to-day operations of the organization. If this becomes necessary, the treasurer and board should consider very carefully how they can reasonably expect to repay these loans. If repayment is in doubt, the board must seriously consider the future of the organization, and why it is prolonging the organization's life. Keep in mind that the board of a not-for-profit organization has a responsibility to act prudently on all matters. If it "mortgages the cow" to pay for its food with the full knowledge that it is going to have to sell the cow to pay the bank back, perhaps it should sell the cow to start with.

Many times a bank will lend funds to an organization on the basis of the members of the board being well known and influential in the business community. This means an organization may be able to borrow money even though the banker may have some doubts about the organization's ability to repay. The banker knows, however, that the board members will not let the organization default. The board members should carefully consider the repayment problem. They will not want their personal reputations tarnished by subsequent difficulties with the bank.

(e) Applying for Foundation Grants

Grants from foundations are other potential sources of financial help. There are approximately 35,000 foundations in the United States, and these foundations are required to distribute a minimum of five percent of their assets every year. While there are limitations regarding to whom such money can be given, generally any organization that is exempt under

IRC § 501(c)(3)—which excludes social clubs and is not a “private foundation”—can receive grants from foundations.¹ When most people think of foundations, they think only of the large ones such as the Ford Foundation and the Carnegie Foundation. While these giant foundations are giving millions of dollars to worthwhile organizations every year, there are thousands of lesser known foundations that are also granting millions.²

Each foundation receives many more requests than it can possibly handle, so it is important that application be made only to those whose stated interests coincide with the organization’s. There is no point in wasting time in submitting a request for funds that will not receive serious consideration because it is outside of the foundation’s scope of interest.

The formal application itself is very important. There are usually no standard forms to fill out. Instead, the application should outline succinctly and with feeling what the objectives of the organization are. It should document why the foundation’s gift would be of significant help and how it would further the foundation’s stated objectives. Keep both of these points in mind—why the grant would be significant and how it would further the foundation’s stated objectives. An application that cannot answer both of these points is defective. The application should contain evidence that the board is effective and that the foundation won’t be wasting its money if it makes a grant. The application should contain complete financial information in a format that clearly indicates that the board has financial control of the organization. In the case of the Center for World Peace, the application would include the five-year summary of income and expenses, the budget for the current year, the projections based on the first quarter’s results, and a projection for five years. This five-year projection is important to show that the crisis is truly under control, or will be under control, and that the foundation’s grant will not necessarily have to be a continuing one.

The application should specify explicitly how the money will be used. Most foundations will not consider requests for money that will be merely added to the “pot” and used for general purposes. *The Foundation Directory* emphasizes this point; and fundraisers need to be warned that at least the larger foundations do not usually make grants toward the operating budgets of agencies, whether national or local, or

¹ Tax-exempt status is discussed in Chapter 28.

² *The Foundation Directory*, published by the Foundation Center, is a good source of information, especially about larger foundations. They are listed geographically by state. Included in each listing is a brief description of the foundation, the size of its assets, the amount of grants made, and the purposes for which the foundation will consider making a grant. In trying to find foundations to approach, an advantage may be gained where members of the organization’s board already know one or more of the trustees of the foundation. There is no question that the chances are improved if the board’s message can be informally presented to individual members of the foundation’s board of trustees in advance of their considering the formal request. This does not mean that such personal contacts can assure success, but it certainly will improve the chances.

for individual need. Many foundations have accepted the doctrine that their limited funds should be used chiefly as the venture capital of philanthropy, to be spent in enterprises requiring risk and foresight, not likely to be supported by government or private individuals. In their fields of special interest they prefer to aid research, designed to push forward the frontiers of knowledge, or pilot demonstrations, resulting in improved procedures apt to be widely copied.

Support for current programs, if it comes at all from foundations, must usually be sought from the smaller organizations, and especially those located in the area of the agency, well acquainted with its personnel and its needs. Most small foundations, and some larger ones, restrict their grants to the local community or state. Immense variety exists; the interests and limitations of each foundation need to be examined before it is approached.

Care must be taken to plan exactly how these funds will be used. This should not be done hastily. It takes many months to get foundation help and an organization that has not carefully thought out its needs may find that when it receives the grant it really would have preferred to spend the money in some other way. Foundations look with disfavor on organizations that ask that their grants be used for different purposes than originally specified.

Another thing to keep in mind is that many foundations like to make grants on a matching basis. That is, they will make the grant at such time as the organization has raised an equal or greater amount from other sources. This is in line with many foundations' concern that recipients not become dependent on foundation help. Timing is important. Many foundations will approve grants only once or twice a year. This means that unless the application is received on a timely basis there may be a long delay before there is an answer. Foundation grants are not very likely to get an organization out of an immediate cash bind. But foundations can be very helpful to the organization that truly plans for its future and knows what it wants and how to accomplish its objectives. For these organizations, foundation help should be carefully considered because there are monies available.

(f) Merging with Another Organization

One of the alternatives that the board must consider if bankruptcy looms on the horizon is the possibility that the organization should merge with another organization having similar or at least compatible objectives. This is not a course of action that is always appealing but if the alternative is bankruptcy, then the only real question is how the objectives and programs of the organization can best be salvaged. It is probably better to have a combined program with another organization than to have no

21.3 CONFRONTING BANKRUPTCY

program at all. If the board doubts that this is true, then the reason for the continued existence of the organization is in doubt, and perhaps bankruptcy is the appropriate answer.

Where do you look for other candidates for merger? There is no easy answer. Basically you have to know the field that your organization is working in, and then you have to approach all possible candidates. Do not hesitate to do so, for it may turn out that there are other organizations in similar financial straits, which if combined with yours would make the resulting organization stronger than either was before. Keep in mind that unless you personally know the board members of the other organization you are not likely to know of their problems before you approach them. Perhaps they are also looking for a merger candidate.

There are other considerations that must be taken into account. One of the more important is to determine whether any of your donor-restricted funds contain restrictions that would prohibit use by a combined organization. Ideally the board could find a compatible organization with similar enough goals and objectives so that any restricted amounts could be effectively used. If there are problems in this area, ask the original donor for permission to change the restrictions. Another consideration is whether the merged organization can accomplish the organization's objectives more effectively and at less cost than if it remained a separate entity. The merger may provide more resources that will probably make possible economies of scale. The chances are that there will be some opportunity for cost saving, perhaps through sharing staff, or facilities, or a combination of both. The board, however, should be sure that it looks very carefully before it leaps. It must analyze the other organization's financial statements and five-year plan very carefully. It serves very little purpose to trade one set of problems for another if several years from now the combined organization will again be on the verge of bankruptcy.

21.3 CONFRONTING BANKRUPTCY

Another possibility is that the board will conclude that the organization has accomplished the purposes for which it was set up, or that times have changed and the original objectives are no longer appropriate. If so, perhaps the humane thing to do is to let the organization "die"—but in a controlled manner so as not to leave a trail of debts behind it. Although this may not seem like a very practical suggestion at first, it is one that must be considered by every thoughtful board member. If the members and contributors are not supporting the organization, then why not? If it is only a temporary problem of a poor economy, it is perhaps appropriate to try to wait for better times. The board, however, must be cautious in drawing this conclusion. It must not get so emotionally involved in the

AVOIDING BANKRUPTCY

mechanics of the organization's programs that it loses sight of the need to respond to today's conditions, which are different from yesterday's. In this "throwaway" society that we are in, not-for-profit organizations are not exempt, and those that do not serve society's current needs will find that bankruptcy will always be close by.

As the board gets closer and closer to a decision to curtail operations, the individual members of the board, as well as the treasurer, have to consider carefully the steps that should be taken to ensure that actual bankruptcy as such does not take place. No board wants to incur financial obligations that cannot be met. This includes salary obligations (and especially payroll taxes, as those will become a personal obligation of the board members and management). As the time for going out of existence looms nearer, consideration must be given to an orderly dismissal of the staff with appropriate termination benefits to help them over the period of relocation. This is expensive, because once the decision to terminate operations is made, sources of income will dry up promptly. This means that the board members cannot wait until the bank account is empty to face these difficult decisions. If they do, either the board members themselves are going to personally face the prospects of making sizable contributions to cover their moral obligations, or they are going to leave unpaid debts and recriminations. Most board members have personal reputations at stake and this last alternative is not very attractive.

One area that must be carefully watched as cash gets low is the payment of payroll withholding taxes to the various levels of government. Usually the federal government can sue the treasurer personally, and all other persons responsible for nonpayment of such withholding taxes. These amounts are not usable funds of the organization as such, but are held in escrow until paid to the government. To use these funds to pay other bills is a very serious offense that can result not only in recovery from responsible persons, but also in subjection to fine and/or imprisonment.

Another consideration, if it is decided to discontinue operations, is that any funds or other assets that remain must either be given to another exempt organization or to the state. This is true for all tax-exempt organizations except social clubs. When thinking about discontinuing operations, competent legal help is needed to consider all ramifications. Timing is of major importance. The point at which operations will be discontinued must be anticipated and this must be before the bank account is empty. No board member wants the stigma of having been on a board of an organization that actually went bankrupt and could not pay its bills.

21.4 CONCLUSION

This chapter has discussed the threat of bankruptcy many not-for-profit organizations face at one time or another. It was noted that one of the

21.4 CONCLUSION

characteristics of such organizations is that they receive support only so long as they serve the needs of the public or their members. Because most organizations find it difficult to build up large cash reserves, they must be responsive.

If they are not, support will drop and unless the organization responds quickly, it could very well find itself on the verge of actual bankruptcy.

The treasurer's role of eliminating the unexpected was discussed, and several techniques were reviewed to help the treasurer stay on top of the current financial situation. It was emphasized that when trouble looms, the treasurer's first and most important responsibility is to call out loud and clear so that the board can take appropriate action. It is the board that must take action.

Most organizations in financial trouble find that it is difficult to increase income by any substantial amount in a short period of time. Accordingly, when financial troubles loom, one of the first things the board must do is to cut back on its rate of expenditures. If some of the budgeting techniques in the previous chapters have been followed, the board will have plenty of warning that it must cut expenses and should be able to avoid actual bankruptcy.

It may be that the board will find, however, that the organization is not viable, and that the reason for its continuation no longer exists. When this occurs, it is important that the board take action on a timely basis to either merge it into another more viable organization or to actually discontinue operations and dissolve the organization in a controlled manner. It is also important to constantly remember that a not-for-profit organization does not have a perpetual life. It can continue to exist only so long as it serves a worthwhile purpose which its members or the public will support.

Small Organizations—Obtaining the Right Accountant

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Obtaining and keeping the right accountant is the key to making life easy and routine for the treasurers of small organizations.¹ Unless the treasurer wants to spend substantial time and effort in keeping the records, a good accountant is essential. There is nothing difficult about accounting as such, but the details can become most wearisome to the busy volunteer treasurer. The time they consume can detract from the treasurer's other responsibilities, particularly that of planning. For most not-for-profit organizations, other than the very smallest, a full-time accountant will be hired.

The problem of finding the right accountant is compounded for not-for-profit organizations because traditionally such organizations pay low salaries to all of their staff, including the accountant. The salary

¹ This chapter deals only with the accounting problems of relatively small organizations. Larger organizations are not discussed because to a very large extent they are run like commercial organizations.

level frequently results in the organization's getting someone with only minimum qualifications. This is false economy. A good accountant can help the organization save money and can free the time of the volunteer treasurer.

Often the other staff in the organization are extremely dedicated individuals interested in the particular program of the organization and willing to accept a lower than normal salary. Accountants are often not dedicated to the programs of the organization in the same way. They have been hired to provide accounting services and may have no special interest in the program of the organization.

22.1 LEVEL OF ACCOUNTING SERVICES NEEDED

The first step in obtaining an accountant is to determine what accounting services are needed. Depending on the size of the organization, there are a number of possibilities. If the organization is very small and fewer than 25 checks are issued a month, the treasurer will probably find that a "checkbook" type set of records will be all that is required or appropriate. If so, the treasurer may very well keep the records and not try to find someone to help. In this case the "accounting problem" is merely one of finding enough time to keep the checkbook up-to-date and to prepare financial statements on a timely basis.

(a) Secretary as Accountant

For many organizations, the number of transactions is too large for the treasurer to handle but not large enough to justify a full-time accountant. If the organization has a paid full- or part-time secretary, often some of the accounting duties are delegated to this secretary. Usually this means keeping the "checkbook" or perhaps a simple cash receipts and cash disbursements ledger.² At the end of the month, the treasurer will summarize these cash records and prepare the financial statements. While this means the treasurer will still have a lot of work to do, the work has been reduced significantly by having the secretary keep the basic records. This is a very practical approach for small organizations with very limited staff and not too many transactions.

² Chapter 30 discusses both a checkbook system of accounting and a simple cash basis accounting system. A secretary could probably keep most of the records in either of these systems with a minimum of instruction.

(b) Volunteer as Accountant

Another possibility for the small organization is to find a volunteer within the organization who will help keep the records. While this can occasionally be effective, it often turns out to be less than satisfactory. There is less control over the activities of a volunteer accountant and it is difficult for the treasurer to insist that the records be kept on a timely basis. After all, volunteer accountants are just that—volunteers—with all the rights and privileges that go with volunteers. Volunteers have to work around their own schedules and it is difficult to insist that they perform their duties on as strict a basis as with paid employees. Another problem with volunteers is that their tenure tends to be short. Keeping a set of books is work, and while a volunteer accountant's enthusiasm may be great at the beginning, it tends to diminish in time. The result is that there are often delays, clerical errors, and eventually the need to get another accountant. The volunteer accountant is often not a good solution. A treasurer who cannot handle the accounting should use a paid secretary or consider hiring a part-time accountant.

(c) Part-Time Accountants

In considering a part-time accountant, the first question is how much time is required. Is the job one that can be handled on a one-day-a-month basis, two-days-a-month, two-days-a-week? For most small organizations, the answer will probably be only a day or two a month, or at the most, a day a week. Where do you go to find a good part-time accountant? This can be difficult.

Some of the best potential may be found among parents who were full-time accountants at one time and whose children are now in school. Since a part-time accounting job can easily fit into a flexible schedule, permitting the parent to be home before and after school, this can be a very good arrangement if the accounting needs are not more than 15 to 20 hours a week.

If the organization wants someone at its office for a full day each week or during hours not suitable for a parent with schoolchildren, then a retired accountant may be a good possibility. Sometimes it is difficult to find a suitable retired person—one with practical accounting experience. For example, a retired assistant treasurer of a large business had accounting in school but may never have used the skills. While this person may have a sophisticated knowledge of business, he or she may not be competent as an accountant. In addition, he or she may find the detail boring, and interest will be short-lived. Also, the hourly rate such persons may demand will probably be higher than that commanded by a competent accountant. An ad in a local newspaper or inquiry of other

organizations are probably the best places to start to look for a qualified person.

(d) Full-Time Accountants

For larger or growing organizations, there is a point when a full-time accountant is needed. An advertisement in the newspaper is probably the best approach to finding a suitable employee. The ad should be explicit and should indicate salary, and the type of experience and competence this person will need. It should also indicate the type of organization since some applicants may not be interested in working for a not-for-profit organization.

Alternatively, an employment agency can be used. A good agency can save time and effort. The agency will place the ad in the paper and will do the initial weeding out of the obvious misfits before forwarding the potential candidates to the organization for review. Agencies also know the job market and will probably be in a good position to advise on the “going” salary. They should also be able to help in checking references.

These agencies charge a fee that is usually paid by the hiring organization, and this can be from two to six weeks’ pay. The question that the treasurer must ask is, is it worth this amount for the help an agency can give? There is no sure answer to this question. In many instances, agency help is most valuable. On the other hand, some agencies do very little screening and the organization ends up with almost the same work that it would have had without the agency. Often a friend of the treasurer knows of someone who is looking for a job and while there is no reason not to consider such a person, the treasurer should also interview others.

One final thought on hiring a accountant (or any other employee, for that matter): Don’t skimp on the salary offered in the hope of “getting a bargain.” Yes, it is easy to think that every dollar spent on staff (some people read that to mean “on overhead”) is a dollar that did not go directly to feeding the hungry, curing cancer, and so on, but without a staff back at headquarters competent to do its job, there will not be much feeding or research going on. In all but the tiniest organizations, volunteers can only do so much without paid staff to back them up. When hiring staff, you usually get what you pay for. If you pay low salaries, you are likely to get under-qualified staff.

22.2 PERSONALITY CHARACTERISTICS

There are several personality characteristics that good accountants often have that the treasurer should be aware of: A good accountant is usually a very meticulous and well-organized person. This often means that the accountant will become impatient with other members of the staff who

are slow in providing the required information or who are sloppy in providing all of the necessary details. To the rest of the staff the accountant often appears to be a “nitpicker.” If the accountant is not diplomatic, this can be annoying to the rest of the staff, but these are desirable qualities that the treasurer should not discourage. Another desirable characteristic is that the accountant will often be critical of the spending patterns of the organization, particularly if the organization is apparently not being frugal. This tendency to be critical of spending habits can be a very helpful trait that the treasurer should not discourage. The accountant sees all of the spending of the organization and is bound to have an opinion about how wisely expenditures are made. The conclusion may not always be correct because the accountant’s vantage point is limited. Yet, from the treasurer’s standpoint, the accountant acts as a watchdog and will often have some good ideas. The treasurer should not ignore them.

22.3 ALTERNATIVES TO ACCOUNTANTS

There are many ways to delegate the actual accounting process to sources external to the organization. *Responsibility* for accounting, however, cannot be delegated outside the organization. The treasurer or another employee of the organization must continuously monitor and review the work of an outside accountant.

(a) Outside Preparation of Payroll

One thing that can be done to reduce the burden on the accountant is to let a bank or a service bureau handle the payroll. This is particularly effective where employees are paid the same amount each payroll period. Some banks will handle the complete payroll function and will use their own bank checks. This eliminates the need for the organization to prepare a payroll bank reconciliation. Others will prepare the payroll but use the organization’s checks, which after being cashed are returned to the organization. Banks usually have a minimum fee. While the charge may seem high, the time saved can be considerable. Remember that in addition to the payroll preparation the bank will also keep cumulative records of salary paid to each employee and will prepare the various payroll tax returns, W-2 forms, and so on. Having payroll tax matters handled by someone else removes a great burden from the organization’s staff. The use of a bank or service bureau works best where the payroll is regular and routine in amount—that is, where there are not a lot of hourly employees, or changes in rates between periods. While a bank can handle such changes, the “input” to the bank is such that the organization would be faced with the need to have someone act as a payroll clerk to assemble the information for the bank, and this takes time. If there are

a lot of changes each period, it may be just as easy for the accountant to handle the complete job and not use an outside service bureau or bank.

(b) Service Bureau Accounting Records

Another possibility is to have a service bureau keep all the accounting records. If there is any volume of activity, a service bureau can often keep the records at less cost than for an organization to hire an accountant. For example, there are some service bureaus that will enter information from original documents such as check stubs and invoices. They can then prepare a cash receipts book, cash disbursement book, general ledger, financial statements, and so on, all automatically. All the organization has to provide is the basic information. The costs for such services vary widely depending on the volume and type of records and the geographic area in which the organization is located. A treasurer starting to think about going to a service bureau should get some outside professional advice on whether it is practical. While talking to the service bureau will provide information on costs, the treasurer must keep in mind that the service bureau will be trying to sell its services and will not describe all the problems that may be encountered or the other alternatives that could be considered.

(c) Accounting Service

Another alternative is to hire an outside accounting service to perform the actual accounting. Many CPAs and public accountants provide accounting services. Under this arrangement, the accountant has one of the staff do all of the accounting but takes the responsibility for reviewing the work and seeing that it is properly done. The accountant usually prepares financial statements monthly or quarterly.

There are still some functions the organization itself usually must perform. The organization will normally still have to prepare its own checks, vouchers, payroll, depositing of receipts, and billings. This means that normally it cannot delegate 100 percent of the accounting to an outside accounting service.

The cost of this type of service is its principal disadvantage. The accountant is in business and has overhead and salaries to pay, including salaries for employees when they are not busy. All of these costs are considered in establishing hourly rates. These rates are generally about twice what it costs to hire a competent accountant on a full-time basis. Nevertheless, it may still be cheaper to hire an outside accountant than to have someone on the payroll. The outside accountant is paid only for work performed with no separate fringe benefits and no overhead. If the work totals 10 hours a month, the pay is for 10 hours. Also, these

22.5 CONCLUSION

services are performed by experienced staff, and there should not be a problem of competency. One problem with this type of service is that the accountant cannot be in two places at the same time. The chances are that sometimes when your books are ready, several other clients will also be ready. This can result in some delay, although, with proper advance planning and adherence to deadlines, usually not an excessive amount.

22.4 TIMING IN HIRING A REPLACEMENT

One question that is frequently asked is: When should a replacement be hired if the present accountant is leaving? Should there be an overlap in employment so that the retiring accountant can indoctrinate the new one and, if so, how long a period of overlap is appropriate? Or is it better to have no overlap at all?

It is appropriate to have some overlap, but it should be fairly short. A good accountant can pick up another accountant's set of books and procedures fairly quickly. An accountant can usually get oriented to the broad outlines of the procedures within a few days. Most of these details are learned by experience and not from having the former accountant tell about them.

For most organizations, it is probably best to keep the overlap short and recognize that things will not be entirely smooth for a month or two. Unless the organization is willing to have an overlap period of at least a month, it must expect that it will take some time for the new accountant to get firmly established.

22.5 CONCLUSION

The accounting needs of not-for-profit organizations vary widely. At the one extreme is the small organization that has so few transactions that the treasurer is able to handle all the accounting. On the other extreme is the large national organization that has an accounting or accounting staff of many persons that is run exactly like a commercial organization. In between is every conceivable combination of full- and part-time accounting need.

A variety of sources for accountants were discussed. Often in small organizations, a paid secretary will keep some simple records for the treasurer. Until the records get voluminous, this can be quite satisfactory. On the other hand, "volunteer" accountants are seldom satisfactory because of rapid turnover and the problem of control. It was suggested that part-time accounting jobs could be particularly attractive to parents with children in school who might want to earn some extra money. This assumes previous accounting experience. The procedures to follow in

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looking for both part- and full-time accountants were discussed and the importance of paying the going salary was emphasized. The use of banks or service bureaus was also suggested as one way to reduce the workload for the accountant. Finally, it was suggested that while some overlap in accountants is necessary, this overlap period should be relatively short.

Small Organizations—Providing Internal Control

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“EMPLOYEE ADMITS EMBEZZLEMENT OF TEN THOUSAND DOLLARS.” “TRUSTED CLERK STEALS \$50,000.” These headlines are all too common and many tell a similar story: A trusted and respected employee in a position of financial responsibility is overcome by temptation and “borrows” a few dollars until payday to meet some unexpected cash need. When payday comes, some other cash need prevents repayment. Somehow the employee just never catches up, and borrows a few more dollars, and a few more and a few more.

The reader’s reaction may be, “Thank goodness, this kind of thing could never happen to my organization. After all, I know everyone and they are all honest. And besides, who would think of stealing from a not-for-profit organization?” Very few embezzlers start out intending to be thieves. Rather, they find themselves in a position of trust and opportunity and when personal crises arise, the temptation is too much. Not-for-profit organizations are *not* exempt from fraud, regardless of size.

The purpose of this chapter is to outline some of the practical procedures that a small organization can establish to help reduce this risk and thus safeguard the organization’s physical assets. For purposes of this chapter, the emphasis is on smaller organizations where one or two persons handle all the bookkeeping. This would include many churches, country clubs, local fundraising groups, and so on. Internal control for

larger organizations is not discussed here because controls for such organizations can become very complicated. The principles, however, are essentially the same. Setting up a set of internal controls requires an understanding of the basic principles plus a great deal of common sense.

23.1 REASONS FOR INTERNAL CONTROL

Internal control is a system of procedures and cross-checking that in the absence of collusion minimizes the likelihood of misappropriation of assets or misstatement of the accounts (collectively, “fraud”), and maximizes the likelihood of detection if this occurs. For the most part, internal control does not prevent embezzlement but should insure that, if committed, it will be promptly discovered, and the identity of the perpetrator known. This likelihood of discovery usually persuades most not to allow temptation to get the better of them. Very few first-time embezzlers are so desperate that they would steal if they expected to be promptly caught. There are several reasons for having a good system of internal controls. The first is to prevent the loss through theft of some of the organization’s assets. A second reason, equally important, is to prevent “honest” employees and volunteers from making a mistake that could ruin their lives. An employer has a moral responsibility to avoid putting undue temptation in front of its personnel. Internal controls are designed to help remove the temptation.

Aside from this moral responsibility of the employer, there is also a responsibility of the board to the membership, donors, and to the general public to safeguard the assets of the organization. The board has an obligation to use prudence in protecting the assets. If a large sum were stolen and not recovered, it could jeopardize the programs of the organization. Furthermore, even if only a small amount were stolen, it would be embarrassing to management and the members of the board. In this case the financial loss would be immaterial, but the “reputational risk,” that is, the impact of the public’s perception of the organization could be significant. A likely side effect of the reputational risk would be a reduction in the amount the public would be willing to contribute to the organization. In either case, the membership or the public would certainly want to know why internal control procedures had not been followed by the board.

A good system of internal controls will help to eliminate all or some of three general conditions generally present when fraud occurs:

- Incentive/pressure
- Opportunity
- Attitude/rationalization

23.1 REASONS FOR INTERNAL CONTROL

Unfortunately, there is a reasonably long list of recent, real, well-publicized frauds involving not-for-profit organizations that can all be at least partly considered to be due to the absence of adequate internal controls. Here are but a few:

- The chief executive officer of a major charity misused some of the organization's funds for personal benefit. If this person had been subject to adequate oversight and review by the organization's board of directors, the amount of money that could have been misused would have been only a small fraction of what the organization eventually lost.
- The chief financial officer of another national organization embezzled money from the organization's bank accounts, and covered up the theft by making improper entries in the books. Had this person been subject to adequate control, including proper segregation of duties, enforced by the organization's board and chief executive, the thefts would likely not have happened at all, or, if money were taken, the loss would have been immediately evident to others.
- A chief executive spent the organization's money on personal expenses and on projects that were not subject to adequate review and approval by the board. Had the board been more aware of what was happening, these wasteful expenditures could have been minimized or avoided altogether.
- A charity that promised to match amounts placed with it by donors and other charities turned out to be simply a fraud run by its chief executive. Again, if the board had realized what was really going on, things presumably would not have gotten as far out of hand as they did.

This is not in any way to condone or excuse the actions of the individuals who did things they should not have done; however, the fact that they were able to do what they did, over a period of time, without being promptly called to account for their actions, indicates that those in positions of oversight above these individuals were not adequately discharging their responsibilities for safeguarding the organizations' resources. In fact, the very presence of adequate internal controls might have either deterred some of these people from even attempting to do anything improper or aided in the more timely discovery of the inappropriate actions. Note that we are not talking here about taking \$50 from the petty cash fund.

These were situations that are so significant that the very existence of the organization and its programs could have been jeopardized. That is surely a major concern of the very top officials of an organization. Further, in every case, the ultimate harm to the organization extended far

beyond the actual amount of money stolen or wasted (reputational risk). Each situation became a public relations disaster—several ended up in bankruptcy court; some people have gone to jail. When the not-for-profit organizations' donors finally became aware of what had happened, contributions dropped significantly. The loss of contributions can never be measured precisely, of course, but it was doubtless many times the actual amount that triggered the donors' reactions. It can take many years for an organization's finances to recover, if they ever do.

23.2 FUNDAMENTALS OF INTERNAL CONTROL

The simple definition of the purpose of internal control noted above relates to small organizations and emphasizes the fraud aspects. For larger organizations, this definition would have to be expanded to include a system of checks and balances over all the systems and procedures to process financial transactions and produce appropriate financial reports. For purposes of this discussion, however, the emphasis is on the physical controls over the organization's assets.

One of the most effective internal controls is the use of a budget that is compared to actual figures on a monthly basis with all significant variances being reviewed at an appropriately high level. (See Chapter 20.) If deviations from the budget are carefully followed up by the treasurer or executive director, the likelihood of a large misappropriation taking place without being detected fairly quickly is reduced considerably. This type of overall review of the financial statements is very important, and every member of the board should ask questions about any item that appears out of line either with the budget or with what would have been expected to be the actual figures. Many times, this type of probing for reasons for deviations from the expected has uncovered problems. It is also advisable that the appropriate committee of the board periodically review these fluctuations to provide another level of oversight.

23.3 SOME BASIC CONTROLS

There are a number of other basic internal controls that are applicable to most not-for-profit organizations. Establishing an effective system of internal control requires knowledge of the particular organization and its operations. The controls discussed here should give the reader some indication of the nature of internal control and act as a starting point for establishing an appropriate system.

In this discussion, we will be considering the division of duties for a small organization, The Center for World Peace, whose financial statements were discussed in Chapter 21. As will be recalled, this organization sponsors seminars and retreats and has a paid staff to run its affairs.

The office staff consists of an executive director, the executive director's secretary, a program director, and a bookkeeper. The officers of the center are all volunteers and usually are at the center only at irregular times. The executive director, treasurer, president, and vice president are check signers. With this background, let us now look at several controls in detail and see how each applies to this organization.

(a) Control over Receipts

The basic objective in establishing internal control over receipts is to obtain control over the amounts received at the time of receipt. Once this control is established, procedures must be followed to ensure that these amounts get deposited in the organization's bank account. Establishing this control is particularly difficult for small organizations because of the small number of persons usually involved.

1. Prenumbered receipts should be issued for all money (cash and checks) at the time first received. A duplicate copy should be accounted for and a comparison made on a regular basis (e.g., monthly) between the aggregate of the receipts issued and the amount deposited in the bank.

The purpose of this control is to create a written record of the cash (and checks) received. The original of the receipt should be given to the person from whom the money was received; the duplicate copy should be kept permanently (i.e., in accordance with applicable federal and state record retention provisions). Periodically, a comparison should be made of the aggregate receipts issued with the amount deposited. The receipts can be issued at the organization's office, or if door-to-door collections are made, a prenumbered receipt can be issued as amounts are received by the collector. It is hoped that all contributors will learn to expect a receipt for cash payments.

It is important that both the duplicate copy and the original be prenumbered to provide control over the receipts issued. If a receipt is "voided" by mistake, both the original and the duplicate should be kept and accounted for. In this way there will be complete accountability over all receipts that have been issued.

In our illustration, the center receives a fair amount of cash at its seminars and retreats on weekends when the bookkeeper and treasurer are not available. One of the participants is designated as the fee collector for that session and in turn collects the fees and issues the receipts. After all of the fees are collected, they are turned over, with the duplicate copy of the receipts (along with all unused receipt forms) to the program director. A summary report of the cash collected is prepared and signed in duplicate. One

copy of this report is mailed directly to the treasurer and the duplicate is turned over to the program director. The program director counts the money, agreeing the total received with the total of the duplicate receipts, and with the summary report. The program director gives the money, the duplicate receipts, and the copy of the summary report to the bookkeeper for depositing. The bookkeeper deposits the money and files the duplicate receipts and summary report for future reference. Once a month the treasurer compares the copy of each summary report with the deposits shown on the bank statement.

2. Cash collections should be under the control of two people wherever possible, particularly where it is not practicable to issue receipts.

In the illustration in the previous paragraph, control was established over cash collections by having the person collecting at each seminar issue receipts and prepare a summary report. The program director, in turn, also had some control through knowledge of how many persons attended, and comparison of the amount collected with the amount that should be collected. This provided dual control.

There are many instances, however, where cash collections are received when it is not appropriate to give a receipt. Two examples are church "plate" collections during worship services, and coin canisters placed in stores and public places in a community for public support. To the extent that only one person handles this money, there is always a risk. The risk is not only that some of it will be misappropriated, but also that someone may erroneously think it has been. This is why it is recommended that two people be involved.

Canisters containing cash that are placed in public places should be sealed so that the only way to get access to the cash is to break the canister open. Someone could take the entire canister, but if the canister is placed in a conspicuous place—near the cash register, for example—this risk is fairly low. These canisters should be serially numbered so that all canisters can be accounted for. When the canisters are eventually opened, they should be counted by two people using the same procedures as with plate collections.

3. Two persons should open all mail and make a list of all receipts for each day. This list should subsequently be compared to the bank deposit by someone not handling the money. Receipts in the form of checks should be restrictively endorsed promptly upon receipt. Alternatively, a lockbox arrangement can be established with your bank.

Two persons should open the mail; otherwise there is a risk that the mail opener may misappropriate part of the receipts. This imposes a heavy burden on the small organization with only one or a few employees, but it is necessary if good internal control is desired. One alternative is to have mail receipts go to a bank lock-box and let the bank do the actual opening of the mail.

The purpose of making a list of all checks received is to ensure that a record is made of the amount that was received. This makes it possible for the treasurer to check later to see whether the bookkeeper has deposited all amounts promptly.

Checks should be promptly endorsed since once endorsed there is less likelihood of misappropriation. The endorsement should be placed on the check by the person first opening the mail.

In theory, if the check has been made out in the name of the organization, no one can cash it. However, experience has shown that a clever enough person can find a way to cash it or deposit it in a "personal" bank account opened for the purpose. On the other hand, once the check is endorsed with the name of the bank and the organization's account number it is very difficult for the embezzler to convert the check to personal use. They then make a list, in duplicate, of all checks received, with one copy of the list going to the bookkeeper with the checks for depositing. They both sign the original of the list, which goes to the executive director. The executive director obtains the copy to see what amounts have been received. At the end of the month, all of these lists are turned over to the treasurer, who then compares each day's lists with the respective credits on the bank statement.

4. All receipts should be deposited in the bank, intact and on a timely basis.

The purpose of this control is to insure that there is a complete record of all receipts and disbursements. If an organization receives "cash" receipts, no part of this cash should be used to pay its bills. The receipts should be deposited, and checks issued to pay expenses. In this way, there will be a record of the total receipts and expenses of the organization on the bank statements.

This procedure does not prevent someone from stealing money but it does mean that a check must be used to get access to the money. This leaves a record of the theft and makes it more difficult for a person to cover up.

In our illustration, it should be noted that the bookkeeper deposits each day's mail receipts intact, and also deposits, separately, the receipts from each seminar. On some days, there are two or three deposits. Making the deposits separately enables the treasurer at the end of the month to compare the copy of the summary of seminar

receipts and the daily mail receipts to the bank statement. This comparison by the treasurer does not take more than a few minutes each month but it provides excellent internal control over receipts and it also gives assurance that the bookkeeper is depositing all receipts daily.

(b) Control over Disbursements

The basic objective in establishing internal controls over disbursements is to ensure that a record of all disbursements is made and that only authorized persons are in a position to withdraw funds. The risk of misappropriation can be significantly reduced if procedures are established to minimize the possibility that an expenditure can be made without leaving a trail, or that an unauthorized person can withdraw money.

5. All disbursements should be made either by check or by properly authorized electronic disbursement. In both cases it is vital that appropriate supporting documentation is kept for each disbursement.

This control is to insure that there will be a permanent record of how much and to whom money was paid. No amounts should be paid by cash, with the exception of minor petty cash items. For the same reason, no checks should be made payable to "cash." Checks should always be payable to a specific person or organization, including checks for petty cash reimbursement. This makes it more difficult to fraudulently disburse funds.

At the center, the bookkeeper is the one who prepares all checks for payment of bills. Before a check is prepared, however, the vendor's invoice must be approved by the executive director. If the purchases involved goods that have been received at the center, the person who received the goods must indicate their receipt, right on the vendor's invoice.

The bookkeeper is not a check signer since, if this were the case, this person could fraudulently disburse funds to him- or herself and then cover up the fraud in the books. The check signers are the executive director, the treasurer, the president, and the vice president. Normally the executive director signs all checks. Checks of more than a certain dollar amount (e.g. \$5000) require two signatures. The executive director carefully examines all supporting invoices, making sure that someone has signed for receipt of the goods before signing the check. After signing the check, each invoice is marked "paid" so that it won't inadvertently be paid twice. Someone other than the bookkeeper should mail all checks to the vendors as an added control. By not letting the bookkeeper have access to the signed checks, the bookkeeper is not in a

position to profit from preparing a fraudulent check to a non-existent vendor.

6. A person other than the bookkeeper should receive bank statements directly from the bank and should promptly reconcile them. This control is to prevent the bookkeeper from fraudulently issuing a check for personal use and, as bookkeeper, covering up this disbursement in the books. While the bookkeeper may not be a check signer, experience has shown that banks often do not catch forged check signatures. The bookkeeper usually has access to blank checks and could forge the check signer's signature. If the bookkeeper were to receive the bank statements, the fraudulent and forged canceled checks could be removed and then destroyed, with the fraud covered up through the books.

In most smaller organizations, the bank statement and canceled checks should go directly to the treasurer, who should supervise the preparation of the bank reconciliations.

(c) Other Areas of Control

7. Someone other than the bookkeeper should authorize all write-offs of accounts receivable or other assets. This control is to insure that a bookkeeper who has embezzled accounts receivable or some other assets will not also be in a position to cover up the theft by writing off the receivable or asset. If the bookkeeper is unable to write such amounts off, someone will eventually ask why the "receivable" has not been paid and this should trigger correspondence that would result in the fraud's being discovered. Generally, write-offs of small receivables should be approved by the treasurer (provided the treasurer is not also the bookkeeper), but if they are large in amount they should be submitted to the board for approval. Before any amount is written off, the treasurer should make certain that all appropriate efforts have been made to make collection. The treasurer must constantly keep in mind the fiduciary responsibility to take all reasonable steps to safeguard the organization's assets.

8. Marketable securities should be kept in a bank safe deposit box or held by a custodian in an account in the name of the organization.

This control is to insure that securities are protected against loss by fire or theft or from bankruptcy of a brokerage house. For most organizations, marketable securities represent long-term rather than short-term investments and certificates should not be kept in a safe in the organization's office or at the broker's office. The organization should provide the maximum protection for these assets. Either a custodian should keep these securities or they should be

kept in the bank safe deposit box under dual signature control. Safeguarding investments is discussed more fully in Chapter 26.

In our illustration, the center does not have very much in the way of investment funds. What endowments the center has it keeps in a bank common stock fund. This is a form of mutual fund that the bank set up to handle investments on a pooled basis for a number of not-for-profit organizations. All decisions at the center to put money into or take money out of this bank fund are made by the executive committee of the board, acting on the advice of the investment committee. The bank insists that the executive committee's minutes accompany any request for withdrawals of or additions to the center's shares in this fund. There are no share certificates as such, although the bank sends quarterly statements to the treasurer showing the number of shares the center has.

9. Fixed-asset records should be maintained and an inventory taken periodically.

These procedures insure that the organization has a complete record of its assets. The permanent record should contain a description of the asset, cost, date acquired, location, serial number, and similar information. Such information will provide a record of the assets that the employees are responsible for. This is particularly important in not-for-profit organizations where turnover of employees and officers is often high. It also provides fire insurance records. An example of the type of fixed-asset record that should be kept is shown in Exhibit 31.3 in Chapter 31 of this book.

23.4 FIDELITY INSURANCE

One final recommendation: Fidelity insurance should be carried. The purpose of fidelity insurance is to ensure that if a loss from embezzlement occurs the organization will recover the loss. This insurance does not cover theft or burglary by an outside person (which is covered by a different kind of insurance policy). It provides protection only against an employee's or volunteer's dishonesty. Having fidelity insurance also acts as a deterrent because the employees know that the insurance company is more likely to press charges against a dishonest employee than would a "soft-hearted" and embarrassed employer.

There is only one catch to this type of coverage, however. The organization has to have good enough records to prove that an embezzlement has taken place. This means that this coverage is not a substitute for other internal controls. If the theft occurs but the employer doesn't know it or if there is no proof of the loss, fidelity insurance will not help. This protection is not expensive because the risk is usually low. The risk varies from one organization to another and, for that reason, the premium will vary.

23.5 CONCLUSION

The cost of this coverage is relatively so little that prudence dictates that all not-for-profit organizations have this coverage.

23.5 CONCLUSION

Internal control as discussed in this chapter for small organizations is a system of procedures that in the absence of collusion minimizes the likelihood of misappropriation of assets or misstatement of the accounts, and if it has occurred maximizes the likelihood of detection. These controls largely depend on a division of duties such that no one person is in a position to both misappropriate assets and to cover up the theft in the records. These controls are very important especially in a smaller organization where it is difficult to provide for this division of duties. One of the principal reasons often overlooked for having good internal control is to remove temptation from normally honest employees. The board should insist that key controls be established. It has the responsibility to insure that all practical measures be taken to protect the organization's assets.

The controls discussed in this chapter are basic ones and should not be considered all-inclusive. A complete system of internal control encompasses all of the procedures of the organization.

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24.1 INTRODUCTION TO INTERNAL ACCOUNTING CONTROL

(a) Definition

Accounting literature defines internal accounting control as the plan of organization, procedures, and records designed to enhance the *safe-guarding* of assets and the *reliability of financial records* of an organization. Internal accounting control provides reasonable, but not absolute, assurance that:

- Transactions conform with management authorization
- Transactions are recorded in accordance with accounting conventions, and accountability over assets is maintained
- Access to assets is limited to authorized persons
- Periodic comparison of asset records and existing assets would disclose significant discrepancies and that appropriate action would be taken with respect to differences

(b) Internal Control—Integrated Framework Definition

Interested readers may want to review *Internal Control—Integrated Framework*, which was the September 1992 report of our predecessor firm Coopers & Lybrand.¹ This report was developed for the Committee of

¹ Additionally, COSO has just issued *Enterprise Risk Management—Integrated Framework* and this expands on its earlier work. This report, which was also developed by our firm, is designed to satisfy both an organization's need for effective internal controls as well as for effective risk management. Interested readers can find *Internal Control—Integrated Framework* and *Enterprise Risk Management—Integrated Framework* posted on the Publications page of the COSO website, <http://www.coso.org/>.

Sponsoring Organizations (COSO) of the Treadway Commission. In this report, internal control was defined broadly as follows:

Internal control is a process, affected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

This definition reflects certain fundamental concepts:

- Internal control is a process. It is a means to an end, not an end in itself.
- Internal control is affected by people. It is not merely policy manuals and forms, but people at every level of an organization.
- Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an entity's management and board.
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

This definition of internal control is broad for two reasons. First, it is the way most senior executives interviewed view internal control in managing their businesses. In fact, they often speak in terms of "control" and being "in control." Second, it accommodates subsets of internal control. Those who want to can focus separately, for example, on controls over financial reporting or controls related to compliance with laws and regulations. Similarly, a directed focus on controls in particular units or activities of an entity can be accommodated.

(c) Benefits to Nonprofit Organizations

Internal accounting control provides important benefits to nonprofit organizations. It improves the quality of information and reduces the possibility of error, mismanagement, and fraud. This in turn increases the probability that the organization will be able to provide effective service to the community, and also reduces the possibility that (1) an organization will incur a loss of public trust; and (2) its board and management will suffer public censure or legal penalties.

(d) Internal Accounting Controls Are Not Static

Nonprofit organizations and the environments in which they operate are dynamic. Internal accounting controls must change in response to the changing character of an organization and its environment, and the changing relationship between the two. Existing controls may become redundant, irrelevant, or cost-inefficient and need to be eliminated. New controls may become necessary. *Periodic review is essential to maintaining the vitality of internal control systems.* Management should have a process

in place, so that on a periodic basis, the internal controls over the significant operating cycles are reviewed and assessed for adequacy and appropriateness.

(e) Role of the Board of Directors and Senior Management

The board of directors and senior management have ultimate responsibility for internal accounting control. This responsibility is particularly pronounced in not-for-profit organizations, where scarce resources often limit the extent and effectiveness of formal control systems. Internal accounting control in not-for-profit organizations is improved by the continuous monitoring of accounting records and procedures, and the overall review of operations by directors and senior management.

24.2 ELEMENTS OF AN EFFECTIVE INTERNAL ACCOUNTING CONTROL SYSTEM

Effective internal accounting control is achieved through an integrated system of people, records, and procedures. The key elements of an effective system are:

- Control environment
- Director and management involvement
- Control objectives
- Organization structure and management controls
- Key policies and procedures manuals
- Segregation of duties
- Recordkeeping and information system
- Financial reporting system
- Budgets
- Periodic review of the control system
- Cost-benefit analysis

(a) Control Environment

Program and administrative staff must understand the importance and philosophy of internal accounting control before an effective system can be initiated. If a control system does not reflect control requirements, or if control procedures are improperly executed, effective management may be impossible and the goals of the organization may not be realized.

Creating a control environment is often an educational process best performed by senior management. Not only must management inspire commitment to control, it must ensure that the personnel complement of the organization is of sufficient size, competence, and discipline to execute control functions. It must be clear from the attitude and posture of directors and management that effective controls are a matter of high priority.

This environment, and management's expectations, can be communicated to all members of an organization through a code of conduct. See Appendix B at the end of this book for a sample code of conduct.

(b) Director and Management Involvement

Control systems are more effective if directors and management who authorize programs and execute transactions are involved in the day-to-day management of the organization. In many instances, the chairman of the board or audit committee chairman will be a business executive who can effectively monitor a control system and determine whether it is operating satisfactorily.

Senior management can also play a vital role in the control process by expressing interest in the day-to-day accounting and financial routines, through inquiries and observation. A well phrased question from time to time can be a more effective control technique than merely a structured set of formal procedures.

Another method of involving directors and management is through a "whistleblower" hotline. This is a mechanism that allows employees and others to anonymously report wrong doings (either known or suspected).

Depending on the size of the organization and the volume of calls, the hotline could be monitored by human resources, a nonfinancial executive or outside counsel. The appointed individual would be responsible to ensure all matters are followed up on and investigated where necessary.

(c) Control Objectives

Overall internal accounting control objectives should be established for the organization, as well as for each individual area of operation. Internal accounting control objectives generally include control over authorization of transactions, recording of transactions, access to assets, and asset accountability. Internal accounting controls should reflect the unique environment, attributes, and risks inherent in the operation of each organization. Key control objectives for each major area of operation should be identified and set forth in written procedures. Documenting key controls is essential to facilitate the assessment of their ongoing effectiveness.

(d) Organization Structure and Management Controls

Organization structure and management controls should facilitate establishment of control objectives and execution of control procedures.

Organization structure should contain the following attributed:

- Clear lines of authority
- Clear definition of responsibility
- Authority commensurate with responsibilities

Organization structure and management controls should address, when necessary, problems associated with use of volunteer personnel.

(e) Key Policies and Procedures Manuals

The operating policies of an organization and the accounting procedures for executing transactions should be clearly communicated. These policies and procedures should be readily accessible to appropriate personnel, and should serve as the primary source of reference for resolving operating and accounting questions (and should be updated on a periodic basis). Effective communication is often achieved by collecting and codifying policies and procedures in reference manuals, particularly when part-time and volunteer personnel control certain aspects of operations.

(f) Segregation of Duties

Responsibilities should be assigned to personnel in such a manner that no one individual, including senior managers and directors, controls all aspects of processing a transaction.

Segregation of duties is a coordinated system of checks and balances in which tasks necessary to complete a transaction either are performed by different individuals, or two or more individuals working in tandem, or are independently reviewed. Division of work assignments along these lines reduces the probability that error, mismanagement, or fraud will go undetected.

Segregation of duties is the cornerstone of internal accounting control. It is often expensive to implement and expected costs and benefits should be carefully analyzed before a decision to enhance or implement is made. Not-for-profit organizations often do not have sufficient personnel to achieve a traditional segregation of duties. In such instances, active involvement of directors and senior management in monitoring the course of activities and the flow of resources into and out of an organization is essential.

(g) Recordkeeping and Information Systems

Information is a key component of a system of internal accounting control. Accurate and timely information permits an organization to examine and verify past transactions and current levels of assets. Collection, classification, and accumulation of information is, therefore, essential to an effective system of internal accounting control.

- *Collection* of information is generally initiated by the person or persons executing the transaction.
- *Classification* of information is achieved by virtue of a chart of accounts. A chart of accounts is a collection of codes that classify transactions on the basis of type of transaction and responsibility for the transaction.
- *Accumulation* of information is generally accomplished through summary or subsidiary journals and a general ledger. Subsidiary journals summarize records of similar transactions and are, in turn, summarized in the general ledger. A hierarchy of accounting records and segregation of responsibility for each are important elements of internal accounting control.

The following records generally provide information necessary for internal accounting control in nonprofit organizations:

- Cash receipts journal
- Cash disbursements journal
- Accounts receivable ledger
- Pledge receivable ledger
- Accounts payable register
- Payroll register
- Fixed assets ledger
- Investment ledger
- General journal
- General ledger

(i) Electronic Data Processing. Many nonprofit organizations use *electronic data processing* (EDP) to perform routine administrative functions and to manage information. While EDP management controls and control techniques differ from manual control procedures, control objectives for EDP systems are similar to those of any processing system.

The transition from manual to EDP systems often creates new areas of control exposure that must be promptly addressed.

(ii) Service Bureaus. Many not-for-profit organizations engage outside organizations, known as service bureaus, to prepare payrolls and vendor checks, process student loan payments and to maintain selected financial records. Use of service bureaus, like use of EDP, does not change the objectives of internal accounting control or the control responsibilities of directors and management. New control procedures applicable to both the not-for-profit organization and service bureau are, however, often required.

A thorough understanding of control procedures surrounding the processing of transactions at service bureaus is essential. A well-defined system of input and output controls is often necessary to provide control over service bureau activities. As a response to their customers' demands, many service bureaus are obtaining an "SAS 70 Report" on their internal controls.² This report, by their independent auditors, documents the service bureau's internal procedures and controls and the independent auditors offer an opinion on the effectiveness of this process and controls.

The SAS 70 Report also details out the controls the service bureau is expecting their clients to have in place and for which the service bureau is not taking responsibility.

(h) Financial Reporting System

A concise, comprehensible, and timely report detailing the financial activity of each major area of operation should be prepared. Such reports provide assurance concerning the propriety and accuracy of reported transactions. Since not-for-profit personnel may not be conversant with technical accounting conventions, functional financial reporting will be an effective control only to the extent it is simple and straightforward. Effective financial reports often contain the following attributes:

- Highlights of important transactions and trends
- Written analysis of operations
- Nontechnical terminology
- Concise display of information
- Comparison of actual results to expected results

(i) Budgets

Budgets are an important element of an internal accounting control system. They allow effective monitoring of the flow of resources into and out of an organization. In not-for-profit organizations, comparison of

² Statement on Auditing Standards (SAS) No. 70 is an internationally recognized auditing standard developed by the American Institute of Certified Public Accountants (AICPA).

actual results to budget estimates often provides the first indication of operating problems or weaknesses in an internal accounting control system. Three types of budgets are generally prepared:

- *Operating budget*—establishes the expected revenue and expenditures for one or more future periods. Such a budget is based on historical events and current assumptions concerning the future.
- *Cash flow budget*—establishes the expected cash receipts and cash disbursements. This budget projects the expected cash balances at different intervals in the operating cycle.
- *Capital budget*—establishes the expected expenditures on capital acquisitions such as land, buildings, and equipment that have been formally authorized by the board. Normally, only capital expenditures approved by this budget are permitted during the period.

Internal accounting control is facilitated by preparation of:

- *Periodic budgets*—the division of annual budgets into quarterly or monthly segments. Periodic budgets should reflect seasonal variations in income, expenditures, cash flow, and fixed asset purchases.
- *Location budgets*—the division of annual budgets by different operating locations. Location budgets should effectively be operating, cash flow or capital budgets for each significant location.
- *Comparative financial information*—includes actual income, expenditures, cash flow, and fixed asset purchases for the current period and comparable data from preceding periods.

Material variances from periodic budgets, location budgets and between current and prior periods should be promptly investigated and satisfactory explanations obtained by the chief financial officer.

(j) Periodic Review of the Control System

Control procedures that are currently effective may become ineffectual if the nature of an organization, its activities, or types of transactions change. Periodic review of the control system assures that control procedures in need of change are identified on a timely basis. Questions that facilitate control system review include the following.

- Have changes occurred in our organization that may require new controls?
- Have “surprises” been encountered that could have been anticipated with better controls?
- Have explanations of variations from budget been confusing or contradictory?

EFFECTIVE INTERNAL ACCOUNTING CONTROL

- Have our accounting or financial functions been overextended, increasing the possibility of error or untimely processing of transactions?
- Have recommendations made by independent auditors for improving our control system been implemented?

In view of the change in the controls environment and the public's perception, it is a "best practice" that the organization periodically review its policies and procedures to ensure any risks that may have recently arisen due to a change in the business or in the environment be addressed and minimized.

(k) Cost-Benefit Analysis

Every organization should have formal procedures for determining whether recommendations for improving the control system are cost justified. Cost-benefit analysis is an effective method of analyzing control recommendations. Cost-benefit or risk analysis examines the cost of new control procedures in the context of the benefits to be derived from eliminating a control weakness. In other words, it compares the likely cost-saving that would accompany reduction of risk with the out-of-pocket expense (and intangible costs) of risk reduction. Cost-benefit analysis should be conducted subsequent to discovery of an internal control weakness or introduction of a new type of transaction, but prior to implementing new control procedures.

The following sequence is useful in applying cost-benefit analysis to internal accounting controls:

- Identify the internal accounting control weakness.
- Determine the importance of the weakness with respect to:
 - Magnitude of possible risk
 - Probable frequency of occurrence
- Identify controls that could be implemented.
- Identify cost elements, both quantitative and qualitative. Costs frequently include:
 - Direct expenditure on controls (includes actual expenditures and employee time involved to perform the control)
 - Negative morale in response to any new restrictions
- Identify benefit elements, both quantitative and qualitative. Benefits frequently include:
 - Reduction in probable loss of resources
 - Improved public image

24.3 BASIC INTERNAL ACCOUNTING CONTROL SYSTEM

- Assign a monetary value or priority ranking to cost and benefit elements. Personal estimates and judgments are often required.
- Execute cost-benefit analysis and document premises upon which a final decision is made.

Controls should be implemented if total benefits derived exceed the total cost of controls. If alternative control procedures are available, the control that yields the highest net benefits should be selected.

A key concept in cost-benefit analysis is incremental costs and benefits—each additional dollar expended on controls should normally produce at least an additional dollar of benefits. The results of this cost-benefit analysis should also be presented to the board (or appropriate committee) to ensure the board's concurrence.

24.3 BASIC INTERNAL ACCOUNTING CONTROL SYSTEM

The following section sets forth a framework for a basic internal accounting control system surrounding cash receipts, cash disbursements, payrolls, receivables, payables, inventory, fixed assets, and petty cash and other working funds. In each control area, *control objectives* and *control procedures* are identified. Control objectives define goals pertaining to each control area. Control procedures identify controls related to each area. Alternate procedures can often be used to achieve control objectives; those suggested in this section are commonly found in nonprofit organizations.

Control procedures are presented as questions to assist directors and managers to assess present controls. "No" answers signal control weaknesses that should be evaluated in terms of magnitude and mitigating circumstances, such as compensating controls.

(a) Receipt of Cash

CONTROL OBJECTIVE: To ensure that all cash intended for the organization is received, promptly deposited, properly recorded, reconciled, and kept under adequate security.

CONTROL PROCEDURES:

- Are the cash receiving, processing, recording, and bank reconciliation functions clearly segregated?
- Is cash listed and are checks restrictively endorsed immediately upon receipt?
- Are prenumbered receipts issued? Is adequate control maintained over the sequence of unused and used numbers?

EFFECTIVE INTERNAL ACCOUNTING CONTROL

- Is the initial listing of receipts sent directly to persons responsible for the general ledger and bank reconciliation functions?
- Does a duplicate listing of receipts accompany receipts for use in preparing deposits and posting detailed receivable records?
- Is cash deposited in a bank account intact, and on a timely basis, by a person independent of receiving and general ledger functions? Are duplicate deposit slips received?
- If credit card payments are received are these reconciled to the bank statement?
- Alternatively, is cash received directly by a bank, which authenticates and forwards deposit slips and a list of depositors and deposits to the organization?
- Is the initial listing of receipts compared with duplicate bank deposit slips? Is a receipts summary prepared by the receipts processing function for use in posting the cash receipts journal?
- Is the cash receipts journal compared to records maintained by the development (fund raising) department?
- Is the cash receipts journal posted by a person independent of the receiving and cash processing functions?
- Is the cash receipts journal posted to the general ledger by a person independent of the cash receiving and processing functions?
- Are bank reconciliations prepared by a person independent of the cash receiving, processing, and recording functions?
- Is it mandatory for employees involved in this cycle to take vacation?

(b) Disbursement of Cash

CONTROL OBJECTIVE: To ensure that cash is disbursed only upon proper authorization of management, for valid business purposes, and that all disbursements are properly recorded.

CONTROL PROCEDURES:

- Are the authorization, processing, check-signing, recording, and bank reconciliation functions clearly segregated?
- Are persons authorized to approve expenditures clearly identified, and are all expenditures approved in advance by authorized persons?
- Are invoices or requests for expense reimbursements supported by appropriate receipts and/or approval indicating receipt of goods or services? Is this policy effectively communicated to all appropriate persons, including volunteers?

24.3 BASIC INTERNAL ACCOUNTING CONTROL SYSTEM

- Are all disbursements made by prenumbered checks?
- Is a record of cash disbursements (e.g., check stubs, check copies, cash disbursements record) kept by the person processing checks? Does a listing of disbursement amounts accompany the checks for signature?
- Is there segregation of duties between the individual who has access to establish a vendor in the payable system and the individual who produces checks?
- Is check-signing authority vested in persons at appropriately high levels in the organization? Do larger checks require a higher level of authority? Is the number of authorized signatures limited to the minimum practical number?
- Are signed checks mailed promptly under the control of the check signer?
- Does the check signer (1) review and initial documentation supporting checks indicating completeness and appropriate approval, and (2) compare check amounts, on a test basis, to the listing of disbursements accompanying checks?
- Is the listing of disbursements initialed by the check signer and compared to the disbursement summary prepared by the check processing function for use in posting the cash disbursement journal by a person independent of the check-processing, check-signing, and authorization functions?
- Is the cash disbursements journal posted by a person independent of the authorization, check-processing, and check-signing functions?
- Is the cash disbursements journal posted to the general ledger by a person independent of the check-processing, check-signing, and authorization functions?
- Are bank statements and canceled checks received directly and reconciled with disbursement records by a person independent of the cash authorization, check-processing, and check-signing functions?
- Is it mandatory for employees involved in this cycle to take vacation?

(c) Payroll

CONTROL OBJECTIVE: To ensure that payroll disbursements are made only upon proper authorization of management to bona fide employees, that payroll disbursements are properly recorded, and that related legal requirements (such as payroll tax deposits) are complied with.

EFFECTIVE INTERNAL ACCOUNTING CONTROL

CONTROL PROCEDURES:

- Are the personnel authorization, payroll preparation and approval, payroll check distribution, recordkeeping, and bank reconciliation functions clearly segregated?
- Are changes in employment (additions and terminations), salaries, wage rates, and payroll deductions authorized by proper nonaccounting personnel? Do policies and procedures exist for accounting for vacations, holidays, and sick leave?
- Are changes in employment status recorded in employee personnel files maintained by a person independent of the payroll processing function?
- Are time and attendance records, including hours worked, overtime, and special benefits, reviewed and approved by authorized nonaccounting personnel?
- Is the payroll register kept by person(s) processing payroll checks? Does the register accompany the checks for signature?
- Is a separate imprest basis payroll bank account maintained? Is the account periodically reconciled? Is a maximum dollar amount set which can be drawn on this account?
- Are all disbursements made by prenumbered checks?
- Is check-signing authority consistent with that for general disbursements?
- Are signed checks distributed promptly under the control of the check signer?
- Are payroll registers reviewed and initialed by the check signer? Does the review periodically include, on a test basis:
 - Comparison of current and previous payrolls?
 - Comparison of check amounts with payroll register?
 - Comparison of changes in wage rates with personnel department records?
 - Comparison of hours worked with time records?
 - Verifying accuracy of payroll computations?
- Is the payroll register initialed by the check signer compared to the payroll summary prepared by the payroll-processing function for use in posting the general ledger?
- Is the summary of the payroll register posted to the general ledger by a person independent of the payroll-processing, check-signing, and authorization functions?

24.3 BASIC INTERNAL ACCOUNTING CONTROL SYSTEM

- Are bank statements and canceled checks received directly and reconciled with the payroll register by a person independent of the payroll-processing, check-signing, and authorization functions?
- Are unclaimed payroll checks controlled by an individual not involved in payroll-processing, check-signing, or distribution functions?
- Are the mailing of W-2 forms and the investigation of questions arising from them the responsibility of individuals independent of the authorization, payroll-processing, and check-signing functions?
- Is payroll classified in proper accounts (e.g., by function) and is classification periodically reviewed?
- Are the information supplied to employee benefit plans and actuarial assumptions and computations periodically reviewed?
- Are the taxes (e.g., social security and unemployment) paid on the wages of each employee monitored? Are all such taxes paid when due?
- Is it mandatory for employees involved in this cycle to take vacation?

(d) Billing and Receivables

CONTROL OBJECTIVE: To ensure that all sales or services are promptly billed and recorded at authorized rates, that payments are received promptly, and that unpaid accounts adequately followed up.

CONTROL PROCEDURES:

- Are the credit authorization, billing, recordkeeping, collection, and cash processing functions clearly segregated?
- Are all billings for services or goods approved in advance by authorized persons?
- Are authorized rates for services and prices for goods clearly established and effectively communicated to those responsible for the billing function? Are changes in rates or prices promptly communicated?
- Are billings promptly recorded in receivable records or are copies of billings maintained in distinct open invoice files? Are control totals of billings prepared by the billing function daily and promptly forwarded to the general ledger function?
- Are accounts receivable records protected from theft, destruction, and alteration?

EFFECTIVE INTERNAL ACCOUNTING CONTROL

- Is the accounts receivable ledger or open invoice file periodically reconciled with the general ledger by a person independent of the billing and receivable records and initial-receipt-of-cash functions?
- Payment—see subsection (a), Receipt of Cash, in this section.
- Are collections promptly recorded in receivable records or on copies of billings by a person independent of the initial receipt of cash?
- Are all adjustments to original billings approved by nonaccounting persons?
- Is the prompt collection of outstanding accounts initiated? Are statements of account periodically sent to persons with outstanding accounts?
- Are disputed accounts reviewed by an authorized person who is independent of the billing and receivable records function?
- Are accounts outstanding properly analyzed for collectibility and periodically aged by a person independent of the billing and receivable functions?
- Is the write-off of uncollectible amounts approved by nonaccounting persons?
- Is it mandatory for employees involved in this cycle to take vacation?

(e) Accounts Payable

CONTROL OBJECTIVE: To ensure that accounts payable are supported by appropriate documentation, are promptly paid, and are properly recorded. See also subsection (b) Disbursement of Cash in this section.

CONTROL PROCEDURES:

- Are the authorization, processing, recording, and payment functions clearly segregated?
- Authorization—see subsection (b), Disbursement of Cash, in this section.
- Are all approved invoices promptly recorded in the voucher (accounts payable) register to establish control for payment?
- Are unpaid invoices maintained in a distinct unpaid open invoice file?
- Are statements from vendors regularly compared with open invoice files?
- Are invoices from unfamiliar or unusual vendors reviewed and approved for payment by authorized personnel who are independent of the invoice processing function?

24.3 BASIC INTERNAL ACCOUNTING CONTROL SYSTEM

- Payment—see subsection (b), Disbursement of Cash, in this section.
- Are payments recorded promptly in the accounts payable register to avoid double payment?
- Is the accounts payable register periodically reconciled with the general ledger by a person independent of the invoice processing function?
- Is a listing of unpaid invoices regularly prepared and periodically reconciled with the general ledger by a person independent of the invoice processing function?
- Is it mandatory for employees involved in this cycle to take vacation?

(f) Inventory

CONTROL OBJECTIVE: To ensure that inventory is appropriately safeguarded and properly recorded.

CONTROL PROCEDURES:

- Are the purchasing, custodial, processing, and recordkeeping functions clearly segregated?
- Is responsibility for inventory established and appropriate physical safeguards maintained?
- Are the receipt, transfer, and withdrawal of inventory items promptly recorded in inventory records, and are quantity records of the more important inventory items maintained?
- Are inventory records periodically reconciled with the general ledger?
- Is a physical inventory periodically taken by persons independent of custody and processing functions?
- Do inventory records permit accounting for items that are expensed when purchased?

(g) Fixed Assets

CONTROL OBJECTIVE: To ensure that fixed assets are acquired and disposed of only upon proper authorization, are adequately safeguarded, and properly recorded.

CONTROL PROCEDURES:

- Are the authorization, purchasing, custody, and recordkeeping functions clearly segregated?
- Are only fixed-asset purchases approved by the board in the capital budget permitted? Is a board-approved amended capital budget required for purchases not initially authorized?

EFFECTIVE INTERNAL ACCOUNTING CONTROL

- Is borrowing for fixed-asset purchases limited to specific authorizations by the board in the capital budget?
- Do requests for capital additions include identification of assets being replaced, and the likely disposition of the replaced asset?
- Is the sale, retirement, or abandonment of fixed assets in conformity with board policy, and subject to approval by the board?
- Is the fixed-asset ledger periodically reconciled with the general ledger by a person independent of the recording and custody functions?
- Are independent appraisals of fixed assets for insurance purposes periodically made?
- Are land, buildings, and equipment recorded in a fixed-asset ledger? Do asset records include description, location, identification number, date of acquisition, and cost of each asset?
- Are fully depreciated fixed assets and fixed assets not currently in use recorded in the fixed-asset ledger?
- Have criteria been established by the board for capitalizing or expensing fixed-asset purchases?
- Have depreciation policies been established by the board?
- Are custodial accountability and physical safeguards maintained by each unit of the organization that has the responsibility for fixed assets?
- Is the movement of equipment from one department to another reported to the recording function promptly?
- Are physical inventories of fixed assets periodically taken by persons independent of custody and recording functions?

(h) Petty Cash and Other Working Funds

CONTROL OBJECTIVE: To ensure that petty cash funds are disbursed only for proper purposes and are adequately safeguarded and properly recorded.

CONTROL PROCEDURES:

- Are petty cash funds maintained on an imprest (i.e., a loan or advance) basis?
- Is the responsibility for each petty cash fund vested in a single custodian?
- Are the types and amounts of petty cash disbursements limited?
- Are advances to employees from the petty cash fund authorized by appropriate personnel?

24.4 SPECIFIC NONPROFIT INTERNAL ACCOUNTING CONTROLS

- Are petty cash transactions periodically monitored, and are increased levels of activity investigated?
- Do persons receiving petty cash sign petty cash vouchers? Are amounts written in letters and numbers?
- Are petty cash reimbursement checks payable only to the custodian?
- Once the fund is reimbursed, are vouchers and receipts marked to prevent reuse?
- Are surprise counts of petty cash funds made by an individual other than the custodian?
- Are physical safeguards over petty cash funds, including fire-resistant boxes, vaults, and overnight depositories, maintained?

24.4 SPECIFIC NONPROFIT INTERNAL ACCOUNTING CONTROLS

Each nonprofit organization has aspects of its operations that require specific control consideration. This section contains a series of control questions relating to several types of transactions frequently executed by nonprofit organizations, which will assist directors and managers to assess the effectiveness of controls presently surrounding these transactions. Again, “no” answers signal control weaknesses that should be evaluated in terms of magnitude and mitigating circumstances, such as compensating controls.

(a) Tuition

CONTROL OBJECTIVE: To ensure that all tuition due is promptly collected at authorized rates and properly recorded.

CONTROL PROCEDURES:

- Is the receipt and recording of tuition payments segregated from the tuition receivable function?
- Is tuition remitted by check, payable only to the institution?
- If credit card payments are accepted, are the receipts to the bank statement reconciled?
- Is tuition due at, or prior to, registration, or early in the period the course is given? If payment is due serially, are payments according to an installment plan schedule?
- Are tuition receipts periodically compared with the tuition revenue estimates in the operating budget?

EFFECTIVE INTERNAL ACCOUNTING CONTROL

- Is tuition revenue periodically compared with enrollment data from nonaccounting departments, such as the registrar's or recorder's office?
- Are tuition adjustments, allowances, and credits approved by an authorized nonaccounting official? Is the write-off of tuition receivables limited to authorized nonaccounting personnel?
- If tuition is based on a standard charge (per semester, for example), is the amount paid by each student compared with the standard by an individual independent of billing, cash receipt, and recording functions?
- If tuition is based on the number or type of courses (or credit hours), is enrollment data for each student verified with registration data from nonaccounting departments, and is arithmetic computation of tuition checked by an individual independent of the billing, cash receipt, and recording functions?
- Are tuition receivables periodically reviewed to determine whether they have been properly analyzed for collectibility and are properly aged, by a person independent of the recording and receivable function?
- Are current delinquents (past due less than one semester) actively pursued and are long-term delinquencies turned over to a collection agency?
- Is the enrollment, awarding of degrees, and providing of transcripts to delinquent students prohibited?

(b) Membership Dues

CONTROL OBJECTIVE: To ensure that all membership dues are promptly collected in authorized amounts and properly recorded.

CONTROL PROCEDURES:

- Are the receipt and recording of dues payments segregated from the dues receivable function?
- Are dues paid by check, payable only to the organization?
- If credit card payments are accepted, are the receipts reconciled to the bank statement?
- Are dues paid prior to, or at the beginning of, the membership period? If payment is due serially, are payments according to an installment plan schedule?

24.4 SPECIFIC NONPROFIT INTERNAL ACCOUNTING CONTROLS

- If the amount of dues paid is based on the size of a member organization:
 - Is the organization membership verified with nonaccounting records, such as industry surveys?
 - Are organization dues periodically compared with the graduated dues schedule?
 - Is the arithmetic computation of organization dues checked?
 - Are dues receipts periodically compared with dues revenue estimates in the operating budget?
 - Are dues receipts periodically compared with membership data from nonaccounting departments?
 - Is dues payment information promptly forwarded from accounting to the membership department?
- Are persons receiving services—as indicated by mailing lists for periodicals, attendance lists for seminars, and enrollment in insurance plans—periodically compared with persons paying dues?
- Are dues receivable periodically reviewed to determine whether receivables are properly analyzed for collectibility and are properly aged by a person independent of the recording and receivable function?
- Is the write-off of dues receivable limited to authorized nonaccounting personnel?
- Is the granting of memberships in future periods to delinquent members prohibited?

(c) Contributions

CONTROL OBJECTIVE: To ensure that substantially all contributions intended for the organization are received, promptly deposited, and properly recorded.

CONTROL PROCEDURES: Additional internal control procedures are listed in the Auditing sections of Chapters 5 and 6 of the audit guide for *Not-for-Profit Organizations*.

- Direct mail: Internal accounting control of incoming mail is similar to controls discussed for subsection (a) Receipt of Cash in this section.
- Direct solicitation:
 - Is the distribution of authorized solicitation material strictly limited?
 - Are collections deposited at the lowest possible level?

EFFECTIVE INTERNAL ACCOUNTING CONTROL

- Is accounting control separated from the physical control of cash at the earliest possible point?
- Are reports prepared which account for all areas and all solicitors?
- Radio and television solicitation:
 - Are pledges promptly recorded and is collection promptly instituted?
 - Are receipt, recording, and custody of collections segregated?
- Contributions from uncontrolled organizations (e.g., United Way):
 - Are amounts due the organization periodically reviewed to determine whether proper amounts are received?
- Special events: Accounting control of special events is similar to control of ticket revenue. See subsection (h), Other Nonprofit Internal Accounting Controls, in this section.

(d) Grants, Gifts, and Bequests Received

CONTROL OBJECTIVE: To ensure that all grants, gifts, and bequests are received and properly recorded, and that compliance with the terms of any related restrictions is adequately monitored.

CONTROL PROCEDURES:

- Is the receipt and recording of grants, gifts, and bequests segregated from expenditure and monitoring of amounts expended?
- Once notified of grant, gift, or bequest award, is the amount expected to be received recorded in a separate receivable account?
- If award is not received on a timely basis, is the awarding party promptly notified? If the write-off of a grant, gift, or bequest receivable is necessary, is the write-off approved by authorized nonaccounting personnel?
- Once the award is received, is the amount received recorded by an individual who is independent of the cash receipts function?
- Are differences between expected and actual awards promptly investigated?
- Are awards contingent upon future events periodically monitored?
- If possible, are budget estimates prepared for grants, gifts, and bequests? Are award receipts periodically compared with award estimates in the operating budget?
- Is there a reconciliation between the cash receipts journal and the development (fund raising) department's records?

24.4 SPECIFIC NONPROFIT INTERNAL ACCOUNTING CONTROLS

- If an organization is responsible for funds used by an individual associated with the organization, does the organization maintain accounts independent of accounts kept by the recipient?
 - Is the disbursement of funds to award recipients approved by nonaccounting personnel?
 - Is all documentation/correspondence from a donor carefully received by qualified personnel to determine the nature of any restrictions or conditions associated with the gift?
 - Are restrictions on use of awards documented? Is compliance with restrictions verified before the initial and all subsequent disbursements?
 - In the case of grants, are accounts periodically monitored for unexpended funds, and are they promptly returned to the awarding party if necessary?

(e) Grants Awarded to Others

CONTROL OBJECTIVE: To ensure that grants are awarded and paid to others only upon proper authorization, and are properly recorded, and that grantee compliance with the grant terms is adequately monitored.

CONTROL PROCEDURES:

- Are the review and approval, disbursement, recording, and monitoring functions clearly segregated?
- Does the grant application identify eligible applicants and projects?
- Is each payment of a grant award authorized by the board or appropriate nonaccounting personnel?
- Is the grantee promptly notified of the award and the conditions of the award, and is grantee acceptance in writing required?
- Once awarded, are grants promptly recorded as a grant payable?
- Does an individual independent of the authorization and disbursement functions verify that payments are made to proper recipients in correct amounts, and that payment is triggered by an appropriate event?
- Do recipients file periodic reports documenting use of grants, which are reviewed by nonaccounting personnel?
- Are grantees monitored for compliance with the terms of grants?
- For grants payable from endowment or other trust funds:
 - Are cash levels continuously monitored to determine whether scheduled payments can be made without eroding principal?

EFFECTIVE INTERNAL ACCOUNTING CONTROL

- Is the level of income and disbursements periodically monitored to determine whether disbursements conform to percentage or other distribution policy of the board?

(f) Loans

CONTROL OBJECTIVE: To ensure that loan funds are properly recorded, disbursed only to authorized persons, and repaid when due.

CONTROL PROCEDURES:

- Are the authorization, disbursement, custody, recording, and collection functions clearly segregated?
- Are new loan funds classified and recorded in separate accounts on the basis of restrictions and sources?
 - Types of restrictions include student need, domicile of student, course of study, and so on.
 - Types of sources include federally funded programs, board-designated unrestricted funds, endowment and other gifts, and so on.
- If provision of loan funds to the institution is contingent upon matching or percentage contributions by the institution, is the extent and computation of the institution's commitment verified?
- If endowment is received with the stipulation that investment income (or part thereof) is to be used for loans, is investment income periodically reviewed to determine whether it is received on a timely basis, in appropriate amounts, and is it recorded in the proper loan fund account?
- If possible, are budget estimates prepared for loan funds? Are loan receipts periodically compared with loan estimates in the operating budget?
- Are the different types of loan programs—including scholarships, fellowships, grants-in-aid, and part-time employment—fully documented and periodically reviewed for revisions?
- Are disbursements periodically reviewed to determine whether they are in conformity with the financial assistance policies of the institution, and in compliance with restrictions on loan funds and programs?
 - Are accounting and financial aid records reviewed to determine the amount of loans students have previously received, the amount of loans students are currently eligible to receive, and so on?

24.4 SPECIFIC NONPROFIT INTERNAL ACCOUNTING CONTROLS

- Are student personnel and financial aid records reviewed to verify whether students qualify for loans on such bases as need, citizenship, enrollment status, and so on?
- Are loan fund assets, usually cash, notes receivable, and short term investments, periodically reviewed to determine whether the loan fund balance is consistent with executing the loan policy of the organization?
- Are loan disbursement records periodically reviewed to determine whether loan funds are used only for designated purposes, and not such undesignated purposes as current operations?
- Is repayment by check, payable to the organization or to a service bureau?
- Are loan receivables periodically reviewed to determine whether receivables are properly analyzed for collectibility and are properly aged, by a person independent of the loan recording and receivable function?
- Is the computation of principal and interest repayment checked for accuracy?
- Are delinquent loan procedures reviewed to determine whether they comply with the requirements of different loan programs? (Federal agencies establish loan retrieval guidelines for federally funded programs.)
- Additional questions related to accounting controls for delinquent loans include:
 - Is a deadline established after which unpaid loans are in default?
 - Are delinquent loans promptly turned over to a collection agency?
 - Are loans that are forgiven periodically reviewed to determine whether cancellations are properly authorized and are in conformity with loan policy?
 - Are loan delinquents prohibited from receiving new loans?
 - Is the write-off of loan receivables limited to authorized nonaccounting personnel?

(g) Endowments and Investment Income

CONTROL OBJECTIVE: To ensure that endowment assets are properly recorded, adequately safeguarded, and managed in accordance with any related restrictions and prudent investment management practices, and that all investment income due is promptly collected and deposited and properly recorded.

CONTROL PROCEDURES:

- Are the receipt, recording, custody, transaction authorization, and performance-monitoring functions clearly segregated?
- Are endowment funds for the respective donors recorded in separate accounts, and are restrictions on investment principal and investment income documented?
- Are the investments held on behalf of the endowments recorded in the investment ledger by a person independent of initial receipt or custody of endowment securities?
- Is the investment ledger reconciled with the general ledger by a person independent of the initial receipt, custody or recording of endowment securities?
- Are endowment securities deposited with an independent custodian or in a bank safe deposit box?
 - If deposited with an independent custodian, are accounting and custodial functions segregated? Does the custodian issue periodic reports to the organization? Does the custodian carry sufficient fidelity insurance?
 - If deposited in a bank safe deposit box, is access limited to two or more authorized persons, and are all visits recorded?
- Are investment securities in the name of the organizations, or an appropriate “street” name?
- Are security transactions—including purchases, sales, renewals, and exchanges—approved by authorized nonaccounting personnel (usually the investment committee of the board or an appropriate financial officer)?
- Is the basis of valuation of investment securities periodically reviewed?
- Are internal control reports (SAS 70 reports) available for the investment custodian(s) and are the results of this report reviewed to ensure a proper internal control environment is maintained at the custodian(s)?
- Is the write-down and write-off of endowment securities limited to authorized nonaccounting personnel?
- Is the disbursement of restricted investment income reviewed by appropriate nonaccounting personnel to determine whether the disbursement is in conformity with donor or board-imposed restrictions? Are restrictions on and proposed uses of investment income reviewed prior to disbursement?

24.4 SPECIFIC NONPROFIT INTERNAL ACCOUNTING CONTROLS

- Is investment income received periodically compared with investment revenue estimates?
- Are the promptness and accuracy of investment income payments by underlying companies and investment counselors reviewed?
- If securities are “pooled” for investment purposes, are the allocation formula and the computation and distribution of investment income and realized and unrealized gains and losses periodically reviewed? Are investment income and realized and unrealized gains distinguished?

(h) Other Nonprofit Internal Accounting Controls

- Is the pledge billing and receivable function segregated from the cash receipt function?
- Are pledges promptly recorded, and is collection promptly initiated?
- Is the aging and collectibility of pledges, as well as the allowance for uncollectible pledges, periodically reviewed?
- Are collection policy and experience, age of pledges, current economic conditions, and credit standing of pledgor examined when reporting pledge income?
- Once received, are pledges recorded in separate accounts and are restrictions documented?
- Are pledge receipts periodically compared with pledge estimates in the operating budget?
- Internal accounting control of donated materials is similar to control of inventory. The basis of valuation is periodically reviewed, and, if donated materials are significant, a comparison to budget estimates is made.
- Internal accounting control of donated services addresses the following issues:
 - Is valuation for each position compared with the fair value of the service contributed?
 - Are time records periodically reviewed to determine whether services are performed?
 - Is the nature of contributed services periodically reviewed to determine whether the services are appropriate for the organization?
 - If material, are budget estimates prepared for donated services? Are actual donated services periodically compared with donated services estimates in the operating budget?

EFFECTIVE INTERNAL ACCOUNTING CONTROL

- Are agency funds segregated from other funds, and separately accounted for and reported on?
- Is disbursement contingent upon written authorization of the owning individual or organization?
- Are the ticket issuance and cash receipts functions segregated from the recording of ticket sales?
- Is ticket printing and inventory periodically reviewed, and are records kept of tickets printed, issued, used, and unused?
- Are ticket sales records maintained, and is ticket revenue periodically compared to ticket sales?
- Is ticket revenue periodically compared to the ticket revenue estimates in the operating budget?

CHAPTER TWENTY-FIVE

Independent Audits

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The laws of many states require that the financial statements of all but the smallest not-for-profit organizations be audited by an independent certified public accountant. Many states that do not have such a requirement are considering it in reaction to the Sarbanes–Oxley Act (“Sarbanes–Oxley”). Sarbanes–Oxley does not apply to other than SEC registered companies, but its provisions are widely regarded as best practices in so far as it relates to the audits of an institution’s financial statements.

25.1 FUNCTIONS AND LIMITATIONS

An audit is a series of procedures performed by a certified public professional accountant to test, on a selective basis, transactions and internal controls in effect, all with a view to forming an opinion on the fairness of the presentation of the financial statements for the period. An audit is not an examination of every transaction that has been recorded; it is a series of tests designed to give the auditor a basis for judging how effectively the records were kept and the degree of reliance that can be placed on the internal controls. The end result of an audit is the expression of an opinion by the auditor on the financial statements prepared by the organization's management.

Several things should be underscored. Auditors do not examine all transactions. If they were to do so, the cost would usually be prohibitive. They do look at what they believe is a representative sample of the transactions. The decision, as to which transactions to look at, is usually determined based on a risk-based approach. If the auditor perceives that more risk exists in a particular area, then they will probably select more transactions within that area. In looking at these selected transactions, they are as concerned with the internal controls and procedures that were followed as they are with the legitimacy of the transaction itself. If internal controls are good, the extent of the testing can be limited. If controls are weak, the auditors will have to examine many more transactions to be satisfied. In smaller organizations where internal controls are often less effective, auditors must examine proportionately more transactions.

Another point that should be made is that for the most part the auditors can only examine and test transactions that have been recorded. If a contribution has been received but not deposited in the bank or recorded in the books, there is little likelihood that it will be discovered. This is why controls should be established over all receipts at the point of receipt and disbursements should normally be made by check. In this way, a record is made and the auditor has a chance of testing the transaction. The end product of the audit is not a "certificate" that every transaction has been properly recorded, but an expression of an opinion by the auditor that the financial statements are fairly presented in accordance with the applicable generally accepted accounting principles in all material respects. The auditor does not guarantee accuracy; the bookkeeper may have stolen \$100, but unless this \$100 is material in relation to the financial statements as a whole, the auditor is not likely to discover it.

(a) Auditor's Opinion Explained

Exhibit 25.1 represents a typical opinion prepared by a certified public accountant that, in this case, is on the financial statements of the

EXHIBIT 25.1

Independent Auditor's Report

We have audited the accompanying statements of financial position of Organization X as of December 31, 20X2 and 20X1, and the related statements of activities and cash flows for the years then ended. These financial statements are the responsibility of Organization X's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Organization X as of December 31, 20X2 and 20X1, and the changes in its net assets and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[Signature]

[Location]

[Date]

organization. This opinion is very carefully worded, and each phrase has significance. The wording is designed to tell the knowledgeable reader what responsibility the auditor takes and does not take. Because this opinion is the end product of an audit, it is important to know exactly what the opinion means. Let's look at the opinion phrase by phrase to see what is being said in the following subsections

(i) Identification of Statements. "We have audited the accompanying statements of financial position and the related statements of activities and cash flows" The auditor is carefully identifying the statements covered by the opinion—the "accompanying" statements of financial position and statements of activities and cash flows. These statements and only these statements are the ones referred to.

(ii) Responsibility for Statements and the Audit Thereof. "These financial statements are the responsibility of the Organization's management. ..." The auditor is pointing out to readers that the financial statements are those of the client who has primary responsibility for their form and contents. The auditor's responsibility is to "audit" the statements.

(iii) Audit Standards Followed. "We conducted our audits in accordance with auditing standards generally accepted in the United States of

America.” Here the auditor is spelling out in technical language how the examination was conducted. There is a whole body of literature that defines generally accepted auditing standards. These include standards of training, proficiency, independence, planning, supervision of staff, evaluation of internal controls, and obtaining evidential matter to support the audit conclusions. They also provide that the auditor must perform certain specific tests where applicable. Additionally, the auditor is clearly indicating under which country’s generally accepted auditing standards the audit was conducted.

(iv) Expanded Procedures. In October 2002, the Auditing Standards Board (ASB) of the AICPA issued Statement on Auditing Standards (SAS) No. 99, *Consideration of Fraud in a Financial Statement Audit*. SAS 99 is effective for audits of financial statements beginning on or after December 15, 2002.

Although the SAS does not change an auditor’s responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement (whether caused by error or fraud), it expands on the guidance in SAS 82. Some of the more significant changes to, or expansions of, existing requirements included the following:

- Expanded inquiries of management, audit committees, internal auditors, and others about their awareness of frauds that have been perpetrated or conditions that they believe could make it likely that fraud could occur
- Expanded gathering of information as a source of input for fraud risk assessment and additional guidance for considering the information in the assessment
- Increased guidance requiring that the auditor ordinarily presume that there is a risk of material misstatement due to fraud relating to improper revenue recognition
- Expanded guidance on dealing with the evaluation of an entity’s response to identified fraud risks and a requirement that auditors assess the risks of material misstatement due to fraud
- A requirement to perform specific audit procedures in response to a risk of management override that cannot easily be addressed through reliance on traditional controls
- Expanded documentation relating to an auditor’s consideration of fraud, including documentation supporting compliance with substantially all of the SAS’s major requirements

This statement will result in the external auditor questioning more directly all levels of management and the board. It will also require more audit work for all not-for-profit organizations.

(v) Essential Tests. There are two specific tests which cannot be omitted by the auditor: confirmation of amounts receivable from outside parties (including pledges receivable) and observation of a physical count of items held in inventory in each case if inventory amounts are considered material to the financial statements. Confirmation of receivables involves writing to those owing money (or who have made pledges) to the organization and asking them to confirm that they do, in fact, owe the stated amount to the organization. Observation of a count of inventories involves going out to the storage facility and personally verifying the existence of the items shown as being held. Both of these tests can require substantial amounts of the auditor's time, and often an organization will ask the auditor to eliminate these tests to save time and cost. If omitted, however, and if receivables or inventories are significant in value, the auditor will not be able to say that the examination has been made in accordance with applicable generally accepted auditing standards and will not be able to express an opinion on the financial statements "taken as a whole."

The phrase "*We believe that our audits provide a reasonable basis ...*" says that in addition to all other auditing requirements spelled out in official pronouncements, the auditor has performed whatever additional tests he or she believes are necessary to be performed in the particular client circumstances.

(vi) Statements Present Fairly. "In our opinion present fairly, in all material respects, the financial position ... and the changes in its net assets and its cash flows ..." Here the auditor is saying the statements "present fairly"—not that they are correct or that they are accurate, but that they present "fairly." What does "fairly" mean? It means that there is no material misstatement of these figures. The statements may not be 100 percent accurate, but they are not materially inaccurate. The question of what is "material" cannot really be answered with any definitiveness since this is largely a subjective question, and in part depends on what figures you are looking at.¹

(vii) Accounting Principles Followed. "... in conformity with accounting principles generally accepted in the United States of America." Here the

¹ The Securities and Exchange Commission, in referring to reporting requirements for SEC filings defines "material" as "... the information ... [about] which an average prudent investor ought reasonably to be informed before purchasing the security registered."

auditor is defining the principles of accounting that have been followed—generally accepted accounting principles for a particular jurisdiction. These words have specific meaning and, for U.S. GAAP, refer to published pronouncements by the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA) and to general usage by organizations similar to the one being audited. Where there have been pronouncements of accounting principles by the FASB or the AICPA, the auditor is saying here that these principles have been followed. Where there have been no pronouncements, the auditor is saying that the principles followed are those generally used by similar organizations. If an opinion is issued without these specific words (“in accordance with accounting principles generally accepted in the United States of America”), the reader should be certain the principles used are clearly explained and understood. This will be the case, for example, if the cash basis of accounting (discussed in Chapters 3 and 10) is used.

(b) Adequacy of Internal Control over Contributions

Because of their nature as nonreciprocal transactions, in which there is usually nothing of value returned to the donor, receipt of contributions is often a difficult area in which to establish adequate internal controls—especially in smaller organizations. Nevertheless, as in all audit areas, the auditor must be satisfied that internal control over contributions is such as to ensure that substantially all contributions intended for the organization have been received and properly recorded. Internal control was discussed in the previous chapter, but one control in particular should again be noted. Normally *two* persons should open all mail to minimize the chance of misappropriation. Note that receipt of an unqualified audit report on the financial statements does not provide assurance as to the adequacy of controls; it merely means that the auditor was able to become satisfied that the financial statement numbers were not materially misstated.

(c) Qualified Opinions

A “qualified” opinion is an opinion in which the independent auditor takes exception to some specific aspect of the financial statements as presented, or is unable to form an unqualified opinion because of an inability to obtain audit evidence about a matter that might affect the financial statements. The independent auditor will spell out in the opinion exactly what the nature of the qualification is. A qualification with respect to presentation can result because generally accepted accounting principles were not followed. A qualification because of an inability to obtain audit evidence results when client records are missing or incomplete or it is not possible to obtain needed documents from outside parties.

25.2 BENEFITS OF AN INDEPENDENT AUDIT

(i) **Adverse Opinion.** An “adverse” opinion results when, in the opinion of the auditor, the financial statements taken as a whole do *not* present fairly the financial position in conformity with generally accepted accounting principles. The distinction between a “qualified” opinion and an “adverse” opinion is primarily one of the significance of the departures from generally accepted accounting principles.

(ii) **Disclaimer.** A “disclaimer” of opinion results when the auditor is unable to form an opinion on the financial statements. This could be the result of limitations on the scope of the examination, because the organization’s records were inadequate and it was not possible to form an opinion one way or the other. When an auditor gives a disclaimer of opinion, the reasons for it are spelled out in the auditor’s report. Any qualification detracts from the credibility of the financial statements. Since one of the functions of an auditor’s opinion is to add credibility to the financial statements, an opinion other than a “clean” or unqualified opinion will detract and raise questions about the statements. Wherever it is possible for an organization to take corrective action to eliminate the qualification, it should do so.

25.2 BENEFITS OF AN INDEPENDENT AUDIT

There are four principal benefits that can be expected from an audit:

1. Credibility of the financial statements
2. Professional assistance in developing meaningful financial statements
3. Professional advice on internal control, administrative efficiency, and other business matters
4. Assistance in tax reporting and compliance requirements

(a) Credibility of the Financial Statements

We have already touched on credibility. This is the principal benefit of having an independent CPA express an opinion on the financial statements. Unfortunately, over the years, there have been many instances where not-for-profit organizations have been mismanaged and the results buried in the financial statements in a manner that made it difficult, if not impossible, for the reader of the statements to discern them.

It has been noted that the purpose of financial statements is to communicate in a straightforward and direct manner what has happened. The presence of an auditor’s opinion helps in this communication process because an independent expert, after an examination, tells the reader that the financial statements present fairly what has happened.

Not-for-profit organizations are competing with other organizations for the money of their members or of the general public. If an organization can tell its financial story accurately and completely, and it is accepted at face value, the potential contributor is more likely to feel that the organization is well managed.

(b) Meaningful Statements

Another benefit of having professional help is that the auditor is an expert at preparing financial statements in a format that will be most clear to the reader. All too often financial statements are poorly organized and hard to understand. The CPA has had years of experience in helping organizations prepare financial statements in clear and understandable language.

(c) Advice on Internal Control and Other Matters

Another benefit is that the CPA will be in a position to advise the board on how to strengthen internal controls and simplify the bookkeeping procedures. As an expert, the CPA can also assist the board in evaluating the competency of the organization's accounting and financial reporting functions. The CPA has had experience in dealing with many different types of organizations and is likely to have a number of general business suggestions.

(d) Assistance in Tax Reporting and Compliance Requirements

As is discussed in Chapter 28, most not-for-profit organizations are required to submit some form of report to one or more agencies of a state government and the IRS. These reports are almost always complex as are the related rules governing the preparation. Unless the treasurer is an accountant, the assistance of an expert will probably be required. The CPA is an expert and can either offer advice on how to prepare the returns or can actually prepare them.

25.3 SELECTING A CERTIFIED PUBLIC ACCOUNTANT

Like doctors and lawyers, certified public accountants depend on word of mouth as advertising to spread their reputation. When it comes time to choose a CPA, talk with your banker, attorney, and fellow members of the board. The chances are that collectively they will know many CPAs practicing in your locality and will know of their reputations. Talk also with officers of other not-for-profit organizations. They will probably have had some experience that may be of help. One significant criterion in the selection should be the CPA's familiarity with not-for-profit entities similar to yours.

A standard practice is to send a request for an audit proposal to several CPA firms that have been identified as probably having the appropriate qualifications. The candidate firms should be invited to meet with management and become familiar enough with the organization to submit a meaningful proposal. Finally, once the proposals have been received, those firms with the best qualifications should be interviewed by management and representatives of the board (usually the audit committee) to select the best firm. The ultimate selection should be made by the board (or its audit committee) and not by management. Appendix 25–A is a checklist that may be helpful in selecting a CPA.

(a) Cost of an Audit

What does it cost to have an audit? This is a difficult question to answer because most CPAs charge on an hourly basis. If the organization's records are in good shape and up to date, the time will be less. There is no way to know how much time will be involved without looking at the records and knowing something about the organization. The hourly rates vary, depending on the individual assigned and his or her experience. Most examinations involve a combination of experienced and inexperienced staff members. In 2004, typical hourly rates ranged from \$100 to \$600, with an overall average effective rate of between \$90 and \$160 an hour. This average rate is a composite. Most of the time spent on any audit will be by less experienced staff members whose billing rates will be lower than for the CPA in charge. The only accurate way to find out what it will cost to have an audit is to call a CPA and ask for an estimate. Even then it will be difficult to know all the problems that may be encountered and the CPA will probably hedge on the estimate by indicating that while it is a best estimate, the final amount might be more or less. Keep in mind that the CPA is providing a professional service just as does a doctor or a lawyer. Sometimes an organization will shop around in an effort to find the CPA that will charge it the least. While understandable, this makes about as much sense as choosing a doctor based on the rate charged for an office visit. You get what you pay for. Because the salaries paid by the various firms are pretty much the same at any given level of competence, each CPA firm will charge about the same amount per hour for a staff member's services. The variable is the length of time it will take to perform the examination. Since the treasurer is not likely to be in a position to judge the quality of the work, there is a risk in choosing a professional accountant solely on the basis of an estimated fee. Choosing a CPA should be on the basis of reputation, expertise—specifically in your type of organization—and willingness to serve the organization.

(b) Review Services

A possible alternative to an audit, for an organization that does not have to submit audited financial statements to a state, a funding source, or another organization, is to have its financial statements “reviewed” by a CPA. A review requires less time, and hence incurs less cost; however, it results in a lesser degree of assurance by the CPA. Instead of saying that the financial statements “present fairly,” the CPA does only enough work to be able to say, “I am not aware of any material modifications that should be made in order for the financial statements to be in conformity.” This is called “negative assurance” and does not give as much credibility to the financial statements as does an audit. Nevertheless, a review may meet the needs of some smaller organizations.

25.4 PUBLIC ACCOUNTANTS

So far we have talked about the advantages of bringing in a “certified public accountant.” There are also “public accountants” in many states. What does the difference in title mean? Certified public accountants are the “professionals.” They have been licensed by the state after proving their competency by passing a rigorous examination, meeting certain educational requirements, and, in most states, working for another CPA for a period of time. The CPA is continually accountable to the state. Only a CPA can join the American Institute of Certified Public Accountants. Public accountants may or may not be licensed by the state. Where they are licensed, there are usually no examinations to pass or educational requirements to meet, and for the most part they can practice without experience. Nevertheless, public accountants are often quite competent and can provide good and effective service to clients, particularly in keeping the records or preparing financial statements. If an organization is going to hire an accountant to help keep the records, the public accountant may well be the right person to hire. However, as a general rule, the organization must retain a certified public accountant if it wants an audit to be made.

25.5 AUDIT COMMITTEES

The institution of audit committees has now become a common practice for not-for-profit organizations. In fact, as pointed out earlier, some states are now requiring that there be an audit committee comprised of independent board members. Certainly donors and funding sources have come to expect there to be an audit committee. For a properly functioning audit committee it is important to demonstrate that the board of trustees has taken prudent steps to perform its administrative and control functions. With the increased impact of the Sarbanes–Oxley Act have come

best practices for all organizations that have audit committees, not just those currently subject to its provisions.

There have been many publications of late outlining best practices for audit committees in various sectors of the not-for-profit world. The National Association of College and University Business Officers (NACUBO) issued fairly specific guidance in its Advisory Report 2003-3—*The Sarbanes–Oxley Act of 2002: Recommendations for Higher Education*. Similarly, PricewaterhouseCoopers LLP published *The Changing Role of the Audit Committee—Leading Practices for Colleges, Universities and Other Not-for-Profit Education Institutions*. These are but a couple of the recent publications that may be helpful to not-for-profit organizations that are establishing or changing their audit committees. With regard to the audit committee, the authors recommend that:

- Every not-for-profit organization that raises funds from the general public or that receives grants or membership dues should have an active and functioning external audit committee.
- For most effective operation, audit committees should be composed of three to five trustees, none of whom are employees of the organization.
- Audit committees should be responsible for the retention of the independent auditors.
- If possible, at least one member of the audit committee should be a “financial expert,” as defined by the Sarbanes–Oxley Act.²
- The audit committee should have a written charter that includes the committee’s responsibility and this should be reviewed and updated periodically. See Appendix 25–C of this chapter for a sample charter.

² The qualifications of the “financial expert” would include:

- An understanding of generally accepted accounting principles (GAAP) and financial statements
- An ability to access the application of these principles in connection with accounting for estimates, accruals, and reserves
- An understanding of audit committee functions
- Experience preparing, auditing, analyzing or evaluating financial statements, or experience actively supervising persons engaged in such activities
- An understanding of internal controls and procedures for financial reporting

The person must have acquired these attributes through one or more of the following:

- Education or experience actually doing these functions or similar ones
- Actively supervising someone who is performing these functions or similar ones
- Experience overseeing or assessing the performance of accountants who are preparing, auditing or evaluating financial statements
- Other relevant experience

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- The audit committee should meet as often as necessary to fulfill the committee's responsibilities, typically four or more times a year.
- The audit committee should ensure there is a system to receive and deal with confidential employee complaints.
- The audit committee should consider requiring management to certify to the accuracy and completeness of the financial reports.
- Audit committees should be responsible for the review and evaluation of the reports prepared by the independent auditors that describe any weaknesses in the organization's internal accounting and management controls and that contain recommendations for improvements in such controls. Audit committees should also determine if management has taken appropriate action on these recommendations.
- Audit committees should be delegated the responsibility to review the annual financial statements with the independent auditors. Another function of the audit committee can be to ensure that management has used proper accounting standards and made all required disclosures in the organization's financial statements. The checklist in Appendix 25–C of this chapter may be helpful both to management and the audit committee in this regard.

In view of the current concern about proper accountability by not-for-profit organizations, the audit committee should conduct a periodic inquiry into the board and management's procedures for ensuring that expenditures (especially in sensitive areas such as professional fees, executive compensation, and travel and entertainment) are appropriate in nature and reasonable in amount. A good test of reasonableness for such expenditures is whether an audit committee member would feel comfortable responding to an inquiry from an investigative reporter or a donor about the expenditures. Another suggestion is to regularly review the organization's conflict of interest policy and the procedures in place to ensure compliance with it.

25.6 CONCLUSION

We have discussed the principal advantages of retaining an independent auditor to make an audit of not-for-profit organizations. In addition to providing "credibility" to the financial statements, the independent auditor can provide recommendations to improve the format of the financial statements to make them more effective in communicating its financial situation to its constituents as well as offer suggestions to improve internal controls and administrative efficiency. In addition, in this increasingly complex society of rules and reports, an independent auditor is an

25.6 CONCLUSION

expert and can help an organization comply with the many reporting requirements.

As with any professional, it is important to find an independent auditor that is both knowledgeable about not-for-profit accounting and interested in serving your organization. The use of an audit committee is suggested as one way in which internal control could be strengthened.

APPENDIX 25–A

Checklist: Criteria for Selection of a CPA

Not all of these criteria will be relevant in every selection process, and their relative importance will vary for different organizations. The order of the items in the list is not intended to indicate an absolute degree of importance to an organization, but criteria listed in the early part of the list are those that are often considered more important.

1. *Characteristics of the personnel to be assigned to the engagement:*
 - Experience and expertise in the area of not-for-profit organization accounting and auditing on the part of the personnel who will be assigned to the engagement. These are the people who will be directly responsible for serving the organization's needs, and it is their abilities on which the quality of that service primarily depends.
 - Personal ability of the designated key engagement personnel to relate well to and work effectively with organization staff. This is for a successful professional relationship.
2. *Ability to respond quickly, effectively, and competently to the organization's needs.* This is a more general statement of the previous criterion, as well as reflecting other factors such as the ability of the engagement staff to call upon other resources if needed. Such resources might include other personnel within a firm, reference material, and other persons with appropriate knowledge and skills. It also encompasses the overall attitude with which the external auditor approaches service to clients.
3. *Experience with similar organizations* (e.g., medium-size symphony orchestras, Red Cross chapters, large trade associations, community colleges). A long list of the external auditor's present clients can be considered positive evidence supporting an ability to meet criterion 2, but, especially in a larger firm, many of these clients may not be served by the same personnel as would serve your organization. Such a list is certainly a plus but should not be the only basis for choosing an external auditor. An organization should request client references and should contact those references to determine the degree that the firm is satisfying their needs.
4. *Reputation.* This includes the two previous criteria, as well as many more intangible factors such as how the external auditor is looked upon by others in and outside the not-for-profit industry, its commitment to serving organizations in the industry, and involvement by personnel in professional activities.

5. *Fee.* This should not be the deciding criterion (although it too often is), unless two or more firms are perceived as nearly equal in all other respects. A firm that proposes a fee significantly lower than others' fees is sometimes (1) not being realistic about the effort required to complete an engagement, or (2) "low-balling" to get the work, and will either give a lower quality of service and/or try to raise the fee significantly in future years. When evaluating a proposal of this type, the organization should question the external auditor about the basis for the quoted fee.
6. *Proposed approach to the engagement.* What does the external auditor believe needs to be done, and how will the engagement be undertaken? A well-thought-out presentation on this subject improves the chances that the external auditor meets criteria 1 and 2. The presentation need not be long but should show evidence that the work will be well planned and tailored to the particular needs and circumstances of the organization. There should also be an indication of the commitment of adequate time to the engagement by more senior personnel.
7. *Proximity of the external auditor's office to the organization's headquarters.* (In the case of a multilocation organization; closeness of one or more offices of a firm to the principal operating locations of the organization.) This is really just part of criterion 2 in this list. Distance can be a negative factor, but it does not have to be.
8. *Size of the firm and/or its local office.* Except for an extremely large and complex organization (which usually does require the services of a large firm), there are no rules on this point. Both larger and smaller firms and individual practitioners can render distinguished service to both larger and smaller organizations, if the conditions of criteria 1 and 2 in this list are well met.
9. *Ability of the firm to provide other services such as consulting work.* Sometimes this may be important to an organization and sometimes not. An organization should think about this in view of its own current and anticipated future circumstances.
10. *Organization structure of the internal auditor's firm.* How centralized or decentralized is it? How much authority does the engagement partner have to make decisions? Usually any effect of this factor is far outweighed by criteria 1 and 2 in this list, unless a large firm is so centralized that local personnel have little authority.
11. *Continuity of staff assigned to the engagement.* Some amount of staff turnover is inevitable in almost any accounting practice, but excessive turnover is not desirable as it partly defeats the goal of building

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familiarity with a client. At the same time, some organizations consider orderly slow rotation of personnel desirable as a way of maintaining the auditor's independence and bringing fresh ideas to bear on the engagement.

Other criteria that are not judgment criteria, but rather should be prerequisites for any CPA to be considered for selection, are:

- Ability to meet reasonable deadlines
- Willingness to furnish recommendations for proposed improvements in internal controls and management procedures identified during the course of other work
- Ability to assign the requisite number and experience levels of personnel to work on the engagement
- Ability to render the desired services in a professional manner

APPENDIX 25-B

Changing Role for the Audit Committee³

The Sarbanes–Oxley Act of 2002 (“Sarbanes–Oxley”) was enacted on July 30, 2002, in response to major corporate and accounting scandals involving some of the most prominent companies in the United States. Since the enactment of Sarbanes–Oxley, an audit committee is more important than ever before. Organizations of all types and sizes are taking a closer look at the criteria for a highly effective audit committee, and they are taking steps to ensure that their audit committee is meeting the new expectations. Among other provisions, Sarbanes–Oxley requires that public companies establish an audit committee, a charter, and qualifications for members.

It is important to note that (except for the provisions providing protection for whistleblowers and preventing the destruction of certain documents) Sarbanes–Oxley is not required for not-for-profit organizations, although there is growing sentiment among boards of trustees that non-profit organizations should voluntarily embrace many of the practices of Sarbanes–Oxley. In fact, legislation has been introduced in some states (and enacted in California) that would require that not-for-profit organizations comply with certain provisions that are very similar to those in Sarbanes–Oxley. Boards are using Sarbanes–Oxley as an opportunity to review the roles and responsibilities of management, the audit committee, and the external auditor.

In addition to the audit committee, Sarbanes–Oxley sets increased expectations of management for greater transparency in financial reporting and accountability in the reporting process. It is likely that a clear set of best practices for nonprofit organizations will evolve as a result of Sarbanes–Oxley.

This appendix presents a summary of some of the more significant provisions of Sarbanes–Oxley in Chart A (provisions affecting the audit committee), Chart B (provisions affecting the external auditor), and Chart C (provisions affecting management).

³ Adapted from PricewaterhouseCoopers LLP, *The Changing Role of the Audit Committee—Leading Practices for Colleges, Universities and Other Not-for-Profit Education Institutions*.

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Chart A

Some Significant Provisions of the Sarbanes–Oxley Act of 2002 for Audit Committees	
Responsibility	Description
Oversight of Accounting and Financial Reporting Practices	The audit committee is responsible for overseeing an organization's accounting and financial reporting processes as well as for various other regulatory and audit matters relating to the financial statements.
External Auditor	The auditor committee is responsible for appointing, compensating, and overseeing the external auditor. The audit committee also is required to pre-approve services that would be performed by the external auditor.
Independence	All members of the audit committee must be independent as defined by Sarbanes–Oxley.
Financial Expertise	The audit committee should include at least one member who is a "financial expert" as defined by Sarbanes–Oxley.

Chart B

Some Significant Provisions of the Sarbanes–Oxley Act of 2002 for External Auditors	
Responsibility	Description
Independence	The external auditor must be independent in fact and in appearance.
Nonaudit Services	The external auditor cannot perform certain nonaudit services.
Rotation	Audit partners should be rotated after five years.
Required Communications	The external auditor is required to report to the audit committee critical accounting policies and practices, alternative treatments of financial information, and other material written communications.
Attestation	The external auditor is required to attest to the assertions made by management related to internal controls and procedures for financial reporting.

Chart C

Some Significant Provisions of the Sarbanes–Oxley Act of 2002 for Management	
Responsibility	Description
Code of Ethics	Sarbanes–Oxley requires that a code of ethics be in place for senior financial officers.
Full Disclosure in Financial Reports	Sarbanes–Oxley requires that financial statements be complete and accurate. They also should include appropriate disclosure of significant transactions, including off-balance sheet financing.
Certification of Financial Statements	The "principal executive officer" and the "principal financial officer" of SEC registrants are required to certify the financial statements. For example, among other certifications, they must certify that the financial statements are fairly presented in all material respects.

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Internal Controls	Under Sarbanes–Oxley, management is responsible for internal controls. Among other responsibilities related to internal controls over financial reporting, management must assess—and make conclusions about—the organization’s internal control system as of a date within 90 days prior to the issuance of the organization’s financial report.
Disclosure of Internal Control Deficiencies and Known Fraud	Under Sarbanes–Oxley, senior executives are required to disclose to auditors and the audit committee all significant deficiencies in the design or operation of internal controls as well as significant changes in internal controls. They also are required to disclose known instances of fraud.

On November 20, 2003, the National Association of College and University Business Officers (NACUBO) issued its Advisory Report #2003-3, *The Sarbanes–Oxley Act of 2002: Recommendations for Higher Education*. The recommendations provided in NACUBO’s report address how colleges and universities might want to consider dealing with auditor independence, corporate responsibility, enhanced financial disclosures, accountability, and certification of financial results. The recommendations are posted on NACUBO’s website at www.nacubo.org.

APPENDIX 25-C

Basic Template for an Audit Committee Charter⁴

1. Overall purpose/objectives

The audit committee is appointed by the board to assist it in discharging its oversight responsibilities. The audit committee will oversee the financial reporting process to ensure the balance, transparency and integrity of published financial information. The audit committee will also review: (1) the effectiveness of the institution's internal financial control and risk management system; (2) the effectiveness of the internal audit function; (3) the independent audit process, including recommending the appointment and assessing the performance of the external auditor; and (4) the institution's process for monitoring compliance with laws and regulations affecting financial reporting and its code of conduct.

The committee is responsible for maintaining free and open communication as well as effective working relationships among the committee members, independent external auditors, internal auditors, and management of the university. To perform his or her role effectively, each committee member will need to develop and maintain his or her skills and knowledge, including an understanding of the committee's responsibilities and of the organization's activities, operations and risks.

The committee will take all appropriate actions to set the overall tone at the institution for quality financial reporting, sound risk practices, and ethical behavior.

2. Authority

The board authorizes the audit committee, within the scope of its responsibilities, to:

- 2.1 Perform activities within the scope of its charter.
- 2.2 Engage independent counsel and other advisers as it deems necessary to carry out its duties.
- 2.3 Have unrestricted access to members of management, faculty and employees as well as to all books, records, and facilities of the institution.
- 2.4 Establish procedures for the receipt, retention and treatment of complaints received from employees regarding accounting, internal accounting controls, or auditing matters.

⁴ Adapted from PricewaterhouseCoopers LLP, *The Changing Role of the Audit Committee—Leading Practices for Colleges, Universities and Other Not-for-Profit Education Institutions*.

- 2.5 Be directly responsible for the appointment, compensation, retention and oversight of the work of the external auditor.
- 2.6 Review and approve the policies for the provision of nonaudit services by the external auditors [and, when required, the framework for pre-approval of such services].

3. Organization

Membership

- 3.1 The board will nominate the audit committee members and the chairman of the audit committee.
- 3.2 The audit committee will comprise at least [insert number] members and all members shall be independent. Members will be considered independent as long as they do not accept any consulting, advisory, or other compensatory fee from the university and are not affiliated persons of the university, its subsidiaries or management.
- 3.3 A quorum of any meeting will be [number] members/[proportion] of members.
- 3.4 Each member should have skills and experience appropriate to the education or not-for-profit sectors.
- 3.5 A majority of committee members shall be “financially literate.” Financial literacy is defined as being able to read and understand fundamental financial statements.
 - 3.5.1 If possible, include one member who is a “financial expert” as it is defined by Sarbanes–Oxley: A “financial expert” is a person who has an understanding of generally accepted accounting principles and financial statements; the ability to assess the application of these principles in connection with accounting for estimates, accruals, and reserves; an understanding of audit committee functions; experience preparing, auditing, analyzing, or evaluating financial statements, or experience actively supervising persons engaged in such activities; and an understanding of internal controls and procedures for financial reporting. The person must have acquired these attributes through one or more of the following: education or experience actually doing these functions or similar ones; actively supervising someone who is performing these functions or similar ones; experience overseeing or assessing the performance of companies or public accountants who are preparing, auditing, or evaluating financial statements; or other relevant experience.

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- 3.6 Members will be appointed for a [insert number]-year term of office.
- 3.7 The secretary of the audit committee will be nominated by the board.

Meetings

- 3.8 A majority of the members of the committee will constitute a forum for the transaction of business.
- 3.9 As part of its responsibility to foster open communication, the committee shall provide sufficient opportunity for the independent external and internal auditor to meet privately with the committee. The audit committee will meet with the independent external auditors [at least once annually] without management present. The independent external and internal auditors shall be invited to make presentations to the audit committee as appropriate.
- 3.10 Meetings shall be held not less than [number] times a year and should correspond with the organization's financial reporting cycle.
- 3.11 Special meetings may be convened as required.
- 3.12 The committee shall maintain written minutes of its meetings.
- 3.13 The secretary of the committee shall:
 - 3.13.1 Circulate the agenda and supporting documentation to the audit committee members a reasonable period in advance of each meeting.
 - 3.13.2 Circulate the minutes of meetings to members of the board, members of the committee, (and the internal audit director and the external auditor where appropriate).
 - 3.13.3 Convene a meeting on receipt of a request by the external or internal auditors.
- 3.14 As a minimum, the chairman of the committee [or another member of the committee] shall attend the board meeting at which the financial statements are approved.
- 3.15 The committee should meet with in-house legal counsel on a regular basis. A meeting with outside legal counsel should be held if it is deemed necessary.
- 3.16 The audit committee may invite others (e.g., the president, chancellor, chief financial officer, internal audit director and external audit engagement partner) to its meetings, as it deems appropriate.

- 3.17 The audit committee may want to consider requesting special reports on topics that may enhance their understanding of the institution's activities. For example, topics could include: capital projects management, new business initiatives, technology, and other initiatives that affect internal controls.

4. Roles and responsibilities

With regards to each topic listed below, the audit committee will:

Internal controls

- 4.1 Evaluate whether management is setting the appropriate 'control culture' by communicating the importance of internal controls.
- 4.2 Understand the internal controls systems implemented by management for the approval of transactions and the recording and processing of financial data.
- 4.3 Understand the controls and processes implemented by management to ensure that the financial statements derive from the underlying financial systems, comply with relevant standards and requirements, and are subject to appropriate management review.
- 4.4 Evaluate the overall effectiveness of the internal control framework and consider whether recommendations made by the internal and external auditors have been implemented by management.
- 4.5 Consider how management is held to account for the security of computer systems and applications, and the contingency plans for processing financial information in the event of a systems breakdown or to protect against computer fraud or misuse.

Risk management

- 4.6 Evaluate the overall effectiveness of the risk management framework.
- 4.7 Evaluate whether management is setting the appropriate tone at the top by communicating the importance of the management of risk.
- 4.8 Inquire of management, the internal auditor, and the independent external auditor about significant risks or exposures to the institution and how these are being managed.

Financial reporting and disclosures

- 4.9 Review significant accounting and financial reporting issues, including recent professional and regulatory pronouncements, and understand their impact on financial reports.

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- 4.10 Oversee the financial reporting process implemented by management.
- 4.11 Review as applicable: (1) the interim financial statements, (2) the annual financial statements, (3) the annual report, and (4) the audit report on federal awards that is required under Office of Management and Budget (OMB) Circular A-133.
- 4.12 Review management's process for ensuring the transparency of the financial statements and the completeness and clarity of the disclosures.
- 4.13 Meet with management and the external auditors to review the financial statements, the key accounting policies, the reasonableness of significant judgments, and the results of the audit.
- 4.14 Discuss with the independent external auditor the alternative treatments of financial information within generally accepted accounting principles as well as the ramifications of the use of such alternative treatments.
- 4.15 Confirm with management and the independent external auditor that the annual financial statements disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships of the institution with unconsolidated entities or with people that may have a material effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.
- 4.16 Ensure that significant adjustments, unadjusted differences, disagreements with management and critical accounting policies and practice are discussed with the external auditor. Resolve disagreements between management and the external auditor.

Compliance with laws and regulations

- 4.17 Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any fraudulent acts or noncompliance.
- 4.18 Obtain reports concerning financial fraud resulting in losses in excess of \$10,000 or involving a member of senior management.
- 4.19 Obtain regular updates from management and the organization's legal counsel regarding compliance matters that may have a material impact on the organization's financial statements or compliance policies.

- 4.20 Be satisfied that all regulatory compliance matters have been considered in the preparation of the financial statements.
- 4.21 Review the findings of any examinations by regulatory agencies.

Working with auditors

Independent external audit

- 4.22 Have the independent external auditor report directly to the audit committee.
- 4.23 Review the professional qualifications of the independent external auditor (including the background and experience of the engagement partner and auditing personnel).
- 4.24 Consider the independence of the auditor as well as potential conflicts of interest. Also assess the independence of the independent external auditor under Government Auditing Standards.
- 4.25 Review on an annual basis the performance of the external auditors and make recommendations to the board for their appointment, reappointment or termination.
- 4.26 Be responsible for setting the compensation of the external auditor.
- 4.27 Review the proposed audit scope and approach for the current year in the light of the institution's present circumstances and changes in the regulatory environment.
- 4.28 At the end of the audit:
 - 4.28.1 Review required communications from the external independent auditors.
 - 4.28.2 Discuss with the external auditor the quality and appropriateness of the institution's accounting policies as well as the consistency of their application and the degree of aggressiveness or conservatism in applying them.
 - 4.28.3 Discuss with the external auditor any audit problems encountered in the normal course of audit work, including any restriction on audit scope or access to information.
- 4.29 Ensure that significant findings and recommendations made by the external auditors and management's proposed response are received, discussed and appropriately acted on.
- 4.30 Meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed

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privately. Ensure that the auditors have access to the chairman of the audit committee when required.

- 4.31 Review policies for the provision of nonaudit services by the external auditor [and where applicable the framework for pre-approval of audit and nonaudit services].
- 4.32 Ensure the organization has appropriate policies regarding the hiring of audit firm personnel for senior positions after they have left the audit firm.

Internal audit

- 4.33 Review the independence, qualifications, activities, resources and structure of the internal audit function and ensure no unjustified restrictions or limitations are made.
- 4.34 Review and concur with the appointment, reassignment, promotion or dismissal of the director of internal audit.
- 4.35 Review the effectiveness of the internal audit function and ensure that it has appropriate standing within the organization. Discuss with the external auditor the standard of work of internal audit staff.
- 4.36 Meet separately with the director of internal audit to discuss any matters that the committee or internal auditors believe should be discussed privately.
- 4.37 Ensure that significant findings and recommendations made by the internal auditors and management's proposed response are received, discussed and appropriately acted on.
- 4.38 Review the proposed internal audit plan for the coming year [or the multi-year plan] and ensure that it addresses key areas of risk and that there is appropriate coordination with the external auditor.
- 4.39 Receive prior to each meeting a summary of findings from completed internal audits and the status of implementing related recommendations.
- 4.40 Receive a progress report on the internal audit plan with explanations for any deviations from the original plan.
- 4.41 Review periodically the internal audit charter for necessary changes.

Complaints and ethics

- 4.42 Ensure procedures for the receipt, retention, and treatment of complaints about accounting, internal accounting controls or auditing matters.

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- 4.43 Review the code of conduct to ensure that it: 1) is easy to access, 2) widely communicated, 3) is easy to understand and implement, 4) includes a confidential mechanism for reporting code violations, 5) enforced, 6) includes a conflict of interest policy and guidelines, and 7) includes the name of a contact for questions.
- 4.44 Review the conflict of interest policy to ensure that: 1) the term “conflict of interest” is clearly defined, 2) guidelines are comprehensive, 3) annual signoff is required, and 4) potential conflicts are adequately resolved and documented.
- 4.45 Require appropriate disclosure of related party transactions, including an annual accounting.

Reporting responsibilities

- 4.46 Regularly update the board about committee activities and make appropriate recommendations.
- 4.47 Ensure the board is aware of matters that may significantly impact on the financial condition or affairs of the business.
- 4.48 Prepare any reports required by law or listing rules or requested by the board (e.g., a report on the audit committee’s activities and duties to be included in the section on governance in the annual report).

Evaluating performance

- 4.49 Evaluate the audit committee’s own performance, both of individual members and collectively, on a regular basis.
- 4.50 Assess the achievement of the duties specified in the charter and report the findings to the board.
- 4.51 Review the audit committee charter annually and discuss any required changes with the board.
- 4.52 Ensure that the charter is approved or re-approved by the board annually.

Adoption of Charter

The Board of Trustees adopted this chart on ____, 200X.

CHAPTER TWENTY - SIX

Investments

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Some not-for-profit organizations have an investment program to manage, resulting from receipt of endowment and other restricted gifts. Some organizations also have excess cash in their unrestricted net assets that can be invested. Together, all of these investments can be very sizable. They are invested in publicly traded securities, in real estate, in mortgages and other debt instruments or various other forms of investment for which there are not readily determinable market values.

26.1 VALUING INVESTMENTS

Many not-for-profit organizations have begun to diversify their investment portfolio beyond the traditional stocks and bonds. It is

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very common now to see investment portfolios with as much as 30% or more committed to alternative investments (which would include venture capital, real estate, hedge funds, distressed debt and other investment vehicles). Due to the increased complexity of organizations' portfolios, the FASB has issued among other statements:

- SFAS 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*
- SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*

At acquisition (either by purchase or through a contribution) certain investments are recorded at fair value. For purchased investments, the fair value would represent the "cost" that was incurred by the organization to acquire the asset. For contributed investments, the value recorded would be the market value for publicly traded securities and the appraised value for investments for which there are not readily determinable market values at the date of the contribution.

(a) Equity and Debt Securities

SFAS 124 requires that investments in equity securities with readily determinable fair values and all debt securities be reported at fair value. SFAS 124 states that securities have readily available fair values if any of these three criteria are met:

1. Sales prices or bid-and-asked quotations for the security are currently available on a securities exchange registered with the Securities and Exchange Commission (SEC), or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by the National Quotation Bureau. Restricted stock does not meet that definition.
2. For an equity security traded only in a foreign market, that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above.
3. For an investment in a mutual fund, the fair value per share ("unit") is determined and published and is the basis for current transactions.

SFAS 124 does not apply to all other investments (e.g., equity securities without readily determinable fair values, real estate, mortgage notes, venture capital funds, partnership interests, and oil and gas interests). It also does not apply to investments accounted for under the equity method or investments in consolidated subsidiaries.

(b) Alternative Investments

Alternative investments are investments in other than publicly-traded securities, including investments in hedge funds, private equity funds and venture capital funds. These are often managed as limited partnerships, with the organization participating as a limited partner.

The information to estimate the fair value of such investments in most cases is only available from the investment manager, sponsors or general partners of the investee. These estimated fair values are usually made available on a quarterly basis. The information for the quarter that corresponds to the not-for-profit organization's fiscal year end may not be available in time to be used in the organization's annual report. Although most of these investees do issue audited financial statements annually, their year ends frequently do not coincide with organization's year-end or are not available on a timely basis. Care must be taken to determine that these estimates can be relied upon (i.e., those providing them are reputable and have the requisite skills to make such estimates). To the extent that the quarterly valuations are deemed reliable and are available on a timely basis, they should be used to value alternative investments included in the organization's financial statements. If the current quarterly information is not available on a timely basis a common practice is to use the previous quarter's estimated value and adjust it for additional cash invested in or distributions received from the investee.¹

26.2 POOLING VERSUS INDIVIDUAL INVESTMENTS

One of the practical problems faced by the not-for-profit organization is how to handle its investment program where there are a number of separate funds, each with amounts available for investment. The question that arises is whether investments should be made on a separate fund-by-fund basis—that is, having to track how separate donations have been invested—or whether all investments should be (or can be) pooled. This section discusses the concept of pooling of investments and shows how to keep the appropriate records.

Typically, most organizations have a number of different individual funds, each having cash that can be invested. These individual funds may include board-designated endowment funds (reported in unrestricted net assets as “funds functioning as endowments”) as well as donor-restricted endowment funds (reported in permanently restricted net assets). (There could also be some term-endowments reported in

¹ For additional information on alternative investments, see PricewaterhouseCoopers' publication entitled *Meeting the Challenges of Alternative Investment* (2004), at their website, <http://www.pwc.com/education>.

temporarily restricted net assets.) Within these net asset groupings, there may be a number of individual “named” funds. All of this means that a not-for-profit organization can have a number of separate accounts that have assets invested in marketable securities. This is where some practical problems arise.

The organization can invest the money of each individual fund in specific securities and keep track of the actual income and gain or loss associated with these specific investments. If it does so, there is no question about the amount of income, or the gain or loss associated with each separate fund.

But for most organizations, it is simply not practical to maintain separate investments and accounts for each such fund. This is why most organizations pool all of their investments and prorate the resulting income and gains or losses, like a mutual fund. Prior to doing this, the organization should consult with their legal counsel as to any restrictions or limitations that the organization may have to adhere to.

(a) Example of Individual Investments for Each Fund

An example will illustrate the difference in these two approaches. The Bradford Museum has investments aggregating about \$200,000. It follows the approach of making specific investments for each fund. What the portfolio looked like at December 31, 20X1, is shown in Exhibit 26.1. As is typical, some of the individual investments have done better than others, but on an overall basis, market value is a third above cost. Because the museum keeps track of its portfolio by individual fund, the gain or loss and the income for each of these funds are based on the actual investments in each fund. The unrestricted board-designated quasi-endowment fund had income of \$3,900, and if the organization were to sell all of these investments there would be a gain of \$55,000. On the other hand, the R. A. Adler Fund has had a decline in value of \$25,000. One of the problems of making investments on an individual fund basis is that there are usually some amounts of cash that are too small to be individually invested. In this case the Bradford Museum has a total of \$18,500 of uninvested cash in all of its funds, which is large enough to be put to work.

(b) Example of Pooled Investments

A fair amount of paperwork is involved in keeping track of specific investments by individual funds. Pooling all investments minimizes the need to keep track of the individual purchases by specific fund. It also provides a larger investment fund that helps to cushion the effect of any single poor investment decision. In the case of the 500 shares of stock F,

26.2 POOLING VERSUS INDIVIDUAL INVESTMENTS

EXHIBIT 26.1

Bradford Museum Investments—Individual Investments

	Cost	Market 12/31/X1	Income Year 20X1
Unrestricted board-designated quasi-endowment fund			
1,000 shares of Stock A	\$ 20,000	\$ 45,000	\$ 800
500 shares of Stock B	20,000	40,000	1,200
1,000 shares of Stock C	40,000	50,000	1,000
Uninvested cash	15,000	15,000	900
	<u>95,000</u>	<u>150,000</u>	<u>3,900</u>
Permanently restricted endowment fund—W. H. Miller			
1,000 shares of Stock D	9,000	31,000	1,500
100 shares of Stock E	5,000	3,000	100
Uninvested cash	1,000	1,000	
	<u>15,000</u>	<u>35,000</u>	<u>1,600</u>
Permanently restricted endowment fund—R. A. Adler			
500 shares of Stock F	37,500	12,500	400
Uninvested cash	2,500	2,500	100
	<u>40,000</u>	<u>15,000</u>	<u>500</u>
Total all funds	<u>\$150,000</u>	<u>\$200,000</u>	<u>\$6,000</u>

which has declined in value, the effect on the R. A. Adler Fund is devastating. It is worth a fraction of its original \$40,000 (and would be considered “underwater”—see Chapter 6). On the other hand, if stock F had been pooled with the other stocks, the effect on the Adler Fund would have been only a pro rata portion. Likewise, the large gain on stock D in the Miller Fund would have been spread over all of the funds. The principal advantage of pooling is that it allows for the more efficient investment of all funds available to the organization which should ultimately produce greater returns on the investments. It also significantly simplifies the related record keeping.

Let us now examine how these funds would have looked if the museum had managed its investments on a pooled basis. For the sake of simplicity, it is assumed that no investments have been sold since the original principal was established in each fund and that all funds were established on the same date. Accordingly, each fund has been assigned “shares” on the basis of one share for each dollar transferred to the investment pool. Exhibit 26.2 shows how the individual funds would look at December 31, 20X1.

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EXHIBIT 26.2

Bradford Museum Investments—Pooled Account

	Number of Shares	Cost	Market 12/31/X1	Income for 20X1
Unrestricted board-designated fund	95,000	\$ 95,000	\$126,666	\$3,800
Permanently restricted endowment funds				
W. H. Miller	15,000	15,000	20,000	600
R. A. Adler	40,000	40,000	53,334	1,600
	<u>150,000</u>	<u>\$150,000</u>	<u>\$200,000</u>	<u>\$6,000</u>
Per share		<u>\$1.00</u>	<u>\$1.33</u>	<u>\$.04</u>

The number of shares in each fund represents the original amount pooled as, in this example, \$1.00 per share. The market value per share is simply the aggregate portfolio market value (including uninvested cash) divided by the number of shares (i.e., \$200,000/150,000 shares = \$1.33). The market value for each individual fund is the value per share of \$1.33 times the number of shares in each fund. Likewise, the overall per-share income of \$.04 is first calculated (\$6,000/150,000 shares) and then the individual fund income amounts are arrived at by multiplying \$.04 times the number of shares.

When a comparison is made of the market value of each fund on a pooled basis to the market value on an individual investment basis, there are significant differences. The Adler Fund is the most conspicuous example because the market on the pooled basis is now \$53,334 compared to only \$15,000 before. Distribution of the income on a pooled basis is also based on shares, and the Adler Fund is again a beneficiary of this method. However, the shares, calculated for each funds participation, in the income and distributions should be weighted to properly reflect the portion of the year that the individual fund was a part of the pool.

**26.3 CALCULATING SHARE VALUES
IN POOLED INVESTMENTS**

The previous discussion was centered on a relatively simple illustration showing the principles involved in pooling. It was assumed that all of the funds pooled their money on the same date, and accordingly each fund received shares with a “cost” of the same amount per share. In practice this does not happen except for the single date when the pool is set up.

26.3 CALCULATING SHARE VALUES IN POOLED INVESTMENTS

At subsequent dates, the market value per share will be higher or lower, and additions or withdrawals to and from the pool must be at the then-existing per-share market value.

Let us look at the transactions that took place in the Bradford Museum portfolio in 20X2:

January X2: The board transferred \$40,500 from the unrestricted general fund to the unrestricted board-designated fund.

February X2: The board found it had transferred more than it should have and needed to redeem some of its shares. It transferred \$14,300 from the unrestricted board-designated fund back to the unrestricted general fund as of the end of the calendar quarter.

March X2: The board received a contribution to be added to the R. A. Adler Fund (permanently restricted).

Exhibit 26.3 shows a calculation of the share values at the end of each of the calendar months. The market value of the portfolio is determined based on actual market values on these dates plus all uninvested cash.

Generally, organizations calculate share values only at the end of a calendar month. If the board wants to buy or redeem shares during a month, the value of the shares purchased or redeemed is based on the value at the end of the previous month in which the request to purchase or redeem is made. Thus, if the board decides to redeem some of the shares in the board-designated fund on March 10, the transaction takes place using the end of February share value. Share values could be calculated as of any date, so if the board wanted to calculate share values on March 10, the transaction could be effected on that date.

(a) Accounting for Investments

With the issuance of SFAS 124, not-for-profits will report most investments at market value in their external financial statements.²

There is no difficulty in determining the amount of gain or loss when individual stocks are purchased and sold in a specific fund. It is quite clear which fund realized the gain or loss. On pooled investments, however, each fund shares in all realized gains or losses on a pro rata basis. This necessitates a calculation of the proper allocation. From a practical standpoint, this allocation is usually not made each time a stock is sold unless such sales are made very infrequently. Instead, these gains or losses are accumulated and allocated at the end of a quarter, or at the end of the year if there has been no change in the number of shares outstanding. (It is usual

² See Chapter 6 for a more complete discussion.

EXHIBIT 26.3

Worksheet Showing How to Calculate Share Values for a Pooled Investment Fund

BRADFORD MUSEUM									
CALCULATION OF SHARE VALUES FOR PURPOSES OF PURCHASING AND REDEMING SHARES									
BY MONTH FOR 20X2									
Date	Shares	Market Value	Value	Shares Purchased		Market Value	Shares	Market Value	Market Value
	Outstanding before Purchase or Redemption			before Purchase or Redemption	(Redeemed) This Date				
December X1	150,000	\$200,000	\$1.33	—	—	\$200,000	150,000	\$200,000	\$200,000
January X2	150,000	202,500	1.35	30,000	\$40,500	243,000	180,000	243,000	243,000
February X2	180,000	257,400	1.43	(10,000)	(14,300)	243,100	170,000	243,100	243,100
March X2	170,000	238,000	1.40	10,000	14,000	252,000	180,000	252,000	252,000

^a The number of shares purchased or redeemed is determined by dividing the amount invested or withdrawn by the value per share.

26.3 CALCULATING SHARE VALUES IN POOLED INVESTMENTS

for this to be done on a monthly basis.) An illustration may be helpful. Assume the following transactions took place during 20X2:

December 10: 500 shares of Stock F were sold for \$12,500 with a cost of \$37,500 and a loss of \$25,000.

February 15: 500 shares of Stock C were sold for \$30,000 with a cost of \$20,000 and a gain of \$10,000.

March 15: 100 shares of Stock E were sold for \$4,000 with a cost of \$5,000 and a loss of \$1,000.

At the end of the second and third quarters the loss of \$25,000 and net gain of \$9,000 are allocated on the basis of shares as shown in the following statement:

	December X1		March X2	
	Shares Outstanding ^a	Gain/(Loss) Allocated	Shares Outstanding ^a	Gain/(Loss) Allocated
Unrestricted board-designated fund	95,000	(\$15,833)	125,000	\$6,250
Permanently restricted endowment funds:				
W. H. Miller	15,000	(2,500)	15,000	750
R. A. Adler	40,000	(6,667)	40,000	2,000
	<u>150,000</u>	<u>(\$25,000)</u>	<u>180,000</u>	<u>\$9,000</u>
Gain (loss)		(\$25,000)		\$9,000
Per share		(\$.16666)		\$.05

^a The purchase and redemption of shares in Exhibit 26.1 have also been reflected here, but notice that the allocation is based on the number of shares before purchases or redemptions on that date.

Here is the balance in each of the individual funds at March 31, 20X2, taking into consideration both gains and losses and purchases and redemptions shown in Exhibit 26.3:

	Number of Shares	Book Cost	Market Value (i.e., Share Value Times Number of Shares)
Unrestricted board-designated fund	115,000	\$111,617	\$161,000
Permanently restricted endowment funds:			
W. H. Miller	15,000	13,250	21,000
R. A. Adler	50,000	49,333	70,000
	<u>180,000</u>	<u>\$174,200</u>	<u>\$252,000</u>

INVESTMENTS

Each of these amounts was calculated at March 31, 20X2, as follows:

	Shares	Book Cost
Unrestricted board-designated fund		
December 31, 20X1 balance	95,000	\$ 95,000
January X2, allocation of loss	—	(15,833)
January X2, purchase of shares	30,000	40,500
February X2, allocation of gain (net)	—	6,250
February X2, redemption of shares	<u>(10,000)</u>	<u>(14,300)</u>
March 31, 20X2 balance	<u>115,000</u>	<u>\$111,617</u>
Permanently restricted endowment funds:		
W. H. Miller		
December 31, 20X1 balance	15,000	\$ 15,000
January X2, allocation of loss	—	(2,500)
February X2, allocation of gain (net)	<u>—</u>	<u>750</u>
March 31, 20X2 balance	<u>15,000</u>	<u>\$ 13,250</u>
R. A. Adler		
December 31, 20X1 balance	40,000	\$ 40,000
January X2, allocation of loss	—	(6,667)
February X2, allocation of gain (net)	—	2,000
March X2, purchase of shares	<u>10,000</u>	<u>14,000</u>
March 31, 20X2 balance	<u>50,000</u>	<u>\$ 49,333</u>

It should be emphasized that while the calculation of share values for purposes of purchases and redemptions of shares is based on the market value of the portfolio at date of valuation, this calculation is only for purposes of this purchase or redemption and does not necessarily have to be recorded in the books. The books may be kept on a cost basis and adjusted only at the end of the period for realized and unrealized gains or losses.

26.4 ALLOCATION OF POOLED INCOME

There has been no discussion of the handling of income and interest received on pooled funds, but the mechanics of allocation are exactly the same as with the allocation of gains or losses. Generally, allocation of income is also made on a quarterly basis, although some organizations allocate at other intervals. Investment income is usually not added back to the principal of the fund and reinvested. It is expended for the purposes specified by the donor or added to the unrestricted general fund in the case of unrestricted board-designated quasi-endowment funds. This means that as income is received, it is put into a separate account. At the end of each quarter, it is allocated to each fund on a share basis. An organization could allocate more often than quarterly but this would complicate

the bookkeeping. Once the mechanics of these calculations are established they should not cause difficulty. It is important to formalize these calculations in worksheets that become part of the records of the organization.

26.5 PROFESSIONAL INVESTMENT ADVICE

Let us turn now to a practical nonaccounting question. Where should an organization go to get good investment advice? The answer is clear: to a professional, to someone who knows the investment markets and is in the business of advising others.

You may feel that this skirts the question. Yet many medium-sized and some large organizations try to outguess the market on their own and they usually do not succeed. They make all of the investment mistakes that many individuals do. They tend to rely on their own intuition and try to outguess the professionals. This does not make sense when an individual's own money is involved and it makes even less sense when the money belongs to a not-for-profit organization. Sometimes the board, recognizing its fiduciary responsibilities, will tend to be too conservative in its investment policy, and will purchase high-grade, low-interest-bearing bonds. This conservatism can be almost as risky as purchasing a highly volatile stock, as many holders of bonds discovered in recent years when high interest rates depressed bond prices. This is why professional advice is needed.

(a) Investment Funds

There are a number of places to go for professional advice. If the total investments are relatively small in size (under \$1,000,000), many organizations find that a no-load mutual fund or a bank common stock fund is the answer. In both cases, the organization is purchasing expertise while it pools its funds with those of many other people. Mutual funds offer a convenient way to obtain investment management when the organization has a minimum amount to invest. There are numerous mutual funds with different investment goals and varying degrees of risk including several that are designed specifically for customers that are not-for-profit organizations.

Bank-commingled or common stock investment funds are a form of mutual fund. One of the advantages of using a bank fund is that the reputation of the bank is involved and the bank will pay close attention to the investments made. Banks are often more conservative than mutual funds in their investment decisions, but this may be appropriate when one considers the fiduciary responsibility of not-for-profit organizations.

If the investment fund is large in size (over \$1,000,000), the organization may prefer to select a professional to advise on specific stocks and

bonds to purchase for its own portfolio. Most brokers are pleased to offer this service. On the other hand, many not-for-profit organizations are reluctant to entrust investment decisions to the brokers who handle the actual purchasing, because they are “wearing two hats.” This can be avoided by going to one of the many available investment advisory services that does not handle the actual purchasing or selling.

(b) Short-Term Investments

Investment professionals can also offer advice on a type of investment that is frequently not given the attention it warrants by not-for-profit organizations short-term investments. Short-term investments are investments in interest-bearing instruments of that portion of an organization’s cash balances that is currently inactive but will be needed to pay for programs and activities in the near future. An ordinary savings account is one type of short-term investment of cash balances that are temporarily not deployed. Often, however, it is possible to improve on the interest rate available in savings accounts without substantially increasing risk by purchasing “money-market” instruments. These vary in interest rate, risk, minimum denomination available, time to maturity, and marketability prior to redemption; included are U.S. Treasury bills, “agencies,” certificates of deposit, and repurchase agreements.

Treasury bills are the most marketable money-market instrument. The smallest denomination currently available is \$10,000 and the shortest maturity is 13 weeks.

“Agencies” are federally sponsored debt instruments issued by federal agencies or quasi-governmental organizations. Some are explicitly guaranteed by the full faith and credit of the U.S. government while others are not.

Certificates of deposit (CDs) are available directly from commercial or savings banks, or through securities dealers. Only large CDs (over \$100,000) are negotiable, and all bear substantial penalties for redemption prior to maturity.

Repurchase agreements are agreements under which a bank or securities dealer agrees to repurchase at a specific date and at a specific premium securities sold earlier to an investor. Interest rates on repurchase agreements are often attractive, and a wide range of maturities is usually available.

(c) Selecting an Investment Advisor

A list of investment advisory services can usually be found in the classified telephone directory. Bear in mind that, as with all professionals, the investment advisor’s reputation should be carefully checked. The bank’s

trust department is usually also happy to give advice on investment decisions. The point to emphasize is that investment decisions should be made by professionals in the investment business.

Remember, too, that even professionals sometimes make errors in judgment. The professional advisor will charge a fee that is generally calculated on the basis of a percentage of the monies invested. The larger the investment fund, the lower the rate charged.

26.6 SAFEGUARDING INVESTMENT SECURITIES

The physical safeguarding of an organization's investment securities is as important as making the right decision as to which stocks to buy or sell. This is often overlooked. The board of directors or the finance committee of the board has general responsibility for all investment instruments owned by the organization. Periodic verification of the existence of the securities should be made, either by independent accountants or the board itself. Verification usually involves a physical counting of the securities at the location where they are deposited or, for securities recorded only in electronic form, periodic confirmation with the custodian. This is always done by the auditor as part of the audit. Three areas warrant special attention. The first is that stock certificates are not lost or misplaced through carelessness or poor handling. The second is that they are not lost through misappropriation by an employee. The third is that the stockbroker does not lose the certificates or, worse yet, go bankrupt. Let's look at the risks in each of these three areas. In today's operating environment it is becoming less common for an organization to actually hold actual stock certificates or bonds, usually they are turned over to the custodian. However, as some smaller not-for-profit organizations may hold actual certifications, these risks will be addressed here.

(a) Careless Handling

If the organization keeps the certificates in its possession, the certificates should be kept in a bank safe deposit box. They should be registered in the name of the organization. The organization should also maintain an investment register that shows the certificate number as well as cost and other financial information.³ There should be limited access to the safe deposit box, and it is wise to require the presence of two persons (preferably officers) whenever the box is opened.⁴

³ An example of an investment register is shown in Chapter 31.

⁴ It is also wise for the board to establish an investment committee charged with the responsibility for authorizing all investment transactions. If an outside advisor is retained, this committee should still review the outside advisor's recommendations before they are accepted. It is not wise to delegate authority to an outside advisor to act except in accordance with an investment policy approved by the investment committee and reviewed by the board.

Some organizations become careless in handling the certificates because they are registered in their name. They know they can “stop transfer” if the certificates are lost. While this is usually true, transfer agents may require the registered owner to post a bond before a replacement certificate is issued. The purpose of the bond is to protect the agent from any loss that might result from misuse of the lost certificate. The bond can be purchased from an insurance company, but it is expensive, ranging between 1 percent and 4 percent of the market value of the lost certificate. This is a high price to pay for carelessness.

(b) Embezzlement

An organization must always be concerned that someone having access to stock certificates may be tempted to steal them. While the certificates may be registered in the organization’s name, there is an underworld market for stolen certificates. Furthermore, if the loss is not discovered promptly and the transfer agent advised to stop transfer, the organization’s rights may be jeopardized.

Unless the securities are kept in electronic form by the custodian, the best control is to have the broker deliver the stock certificate directly to a custodian for safekeeping. When the stock is sold, the custodian is then instructed to deliver the certificate to the broker. In this way, the organization never handles the certificate. The use of a custodian provides excellent internal control. There is, of course, a charge for this custodian service.

(c) Leaving Certificates with Brokers

Some organizations leave their certificates in the custody of their broker. This has certain risks. One is that the broker will temporarily lose track of the certificates if the back office falls behind in its paperwork or incorrectly records the certificates. If this happens, there might be some delay before the broker straightens out the records. This is a risk that cannot be completely avoided since the broker must buy or sell the stock. But it increases if the organization also has the broker hold the certificate in safekeeping. As long as the broker does not go bankrupt, the worst that is likely to happen is that there will be delay in getting the certificates when the organization wants them. This risk can be minimized by making inquiries as to the broker’s reputation for handling back office problems.

The other risk is the broker’s going bankrupt while holding the stock. Provided the broker has not fraudulently hypothecated the stock, bankruptcy should not result in a loss to an organization. However, there could be considerable delay before the stock is released by a court. On the other hand, if the broker has, without the consent of the organization,

26.7 CONCLUSION

pledged the stock for personal borrowings, there is a possibility of actual loss. While the organization might be able to take both civil and criminal action against the broker, this would be of little consolation in bankruptcy. The first \$500,000 of such losses, however, would be recovered from the federally chartered Securities Investor Protection Corporation.

While these risks might be relatively small, a not-for-profit organization has a fiduciary responsibility (including the individual board members) to act with more than ordinary care and judgment. Accordingly, it would be prudent for an organization to have the broker deliver the stock certificates in the organization's name, either to an independent custodian or to the organization.

26.7 CONCLUSION

The board of a not-for-profit organization has an obligation to act prudently in all of its actions. When it comes to handling investments, not all boards are competent to make informed professional decisions. Accordingly, professional advice should be obtained to ensure that the organization's investments are made wisely. For very small organizations, this can be accomplished by choosing a mutual fund or bank common stock fund. For larger organizations, a professional advisor should be retained. Investment counsel should also be sought for short-term investments.

The board should not overlook its responsibility for security of its stock certificates. The most effective arrangement is to have the broker deliver all certificates to a custodian. In this way, neither the employees of the organization nor the broker have access to the certificates.

P A R T F I V E

**Principal Federal Tax
and Compliance Requirements**

E-Business for Not-for-Profit Organizations: How Can Not-for-Profits Manage the Risks to Maximize E-Business Opportunities?

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27.1 WHETHER YOU CALL IT E-BUSINESS OR TECHNOLOGY-ENABLED BUSINESS, IT STILL MATTERS

Many people are not using the term *e-business* the way they were several years ago. When many dot.com companies failed, the term e-business took on a more negative connotation. A more descriptive term today is *technology-enabled business*. Whether you call it e-business or technology-enabled business, it is about the application of information technologies to facilitate the buying and selling of products, services, and information over networks. More importantly, it encompasses using technology to improve the speed and quality of information to increase business performance and to increase the value delivered to all stakeholders (e.g., customers, employees, and suppliers).

Organizations of all types are:

- *Using new technology to decrease purchasing costs and increase the efficiency of purchasing practices.* Some use the term *e-procurement* to refer to the business-to-business purchase of supplies and services over the Internet. The objective of e-procurement is to leverage high-volume orders and ongoing purchases to qualify for significant discounts. Additionally, procurement technology improves the efficiency of the procurement transaction, reducing the cost of the purchasing transaction.
- *Leveraging the Web as a new sales and customer service channel.* Many organizations are implementing *customer relationship management* (CRM) systems to better manage the sales process and customer interactions. CRM encompasses the methodologies, software, and usually Internet capabilities that help a business manage customer relationships in an organized way. For example, CRM could include the use of databases to hold useful information about customers, allowing sales or service people to match customer needs with product plans and offerings, remind customers of service requirements, know what other products a customer had purchased, and so on.
- *Implementing ERP systems.* By implementing the next generation of *enterprise resource planning* (ERP) systems, organizations can achieve necessary internal and external collaboration while triggering significant opportunities for cost reduction and tax planning. This means more collaboration and information sharing between organizations and their business partners.
- *Entering into new business relationships.* In efforts to focus on their core competencies and to cut costs, many organizations are entering into new business partnerships, joint ventures, and IT outsourcing

27.2 ASK YOURSELF THESE QUESTIONS

arrangements. These new relationships result in changes to an organization's controls structures and the need for strong relationship management monitoring controls.

For example, organizations are entering into agreements with ASPs (ASP stands for Application Service Provider). ASPs are third-party entities that provide, over the Internet or over a private network, software-based services and solutions to customers from a central data center. ASPs enable companies to outsource some or all aspects of their information technology needs:

- *Building portals.* A portal is a gateway or main entrance to the Web. Some organizations use portals to improve information access throughout their organizations—for their employees, for example. Some organizations use procurement portals to effectively combine their purchasing. An example of this type of marketplace is *www.covisint.com* (the joint venture between General Motors, Ford, and DaimlerChrysler). So far, colleges and universities, for example, are using portals to consolidate online services and information for students and are just beginning to use them for procurement.

There is a philanthropy portal for not-for-profit organizations—Network for Good. Its goal is to connect people to charities via the Internet. Network for Good was founded in 2001 by the AOL Time Warner Foundation and AOL, Inc.; the Cisco Foundation and Cisco Systems, Inc.; and Yahoo! Inc. It is an independent, IRC § 501(c)(3) not-for-profit organization headquartered in San Francisco, California.

The rewards for a successful e-business strategy are evolutionary. They can include stronger customer and member relationships, market leadership, streamlined and more cost-effective business processes, new products and services, and access to new markets. E-business has the potential to transform the competitive landscape for all organizations.

New technologies are changing the way customers and organizations access and use the Internet, and thus they are changing how organizations implement e-business. The enablers include extranets, broadband, peer-to-peer, and wireless technology (see Exhibit 27.1). However, it is not the technology per se that is important in the new economy. It is how an organization uses technology. Numerous business models already exist for e-businesses, and new ones continue to emerge.

27.2 ASK YOURSELF THESE QUESTIONS

Assume, for a moment, that your not-for-profit organization views e-business as a real opportunity. You have already explored several possibilities. In fact, let's take it a step further. Let's assume that you have just

EXHIBIT 27.1

Enabling Technologies for E-Business

Extranet

An extranet allows authorized external parties, such as members, students, customers, or business partners, to communicate over the Internet. The extranet technology allows users to share data as well as business processes over a private network. The technology addresses the security risks associated with using the public Internet for transactions.

Broadband

Broadband refers to cable and digital subscriber lines, or DSL for short. These technologies give customers faster access to the Internet resources that enable e-business. For example, consumers with broadband Internet access can more effectively view webpages with multimedia graphics, which increases the type of e-learning course content that can be developed.

P2P

P2P, or peer-to-peer technology, allows users to access resources, such as processing and storage space, on each other's computers. Napster, which enabled users to access storage space on each other's personal computers and thus share files, is an example of P2P technology.

Wireless

Wireless technology, including cell phones, computers, and Web-enabled personal digital assistants (PDAs), is an enabler of e-commerce. It is a vehicle through which e-commerce can occur. For example, when users buy movie tickets using their PDAs or when they use their cell phones to buy soda from vending machines.

VRU

Although the Internet is certainly the most prevalent enabler and driver of e-business, non-Internet-based technologies, such as voice response units or VRU, can also be key to e-business. VRU's are systems that customers dial into through the phone system to perform transactions. One example is a course-scheduling VRU, which enables students to register for courses via the telephone system. Another example is a not-for-profit organization that uses VRUs to enable its employees to select health insurance and benefit options. Finally, a museum might set up a VRU to enable visitors to select options, such as press 1 for hours, press 2 for directions, and so on.

finished designing a new Web-based retail shop and are about to launch it. Before you do so, stop for a moment to ask the following questions:

- How reliable is our technology? Can it support our growth? Are our processes and procedures in sync with our technology? And how far can they take us on our busiest day?
- How careful are we with our information? Do we respect information entrusted to us by our customers or other stakeholders? Who has access to it? When? Why?
- How vulnerable are we to the criminal element? What are the costs—financial, market share, and reputation—if our systems are attacked? What should we be protecting, and how?
- Do we articulate our policies and procedures to those with whom we do business? Do we actually do what we say we will do? Are we timely, orderly, respectful, and fair?

27.3 OBJECTIVES

- Do our customers and business partners trust us? If so, how do we ensure that we do not violate this trust?

If you have already asked yourself these questions and you are comfortable with the answers, then you are e-business savvy and you are ready to go live with your new online retail shop. However, most organizations have not asked these questions. Today's business world is changing extremely rapidly, pressuring organizations to move quickly in executing their e-business strategy. In the process, they sometimes forget to ask these critical questions. But ignoring them can jeopardize the success of an e-business initiative. Moreover, it can put the organization's reputation on the line.

27.3 OBJECTIVES

Effective risk management can help a not-for-profit organization take full advantage of the new paradigms that e-business has to offer. This chapter defines e-business and explains its emergence as a viable new way of doing business. It also highlights the risks an organization is exposed to as a result of the rapidly changing and global e-business world. Then, we will suggest a strategy to help manage the risks. The objective is to help you embrace e-business at your not-for-profit organization.

PricewaterhouseCoopers' informal survey of not-for-profit organizations in one region of the United States revealed the following e-business initiatives:

- Many organizations are focusing on integrating key systems.
- Many educational institutions are working on accepting online admissions and online course registration.
- Many are implementing portals.

However, the survey revealed several surprises:

- Few organizations accept receipts online, and few have it listed as a future initiative.
- Some organizations are involved in e-procurement; yet many have not considered it.
- Most organizations use their websites to provide information only.

These themes indicate that not-for-profit organizations are embracing e-business but not perhaps fully exploring the e-business opportunities that exist. This chapter will help not-for-profits understand the full spectrum of opportunities that e-business has to offer. Moreover, we will propose a framework to manage the risks associated with e-business.

27.4 HOW DID WE GET TO THE INTERNET ECONOMY?

First, let's understand the origins of the Internet economy. What is the Internet? How did the information superhighway get started? In the early 1960s, the Rand Corporation, a U.S.-based think tank, was asked to answer the question: How would U.S. authorities and military bases communicate after a nuclear war? The Rand Corporation's answer was to create a network that has chaos built into the design. This network should have no central control because any body of central control would be a military target. In addition, the network should be designed so it could operate while in tatters.

So, in 1968, such a network was founded by the Department of Defense's (DOD) Advanced Research Projects Agency (ARPA). It was called the ARPAnet. In the 1970s, colleges and universities began to use the Internet to share research. Then in 1972, the concept of e-mail was born, and Queen Elizabeth sent the first e-mail in 1976.

The network continued to evolve. It became more standardized in 1982 when the DOD declared Transmission Control Protocol/Internet Protocol (TCP/IP) their standard. At this time, the Internet as we know it today was born. In 1983, the domain name server was created, which is essentially a phone book for the Internet. Foreign countries chose to use geographic names such as .uk for their domains. The United States chose to use six basic addressees: .gov, .mil, .edu, .com, .org, and .net.

By 1984, there were 1,000 hosts on the Internet. A host is a machine with a permanent connection to the Internet. In 1986, the National Science Foundation's (NSF) NSFnet was created. This project essentially upgraded the network links. As a result, by 1987, there were 10,000 hosts on the Internet. By 1989, the number had exploded to 100,000.

In 1991, the first search engine was released. It was called *Gopher*, because you asked it to "go for" information. In 1992, the World Wide Web (WWW) was released. At this time, there were a million hosts on the Internet. In 1993, the Internet took giant steps forward: The White House went online; *Mosaic*, the first browser, was released; WWW use grew 341,634 percent; Gopher use grew 997 percent; and businesses and the media found the Internet.¹

A year later, shopping malls began to sell merchandise on the Internet, and communities began to use the Internet to facilitate distance learning. By 1995, there were more than 2.2 million hosts on the Internet. Then in 1997, the Federal Trade Commission (FTC) held the first hearings on consumer online privacy. In 1998, the Internet and the World Wide Web started to become mainstream.

¹ Mark Keeley, Cheryl Fletterick, and Chris O'Hara, *What Senior Management Needs to Know About the Internet, KnowledgeLink* (September 1998), published by Pricewaterhouse-Coopers.

The past few years have marked the beginning of the new economy, which is commonly referred to as the Internet economy or the digital economy. Despite a presence since the 1960s, why is it that only in the last few years has the Internet received mainstream media attention? And why is it that only very recently have consumers begun to embrace the Internet?

First, the real value of the Internet could not be seen until it became widely used. Initially, only higher education institutions and the government used it. From a business perspective, there was not yet a lot of value in the Internet.

Metcalf's Law helps to explain the evolution of the Internet as a valuable business tool. Metcalf's Law states that the value of technology increases as the number of people who have implemented it increases. The telephone provides a good illustration of Metcalf's Law. If only two people in the world have a telephone, its value is clearly negligible. However, as more people get a telephone, each person can call more people. Thus, its value increases.

The railroad is another example of Metcalf's Law. The construction of the American railroad system had a significant impact on society. With a national railroad system in place, people were able to send and receive information and goods much more quickly. The Internet is similar—it enables people to more easily buy and sell goods in distant cities. Moreover, with the railroad came the telegraph and the first electronic money transfers. Like the railroad before it, the Internet has evolved into a commerce system.

This evolution was able to occur only because the tracks on the east and west coasts were compatible. In Internet terminology, the common set of tracks is the TCP/IP protocol suite. This is the language of the Internet, and it allows computers on the Internet to communicate with each other.

Second, although the fundamental Internet technology existed, personal computers did not become mainstream until the early 1990s. Another law, Moore's Law, can be used to explain the rapid advancements in personal computer technology. Moore's Law states that each new computer chip should contain about twice as much capacity as its predecessor, and that a new chip should be released within 18 to 24 months of the previous chip. So far, this law is holding true.

Third, it was not until 1993, when government restrictions were lifted, that private companies and individuals were permitted access to the Internet. Furthermore, the first graphic browser did not appear until 1993. With the browser, the World Wide Web (WWW) began to grow quickly. The WWW refers to the graphical component of the Internet. Despite issues of compatibility, speed, and so on, amazingly, the adoption of the Internet

was 10 times faster than the adoption of the radio and four times faster than the adoption of the television.

27.5 WHERE ARE WE TODAY?

The growth of the Internet has been nothing short of phenomenal. For example, experts estimate that there are over 2.7 billion webpages today; this number is growing at rate of approximately 5 million new pages a day. According to a January 16, 2004 article on the CyberAtlas website (<http://cyberatlas.internet.com/>), there are 165.75 million Internet users in the United States. China is second with 79.5 million Web surfers at the end of 2003. This is per a report by the China Internet Network Information Center. Japan is third, with 56 million Internet users. (For more Internet statistics, see Exhibit 27.2.)

Despite this growth, the dot.com boom has faded recently. The capital markets no longer shine favorably on all companies with a .com in their name. In fact, many Internet startups are closing their doors. Business models appear and disappear as companies recognize that what worked yesterday does not necessarily work today and what works today will not necessarily work tomorrow. Business-to-consumer (B2C) models were at the center of attention, then business-to-business (B2B) models. Today's focus is on B2B exchanges and e-markets. (For more information about e-business models including B2C and B2B models, see Appendix 27–A.)

The concept of portals is hot right now. A portal is a tool to help users navigate their way to content on the Web. In a single webpage, it can unify disparate technologies. It also can be personalized to the needs of individual users. For example, a university might create an online student center. Prospective students could tour the campus virtually. They could also apply for admission, search for scholarships, check admissions status, and apply for financial aid. Accepted students could apply for housing and research majors as well as sign up for orientation and e-mail an advisor.

EXHIBIT 27.2

A Sample of Internet Statistics

- 31 billion e-mail messages are sent daily.
- There are more than 6 billion people in the world—13% are online.
- 67% of Americans are online and half of those are women.
- U.S. business-to-business e-commerce is expected to exceed \$6.3 trillion by 2005; 56% of U.S. companies buy on-line.
- U.S. consumer e-commerce was \$100 billion in 2003.

27.6 WHAT IS RISK MANAGEMENT?

M-commerce might emerge as the next wave of e-business. *M-commerce* is defined as the ability to buy goods through a wireless, Internet-enabled device. Wireless technologies include cell phones, computers and digital organizers (like the Palm Pilot) that connect to the Internet. M-commerce is still in its infancy, but some experts believe it will eventually evolve into mobile business, or m-business, as the full potential of the technology is realized.

Clearly, there is much more to come—if only we could predict the form it will take. So far, it appears that the market will not tolerate indefinitely e-business initiatives that do not generate profit. In addition, venture capitalists will no longer fund any dot.coms. When society enters a new era, new companies emerge, and then a shakeout occurs leaving a handful of survivors. This pattern is to be expected; it is in accordance with the fundamental law of evolution and survival of the fittest.

The automobile industry provides a good example of industrial evolution. Within a short time after the automobile was invented in the late 1800s, there were numerous automakers. Later, in the United States, it became the “Big Three” automakers: General Motors, DaimlerChrysler, and Ford.

The Internet economy is still a dynamic environment and is full of new opportunities. Organizations are starting to see the benefits of e-business. There is still a strong belief that e-business will continue to bring business transformation, which translates into operational, process, application, and technological change. Yet, as organizations pursue e-business opportunities, it is critical that they have an e-business risk management strategy. Only by effectively managing risk will organizations be able to benefit from e-business.

27.6 WHAT IS RISK MANAGEMENT?

Although we might not think about it very much, everyone manages risks. Consider the act of driving to work. Each morning you face the risk that your car will be involved in an accident and damaged. You can choose to avoid the risk by not driving your car to work. This is risk avoidance. Or, you can mitigate the risk by learning to drive defensively or by driving to work early in the morning and avoiding heavy congestion. This is considered risk mitigation. You are mitigating the likelihood of your car being damaged by not driving it during peak traffic periods. As another option, you can purchase collision auto insurance. This is risk transfer. The insurance company now bears the risk.

In short, you have three risk management options—avoid the risk, mitigate the risk, or transfer the risk. The decision you make depends on the cost–benefit analysis you more or less consciously perform. The

same risk management options are available to organizations. The risk management decisions of organizations are based on weighing the cost of doing nothing against the cost of mitigating or transferring the risk.

(a) Why Is E-Business Risk Management Necessary?

In the old economy, organizations and customers chose to interact with each other based on trust. The concept of trust is still evolving in the new Internet economy, but it will play an instrumental role in the success of e-business initiatives. Trust is built when customers and business partners have a successful experience with an organization. The level of trust continues to grow with each successful and positive interaction. It can even become a competitive advantage. If customers and business partners trust an organization more than its competitors, they are likely to select the trustworthy organization over its competitors.

If an organization fails to earn its customers' trust, its reputation will suffer. Few not-for-profit organizations will forget the Foundation for New Era Philanthropy that John Bennett, Jr. created in 1989. Over New Era's six-year life, he persuaded many charities to invest millions in New Era, assuring them that their money would be doubled with contributions from anonymous donors. Unfortunately for the charities, Bennett had created a Ponzi scheme, under which early participants were given the funds that later participants had donated until the scheme collapsed.

Directly linked to e-business is the following example. Consider the companies, including Macys.com and Toysrus.com, that were not able to deliver the merchandise consumers purchased online for Christmas several years ago. They were fined by the Federal Trade Commission (FTC). AOL was fined \$3.5 million by the Securities and Exchange Commission (SEC) for improperly accounting for advertising costs.² Unfortunately, there are numerous examples of organizations that failed to manage their risks.

The take-away message for organizations of all types? Without trust, e-business will never reach its full potential.

(b) So How Do You Manage E-Risks?

First, let's consider a car. Cars have brakes. Most people view the brakes as being the mechanism for slowing down the car. However, when viewed from another perspective, brakes allow the car to travel faster. Similarly, by effectively managing e-risks, an organization is able to move ahead at a fast and controlled pace in order to achieve its e-business objectives.

² Muehlbauer, "AOL's \$3.5 Million 'Oops'," *The Industry Standard* (May 16, 2000), www.thestandard.com.

Effective risk management needs to occur within a positive control environment. A positive control environment is one that promotes individual responsibilities and is supportive of risk taking. There are three key elements of a positive control environment:

1. *Management commitment.* Concrete action is required to change the culture.
2. *Individuals making decisions.* Empowerment of individuals is key. Group decision making is bad risk management because no one is accountable.
3. *Questioning.* In a positive risk culture, people question everything.

(i) **Understand the Complete Spectrum of E-Risk.** The new Internet economy presents a time of great change. With change comes great opportunity and great risk. E-business risks are plentiful:

- Increased dependency on business partners
- Decisions based on incomplete information
- Inadequate back-up and contingency plans
- Poorly controlled outsourcing agreements
- Inadequate technical skills of employees
- Increased employee turnover
- Inability to scale to meet growing demand
- Inability to deliver goods and services
- Poor website presentation and navigation
- Inaccuracies in website content viewable globally
- Lack of customer confidence in performing financial transactions using a website
- Erroneous financial filings
- Unauthorized system access that is possible from anywhere in the world
- Difficulty defining and thus controlling network boundaries
- Inability to identify and authenticate users
- Unfamiliarity with other countries' customs
- Computer viruses and worms
- Inconsistent information from disparate systems
- Misinterpreting complex and conflicting laws that might affect e-business

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- Not recognizing applicable regulations
- Ignoring tax implications of e-business transactions

This is just to name a few risks. Given such a jumble of risks, the first step in risk management clearly needs to be identifying the risks and then organizing them in a way that they can be addressed. A risk management framework is a valuable tool to help ensure that the complete spectrum of e-business risks is considered.

We suggest using the framework presented in Exhibit 27.3 that organizes risks into nine categories.³ This framework will help organizations focus their risk identification process. By logically organizing e-risks in these categories, organizations will minimize the possibility of forgetting to consider key e-business risks.

EXHIBIT 27.3

Nine Categories of Risk

The Nine Categories of Risk	Included in the category are the following:
1. Strategy	Strategy risks, including setting strategic direction, analyzing competitors, and leveraging information technology
2. Security	Security risks, including cryptography, confidentiality, integrity, and availability
3. Systems and technology	Systems and technology risks, including customer support technologies, for example, and integrated software solutions; also includes emerging technology trends
4. Performance management	Performance management risks, including how an organization plans, measures, monitors, and controls the performance of its e-business capabilities and functions
5. Organization and competencies	Organization and competencies, including whether an organization requires new skills, new competencies, new ways of working, and/or a new set of business partners
6. Tax liabilities	Tax risks, including an organization's e-business tax exposure and liabilities
7. Legal	Legal risks, including whether an organization knows its rights, obligations, and potential liabilities, and privacy concerns

³ This framework is called emm@. It was jointly developed by Pricewaterhouse-Coopers and Carnegie Mellon University.

EXHIBIT 27.3 (CONTINUED)**Nine Categories of Risk**

The Nine Categories of Risk	Included in the category are the following:
8. Delivery and operations	Delivery and operations risks, including those affecting the day-to-day operations of an e-business, such as content creation and management, risk management, financial cost management, and project management
9. Value network processes	Value network processes risks, including those affecting the primary value chain processes, such as customer interaction and delivery systems

It is important to note that risk identification is not a one-time process. As the organization gets more sophisticated in its use of e-business, new risks can emerge. Thus, proactive risk identification is necessary as the organization's e-business initiatives mature. For example, if an organization only uses its website to provide information to its users, then there is not a risk of unauthorized financial transactions through the website. However, once the organization implements functionality allowing users to purchase goods from its website and pay electronically, the organization does need to consider the risk of unauthorized transactions.

(ii) Identify the Value at Risk. The next step in the risk management process is to identify the value at risk. This means that we can assign a specific dollar value of worth to the asset. If the asset is stolen or destroyed, what is the dollar value of the loss to the organization? Assets at risk include intellectual property, such as unpublished faculty research, or it can be a donor list. At the extreme, it can be an organization's reputation that is at risk. Assigning a specific dollar value to an organization's reputation is very difficult to do.

(iii) Manage the Risk. After determining the value of what is at risk, an organization is in a better position to manage it. Does the organization choose to ignore it, mitigate it by implementing controls, or transfer it? For example, a university might want to mitigate its risk by investing in data encryption controls to protect student data in order to comply with privacy laws. Noncompliance with such laws could result in monetary fines and put the organization's reputation at risk.

Another example would be managing the risk of downtime for a website. In order to prevent the site from crashing, an organization could install a back-up computer system. An organization might consider this to be a worthwhile investment if it is critical that the website be available 24 hours a day and seven days a week. On the other hand, if it is not critical,

the organization could transfer the risk of downtime. It could purchase, for example, e-business insurance that covers the value of transactions lost due to a website failure.

Again, cost–benefit analysis is key. The cost of the insurance policy should be equal to or less than the value of what is at risk.

Especially in the not-for-profit environment, be sure to consider the value of the organization’s reputation in the equation. We made the point earlier that if an organization fails to earn the trust of its constituents, its reputation will suffer. The impact may very well be financial. With so many worthy charities to consider, how many donors will contribute to an organization with a tarnished reputation? Remember that trust is key to the success of e-business initiatives.

Internal control is broadly defined as a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations.⁴

Used correctly, controls are a powerful risk management tool for two reasons:

1. *Controls empower people.* They specify how people can accomplish what needs to be done.
2. *Success of controls depends on a positive risk culture.* A simple set of procedures can make an enormous difference to an organization if people take personal responsibility for upholding them.

Controls can be management controls or technical controls. Management controls are based on people, policies, and procedures. However, technical controls are accomplished by implementing an information technology solution. The purpose of both management and technical controls can be classified as prevention, detection, recovery, or avoidance.

- Preventive controls are designed to stop a risk from happening. For example, when systems require a user to log in with a valid user ID and password, they are preventing unauthorized individuals from accessing the systems.
- Detective controls alert management after a risk happens. For example, management reviews the bank statement for electronic

⁴ *Internal Control—Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission, from the Executive Summary on page 1.

banking transactions and detects a transaction made for the incorrect amount.

- Recovery controls enable the organization to restore to a previous state after a risk has occurred. For example, if a system crashes, it can be restored from back-up tapes. The back-up process is a recovery control.
- Avoidance controls do not expose the organization to the risk. For example, an organization can elect not to accept credit card donations through its website in order to avoid the risk of customers' credit card numbers being stolen off of the site. (Keep in mind, though, that avoidance controls shield an organization from the opportunities as well as the risks.)

At the fundamental level, controls help organizations ensure the authentication, integrity, confidentiality, auditability, and nonrepudiation of e-business transactions. Authentication is the verification of a user's identity. Integrity is the assurance that stored and transmitted data is accurate and can only be modified by those people who are specifically authorized. Confidentiality is the assurance that stored and transmitted data can only be viewed by those people who are specifically authorized. *Auditability* is the ability of systems and applications to create and maintain usable records for all user actions and system events.

Many readers may not be familiar with the term *nonrepudiation*. By definition, nonrepudiation is the strength and accuracy of authentication, integrity, confidentiality, and audit controls so users can or cannot deny the validity of their transaction. This is becoming a hot topic as the use of the Internet for electronic transactions increases.

An example of nonrepudiation occurs when you go to a grocery store and sign your check in front of the cashier. The cashier looks at the picture and signature on your driver's license and then compares them to your face and signature on the check. As a result, you cannot deny that you signed the check. (Of course, this example assumes that you can rely on the integrity of the driver's license and the integrity of the review performed by the clerk.)

Ideally, organizations should have controls in place to manage each of the nine domains of risk that were defined earlier in this chapter. For example, e-business strategy risks would include failing to adequately and appropriately set strategic direction, analyze the competition, and leverage information technology. What controls would an organization develop to manage its e-business strategy risks? Good controls might include the following:

- Communicating an organization's e-business vision and objectives to its employees, partners, and shareholders.

- Defining, approving, and communicating its business plan and new growth opportunities regarding its evolution in e-business to employees, key partners, and other stakeholders.
- Studying its competitors, their value propositions, target audience, and strengths and weaknesses.
- Developing an e-business strategy that would allow the organization to react quickly to changes in its business environment.
- Securing strategic partnerships, domain names, and unique technologies and services, thereby creating an advantage over its competitors by having made its strategy difficult to replicate.
- Integrating its existing business processes with the new technology-enabled business processes.
- Establishing a system for knowledge management and transfer to improve the key e-business processes.
- Conducting regular competitor analyses, and benchmarks of new technologies, and keeping track of regulations and their impact on the e-business strategy.

What controls should a not-for-profit organization implement to manage its other e-business risks? On the following pages, we consider each of the remaining eight domains of e-business risk (see Exhibit 27.3), beginning with security risks. E-business depends on trust. Visitors to a website want to know that the organization has addressed their security. Security risks would include, for example, failing to maintain the confidentiality or integrity of a site. Good controls for managing e-business security risks might include the following:

- Communicating the organization's security and Internet policies to employees and business partners
- Educating end users to respect good security practices (e.g., handling sensitive information, hardware security tokens, and password maintenance)
- Developing and maintaining a cryptography policy
- Implementing and enforcing proper access controls over the programs (compiled binaries/software) and program content (code) used for e-business applications
- Researching, documenting, and implementing for administrative accounts strong password controls as well as a process for immediately applying patches to new security issues
- Researching, documenting, and implementing monitoring controls to detect unusual volumes of transactions or inconsistent activities

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- Researching, documenting, and implementing intrusion response procedures that includes problem escalation, the time frame in which the problem should be addressed, and the contact information for the responsible actionee
- Developing a configuration policy for each technology
- Using secure payment methods that cover the complete transaction, including the customer, the vendor, and the financial institution

Information technology enables e-business. The systems and technology risks would include, for example, failing to provide adequate and appropriate customer support technologies for the e-business initiative. Another example would be failing to identify and provide for rapidly emerging technology trends. To mitigate against these risks, an organization might deploy appropriate systems and technology controls that could include the following:

- Negotiating a service level agreement with the Internet service provider, covering network uptime, bandwidth, division of responsibilities, nondisclosure, and data integrity requirements
- Researching, documenting, and implementing a strategy for integrating Internet technologies into the organization's existing framework
- Considering load-balancing
- Using scalable transaction servers if high transaction volumes are anticipated
- Choosing e-business technologies that provide interoperability and integration
- Considering and documenting an approach for firewall and proxy management
- Defining a contingency plan in the event of a general failure of the e-business system
- Documenting and communicating the procedures for authorization, planning testing, and contingency planning when updating software
- Carrying out regular tests of the organization's contingency plans

Well before an e-business initiative is launched, objectives and goals must be developed. Accountability for meeting the goals is key. Controls for managing e-business performance risks might include the following:

- Paying constant attention to the nature and quality of the customer relationship

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- Regularly tapping outside e-business expertise to learn about new ideas on how e-business can create value
- Regularly collecting and analyzing information and data about the following e-business issues: feedback from customers and business partners, press coverage, traffic, and matching of achievements with original objectives of the website
- Setting goals to measure the performance of e-business initiatives on value chain management (e.g., transaction cost reduction, speed improvement, quality improvement, etc.)
- Monitoring the order fulfillment cycle and setting new goals as appropriate (e.g., time to process and receive order)
- Monitoring the following issues: employee satisfaction, employee performance, cost reduction, and process efficiency improvement
- Monitoring the organization's value chain to ensure control over its own proprietary customer and company data
- Establishing key business performance indicators that are supported through e-business and ensuring that the overall business plan is monitored regularly against these measures
- Instituting measurable business goals for each transaction type and identifying the value associated with using e-business to decrease transaction costs
- Regularly performing postimplementation reviews for all key systems to monitor actual costs and realization of benefits

Not-for-profit organizations need to develop an organizational structure with reporting relationships for the e-business initiative. They also need to identify the right people to run it, and the people need to have the right skills to do the job today as well as tomorrow. Good controls for managing organizational and competencies risks include the following:

- Building commitment around the organization's e-business strategy by communicating the costs associated with not changing
- Communicating the e-business strategy and its impact on the employees throughout the company
- Establishing a compensation system that includes an incentive program to reward performance and a retention program to retain key employees
- Assigning personnel to assess and manage risk associated with the e-business
- Appointing purchasing personnel responsible for managing electronic procurement with suppliers

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- Ensuring that representatives of legal and tax staff are part of the team when assembling the e-business project team
- Appointing personnel knowledgeable of Web technologies to be in charge of human resources and to be responsible for Internet resume screening, online job posting, and headhunter management
- Appointing a manager to be responsible for coordinating the customer relationships at all customer touch points
- Choosing partners carefully, based on metrics, in which technology, quality, cost, availability, and business practices are important criteria
- Defining, documenting, and communicating service level agreements with all outsourcing partners

Many organizations fail to consider the tax implications (e.g., unrelated business income tax) of an e-business initiative. Good controls for managing e-business tax risks might include the following:

- Considering the availability of low tax rates, local tax incentives, or advantageous tax rulings when deciding where certain functions/activities will be located
- Monitoring the content of the organization's website to ensure it is supportive of the way in which it represents its business and its tax
- Investigating whether the organization has to complete registrations or declarations for value-added tax purposes prior to entering into e-business via the Internet (i.e., since the website is accessible globally)
- Monitoring the flows of goods, recording the place of departure and the place of arrival of the goods, and keeping a set of relevant documents with respect to each shipment of goods
- Ensuring that the exporting and importing organizations obtain any necessary export/import licenses and that the goods comply with the rules of origin (may be different from preference rules of origin) to which the license refers
- Reviewing operations in each jurisdiction to determine whether they give rise to a taxable presence/permanent establishment and monitoring/documenting changes
- Considering the characterization of its income and expense streams to determine the withholding tax position
- Considering where development costs should be incurred in order to maximize the tax deductions available

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- Tracking, identifying, and quantifying the organization's intercompany e-business transactions
- Determining where each transaction is taxable according to the applicable tax law

E-business initiatives also carry legal risks. For protection, the not-for-profit organization needs to know its rights, obligations, and potential liabilities. Good controls to manage legal risks might include the following:

- Informing visitors to the website what personal and nonpersonal information about them will be collected and what uses will be made of that information, including the disclosing of any information to third parties
- Creating awareness throughout the organization of the privacy policy, and establishing controls to ensure compliance
- Reviewing the privacy practices of the organization's business partners to ensure that they do not conflict with its own policy
- Developing procedures and contracts to ensure business partner compliance with their stated policies
- Making available the terms of contracts with customers before they commit to the purchase
- Reviewing contracts with customers to ensure that their terms are not invalidated by the consumer protection laws of any domestic and international jurisdictions from which the organization expects to attract customers
- Being knowledgeable about the regulations for a particular industry and establishing procedures to help ensure compliance with applicable industry regulations
- Ensuring that the content of the organization's website complies with the general legal requirements of the jurisdictions in which the organization is established and in which the website is hosted
- Putting a contract in place that includes the appropriate clauses covering the obligations of the service provider when the organization's website is developed or maintained by an external service provider and specifying the quality of service and intellectual property rights
- Actively using technology to protect the organization's intellectual property

Once the excitement of launching an e-business initiative has passed, the efficiency and effectiveness of its day-to-day operations must be

maintained. Otherwise, the initiative cannot succeed. Good controls for managing operational risks might include the following:

- Ensuring that the content of the organization's website is in line with its objectives
- Ensuring that the website's marketing and sales approach is consistent with the organization's approach for marketing and sales through its traditional channels
- Defining, approving, and communicating the standards for Web design
- Considering the issue of content creation and maintenance, and perhaps creating a written document that describes the organization's approach to content creation and maintenance
- Using technology that automates content customization to the extent possible
- Supporting the content life cycle with automated integrated content management tools
- Setting specific financial goals for e-commerce revenue (i.e., online receipts)
- Controlling the e-business plan on a cross-functional and cross-organizational basis to reduce risk and gain support for the initiative
- Verifying that existing insurance coverage extends to the organization's e-business transactions
- Assessing how new e-business alliances and partnerships will affect existing alliances, partnerships, and licensing agreements
- Evaluating opportunities relating to the participation in exchanges, online auctions, and e-marketplaces

An e-business initiative should add demonstrable value for the not-for-profit organization's constituents (e.g., its members, patrons, customers, and students). Perhaps the initiative will make the interactions or the processes that occur between the organization and its constituents easier, faster, or less expensive. Good controls to manage the processes in the value chain might include the following:

- Exploring opportunities to simplify and integrate the supply chain and distribution channel in designing its e-channel
- Considering in the organization's pricing model the implications for online versus offline conflicts
- Understanding the pattern of activities through the organization's website and developing the necessary infrastructure to support these activities during demand surges

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- Integrating all available elements of communication (e.g., print, broadcast, and Web) in the organization's promotion campaigns to maximize its effectiveness
- Implementing online surveys for customers, members, students, and so on to learn about customers' satisfaction with customer service
- Using data mining to capture customer needs and preferences and integrating the information into the product development process
- Effectively using customer self-service on the Web to provide product information, service request status, and other relevant information
- Guaranteeing a high degree of interactivity so that the customer can easily create, edit, send, confirm, and track orders electronically
- Maintaining controls to ensure that the correct goods, services, and quantities, at correct price (agreed with customer), are shipped to the correct location within the agreed delivery time frame

The process chart in Exhibit 27.4 describes the risks associated with e-procurement and Exhibit 27.5 discusses how to manage such risks.

EXHIBIT 27.4

Example E-Procurement Process

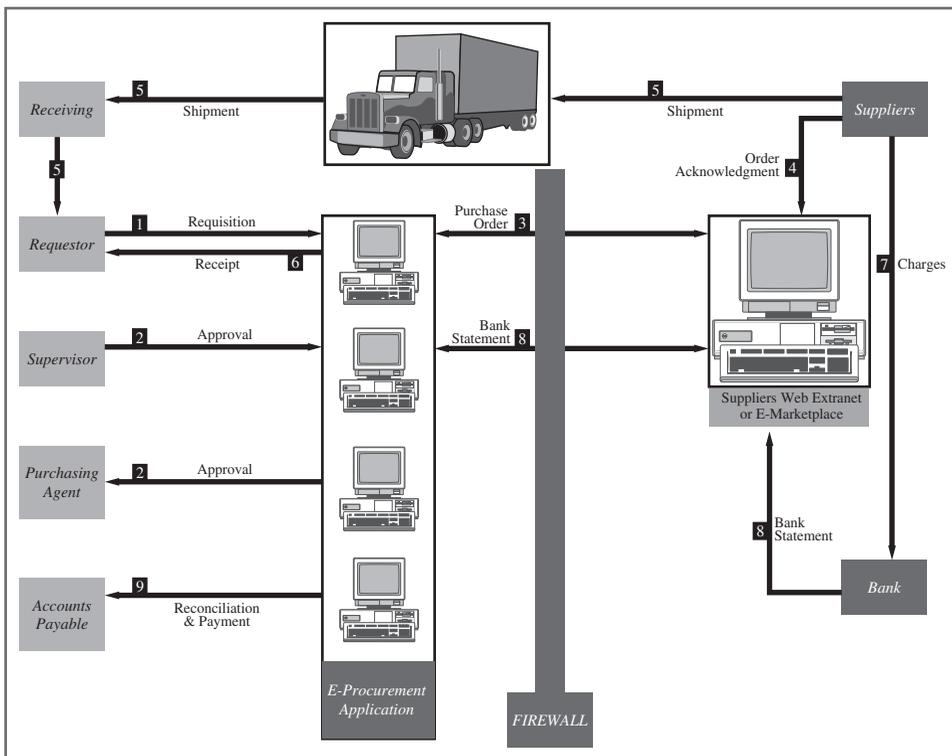


EXHIBIT 27.5

E-Procurement Process and Risks

E-Procurement Risks

- Employees making purchases without approval
- Employees attempting to purchase unauthorized materials
- Rogue or fraudulent buying
- Contract terms being incorrectly applied within the e-procurement system
- Outdated or inaccurate catalog product and pricing data
- Commercial disputes arising from disagreements between the buyer and supplier over aspects of website content used in making purchasing decisions

E-Procurement Controls

- Establish a process to accurately maintain employee purchase authorizations.
- Use a process to authorize spending by user by supplier/category (i.e., banding).
- Monitor reports of spending by employee.
- Set spending authorization limits by employee.
- Monitor the volume of Internet spending, documented by buyer, supplier, department, and product segment, including dollar volume and the number of transactions.
- Establish procedures and guidelines for off-catalog buying.
- Establish an off-catalog approval routing process.
- Compare system business rules to contracts.
- Monitor changes to contracts and changes to the business rules in the e-procurement system.
- Periodically validate Internet data against alternative sources to assess the validity, completeness, and accuracy of the data.
- Use exception reports on price variability between catalog or supplier data feeds and contracted pricing.
- Maintain an audit trail of what was on the website at any point in time.
- Order information (including price, quantity, payment information) being accessible to unauthorized parties.
- Unauthorized users modifying purchase requisitions
- Use of unapproved catalogs
- Unauthorized purchases being missed at purchase requisition approval
- Unauthorized purchases being missed at purchase order approval
- Collusion between buyers and suppliers
- Missing or phantom deliveries
- Price inconsistencies between purchase orders, invoices, and payment requisitions
- Conduct random tests of firewalls.
- Check for the existence of adequate electronic security measures.
- Use encryption to ensure the confidentiality and integrity of transactions.
- Review user access rights on a regular basis.
- Consider restricting access to specific catalog items to specific users.

EXHIBIT 27.5 (CONTINUED)

E-Procurement Process and Risks

- Reconcile data between the back-end ERP system and the e-procurement system.
- Implement a process that halts payment on unrecognized goods.
- Develop a means for identifying unmatched or undelivered goods.
- Monitor an exceptions report of unmatched/undelivered goods by supplier and buyer.
- Implement a process that halts payment on unrecognized goods.
- Employ data integrity and information nonrepudiation tools.

(iv) **Review Decisions Regularly.** An organization should regularly review its risk management decisions. Reviewing risk management decisions is the final step in the risk management process, and it is absolutely critical, given the following:

- Complexity and velocity of change in the new economy
- Spectrum of new risks stemming from e-business
- Global visibility of an organization as an e-business

Organizations also need to implement process for changing controls. This is an excellent mechanism that encourages people to recognize changes as they take place.

In summary, risk management is a four-step iterative process. It entails using a framework to identify the full spectrum of e-business risks faced by an organization and then determining the value at risk. Next, an organization must decide whether to manage the risk by ignoring it, implementing controls over it, or transferring it. Finally, monitoring the appropriateness of risk management decisions given the ever-evolving e-business world is critical. Only if e-risks are effectively managed will organizations be able to truly recognize the value of e-business.

27.7 HOW ARE NOT-FOR-PROFIT ORGANIZATIONS USING E-BUSINESS TODAY?⁵

Some not-for-profit organizations are using the Internet as a new channel to generate product revenue and as a way to cut back office costs. Save the Children, an international children's relief charity, is using the Internet to sell its goods, including cards, jewelry, and gifts for the home as

⁵ PricewaterhouseCoopers is not endorsing any of the websites mentioned in this section. We are presenting them for information only. We have not tested the authentication, integrity, confidentiality, auditability, and nonrepudiation of any of these sites. The websites mentioned in this section were "live," when this chapter was written. Given the rapid pace of change in the Internet economy, some of them may no longer be "live."

well as for kids. It was too costly to send out a catalog more than once a year. Adding the e-channel has increased sales in a cost-effective manner (see <http://www.savethechildren.org>).

The authors are not endorsing any of the websites mentioned in this section of our chapter. We are presenting them for information only. We have not tested the authentication, integrity, confidentiality, auditability, and nonrepudiation of any of these sites. The websites mentioned in this section were “live,” when this chapter was written. Given the rapid pace of change in the Internet economy, some of them may no longer be “live.”

The Philadelphia-based Pew Charitable Trusts has cut operating costs by allowing prospective grant recipients to submit some parts of their grant applications online. ... [T]he organization might also build an extranet password-protected website, so its grant recipients can communicate more effectively with each other and with the Pew trusts (see <http://www.pewtrusts.com/>).

(a) Soliciting Donations

Donations are a key revenue source for most not-for-profit organizations. They solicit donations through such vehicles as events, direct mail, auctions, and increasingly through the Internet. According to ABC News, however, Internet donations are on the rise, but a survey of “socially engaged Internet users” showed that while more than 80 percent had made charitable donations during the last two years, only 7 percent had donated online.⁶

The United Way of Greater Toronto is one example of a not-for-profit organization that is using the Internet to raise money. This United Way sends customized campaign messages to potential donors. The messages emphasize the particular charitable interests of a donor.

When it’s time to contribute, a tool on the site allows the donor to calculate an estimate of his or her tax savings. Then the United Way of Greater Toronto sends follow-up messages to update the donor about how his or her donations are being used (see <http://www.uwgt.org>).⁷

Another example is the American Red Cross (ARC), one of the largest charities in the United States. It raised approximately \$2.5 million in Internet contributions from July 1998 through June 1999, up from \$172,000 in the same period the previous year. But overall gifts to the Red Cross last year totaled \$543.3 million—more than 200 times its Internet

⁶ Ibid.

⁷ For more information about online giving, consider contacting the Council for Advancement and Support of Education (CASE) in Washington, DC. CASE is an international association of advancement officers, including fund raisers and public relations managers. It offers information resources on its website (<http://www.case.org>) that are very helpful online giving. Although most resources are geared to education, they are applicable to all different kinds of not-for-profit organizations.

earnings.⁸ Interestingly enough, the online donors give more, according to the American Red Cross. Its average third-quarter individual gift online was \$125, compared to an average individual gift of \$75 via phone or mail (see <http://www.redcross.org>).

(b) Using Dot.coms

Some dot.coms collect donations for not-for-profit organizations. For example, Entango.com provides a secure server on which charities can collect donations. When a donor visits a charity's site and clicks on the *Donate Now* button, he or she is then routed to the Entango server to make the financial transaction. The server appears to be part of the charity's website. Entango charges a flat five-percent fee. Also, a charity's staff can monitor the development campaign using Entango.com's secure site (see <http://www.entango.com/>).

America Online's AOL Foundation launched Helping.org. Helping.org is a philanthropy portal. It is designed to provide an easy, cost-effective way for Americans to donate money or time to a wide range of charitable organizations. Calling it the most comprehensive philanthropy portal on the Internet, the AOL Foundation said that the nonprofit site connects users to over 620,000 charities and 20,000 volunteer activities, and does so completely cost-free to donors and the recipient charities.⁹ The AOL Foundation supports the site and pays its operating cost (see <http://www.helping.org>).

(c) Using the Internet Creatively

Goodwill Industries International, Inc. (<http://www.goodwill.org>) is the first not-for-profit charity to launch its own auction site, making it a clicks-and-mortar not-for-profit. According to its website (<http://www.shopgoodwill.com/>), Shopgoodwill.com offers a wide array of antiques and collectibles—from one-of-a-kind items to estate pieces—that are selected from Goodwill's inventory of donated goods. Goodwill uses the revenue from auction sales to fund education, job training, and job placement programs for people with disabilities and other disadvantages.

Junebox.com is also an exchange. It is a subsidiary of School Specialty Inc., one of the largest school supply distributors in the United States. It fills the needs of the Pre-K–12 school market, enabling these schools to select from more than 3,500 suppliers (see <http://www.junebox.com/>).

⁸ Giselle Smith, "Online Philanthropy," ABCNews.com (December 2000), <http://www.abcnews.go.com/>.

⁹ Robert Conlin, "AOL Launches Philanthropy Portal," *E-Commerce Times* (October 20, 1999), <http://www.ecommercetimes.com/>.

The U.S. government also is embracing e-business. For example, Govworks, Inc., is a government-supported Web portal. It is a comprehensive, nationwide site that interfaces with national, state, county, and over 36,000 city governments. You can learn about government, look up information, participate in government auctions, find government websites, discuss issues with fellow surfers, or pay fees or taxes online (see <http://www.govworks.gov/>).

27.8 HOW ARE ACADEMIC INSTITUTIONS USING E-BUSINESS?

Web-enabled services are almost a necessity for colleges and universities, especially since today's students are so comfortable using the Internet. Moreover, the number of college students using the Internet exceeded 13.5 million by 2002, up from 3.4 million in 1995.

Due to statistics like these, many colleges and universities are using the Web as a way to provide better student service. Using the Internet, students can access their records, request transcripts, check their tuition bills, read course descriptions, register for classes, and see what requirements they still need to fulfill in order to graduate (degree auditing). Some institutions offer students and their families the opportunity to pay their tuition bill online. For example, the University of Washington encourages students to pay their tuition bill online (see www.washington.edu).

(a) Selling Merchandise on the Web

Some institutions are replacing their physical bricks-and-mortar computer stores with online stores. Many institutions are using the Internet as a new channel to sell their branded merchandise, such as sweatshirts and T-shirts. Some are partnering with one of the book e-tailers to create online bookstores. The big three textbook vendors on college campuses—Wallace's College Bookstores, Follett Corporation, and Barnes & Noble—have online versions. However, VarsityBooks.com has been an aggressive and increasingly successful competitor.

VarsityBooks.com is one of the many dot.coms that have sprung up in recent years to provide services to the education market. Founded in 1997, VarsityBooks.com began selling discounted textbooks over a website it launched in 1998. It grabbed market share quickly. According to its website (<http://www.varsitybooks.com/>), VarsityBooks.com is now a wholly owned subsidiary of The Varsity Group, which describes itself as a leading college marketing company. It reaches students online through VarsityBooks.com, which it says is the most visited and well-known student-oriented website.

(b) Building Communities

Not surprisingly, students jumped on the e-business bandwagon early. Student.com is an online newsmagazine for college students founded by six students at Yale and Columbia Universities in 1995. In addition to news, movie reviews, and the like, it also offers such goods and services as travel tours, hardware and software, and music. Today, Student.com defines itself as a leading Internet publishing company, backed by Media-One Group and other sources. According to its website (<http://www.student.com/>), Student.com derives revenues from multiple sources, including advertising, electronic commerce, and content syndication.

(c) E-Learning

Colleges and universities also are engaging in e-learning, which can be defined as Web-enabled education. Some think that e-learning is key to meeting the surging demand for education. The current bricks-and-mortar systems do not have the ability to service the expected future demand for higher education. According to Merrill Lynch's The Knowledge Web, U.S. colleges and universities offer over 6,000 accredited courses on the Web. (For more facts and figures from The Knowledge Web, see Exhibit 27.6.) The bar chart in Exhibit 27.7 indicates the growth of distributed learning courses.

Some universities are virtual. This means that they use the Internet pure play e-learning business model. Consider Western Governors University (WGU), which began its first degree and certificate programs in 1998. WGU does not have a physical campus. It also does not teach its own courses. Instead it forms partnerships with other institutions in the United States to provide instruction through distance education. WGU passed a crucial milestone in November 2000, when it received candidate status from a group of regional accreditors. Winning full accreditation, which is

EXHIBIT 27.6**Sizing the Higher Education Market****Online Education**

UMassOnline, the University of Massachusetts' web-based learning division, had 30% growth in enrollments in 2004.

Student Enrollment

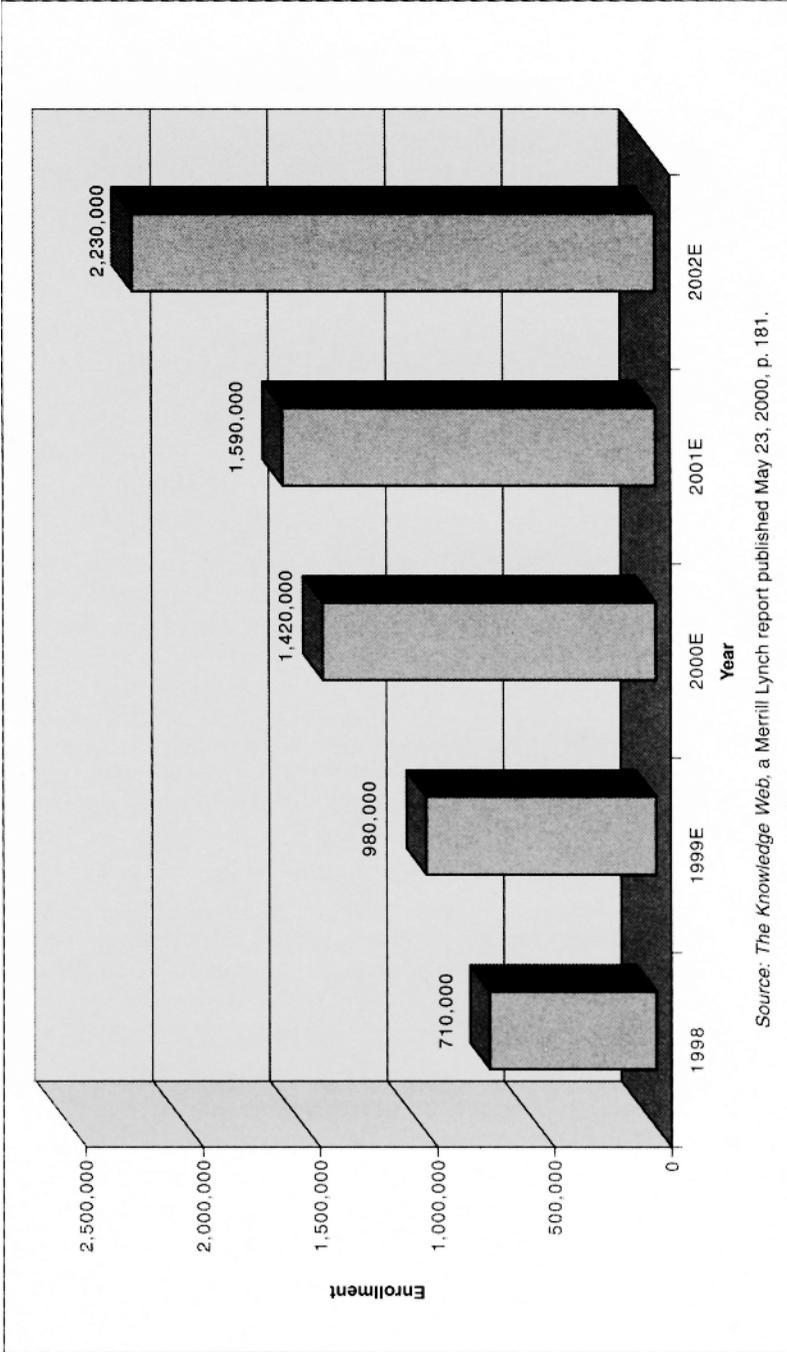
In terms of the number of higher education students enrolled in higher education worldwide, the potential is enormous. Merrill Lynch estimates that there are more than 90 million such students now and that there will be 160 million such students by 2025.

Distance Learning

In 2001, 3.1 million students were enrolled in distributed learning courses, up from 1.7 million in 1998.

EXHIBIT 2.7.7

Enrollment Growth in Distributed Learning Courses



Source: *The Knowledge Web*, a Merrill Lynch report published May 23, 2000, p. 181.

the final step in the three-step process, usually takes two to five years, but in the meantime, candidate status should give the University more legitimacy and help its enrollment grow (see <http://>).

With more than 12,000 students online, the University of Phoenix Online (UOP Online) is the largest virtual university in the United States. It is owned by the Apollo Group, a publicly traded company. UOP Online features a computer conferencing system that allows students and faculty to work together in groups of 8 to 13 students. Students can download assignments, correspond with the faculty, and work with their study groups online (see <http://online.phoenix.edu/>).

A few years ago, organizations with physical structures were seen as being at a disadvantage when competing with organizations with only an electronic presence. However, today this view has changed. Amazon.com was originally an Internet pure play but became a clicks-and-mortar after building warehouses to support its business model. Effectively integrating physical and electronic channels can lead to significant competitive advantages. Consider the following examples of bricks-and-mortar universities who have moved into the online world.

For example, Pennsylvania State University was a fairly early adopter of online educational programs. Penn State World Campus, which was launched in January 1998, offers Web-based courses at the undergraduate and graduate levels as well as a number of noncredit courses (see <http://www.worldcampus.psu.edu/pub/index.shtml>).

Another successful for-profit provider of education is the DeVry Institutes. The Keller Graduate School of Management, which is part of DeVry, is a clicks-and-bricks master's degree program focusing on developing practical management skills for working adults. Faculty are practicing professionals. Keller features an Internet-based Online Education Center, which is available 24 hours a day, providing such necessities as text and course materials, instructor lectures, and CD-ROM companion disks as well as academic advising and career services (see <http://www.devry.edu/>).

27.9 WHAT IS THE PATH TO E-BUSINESS SUCCESS?

As you can see from the examples in this chapter, significant e-business opportunities await not-for-profit organizations. E-business is not just for corporate America. The opportunities for not-for-profit organizations are numerous. They range from providing better customer and member services to reducing internal costs through the use of exchanges to appealing to donors for support.

We believe that if they have not already experimented with e-business, not-for-profit organizations need to seriously consider doing so. Start with a small experiment. Use it as a pilot and evaluate afterward

whether a larger e-business initiative is warranted. Consider the factors for success that are presented in Exhibit 27.8. If the pilot is successful, consider implementing a more comprehensive e-business strategy.

EXHIBIT 27.8

Key Factors for Success with E-Business

PricewaterhouseCoopers has identified the following key factors for a successful e-business:

- Do not treat e-business as just a front-end—it changes the way organizations operate.
- Remember that e-business must be driven by needs, rather than by technology.
- Identify and encourage senior champions in your organization who are committed to the e-business initiative.
- Form an e-business team with functional skills (e.g., fundraising) as well as project management and IT skills.
- Plan thoroughly how to integrate e-business into the existing organization and its systems.
- Pay attention to culture and manage change proactively.
- Include key business partners in your e-business initiative.
- Manage e-business risks with a formal risk management strategy.
- Explore the opportunities e-business brings to your organization, keeping an eye on the marketplace and what peer not-for-profits are doing.

APPENDIX 27–A

What E-Business Models Exist?

Models for technology-enabled business are continuing to emerge (see Exhibit 27–A.1). The business-to-consumer (B2C) and business-to-business (B2B) models are often referred to in business journals. B2C models would involve a retailer who sells directly to the consumer, while B2B would be a business selling directly to another business. Other models have emerged, such as those involving government.

An example of the consumer-to-government model (C2G) would involve a citizen submitting his or her individual tax returns electronically. Business-to-government or B2G might be a business submitting its corporate tax return electronically.

(a) B2C Business Model

B2C refers to the business-to-consumer form of technology-enabled business. Examples of B2C e-business can be found in the retail environment. Companies with a B2C model include Amazon.com and Yahoo.com. Amazon.com sells its products through its electronic channels to consumers, as does Yahoo.com.

The implementation of the B2C model can be through a portal site. (Note that portals are not specific to the B2C world.) Lycos.com is an example of a B2C portal site. As a B2C portal, Lycos.com acts as an *infomediary*, providing information to its users. Providing rich website content and building communities are two key aspects of portals. The original revenue model in the B2C arena was advertising revenue and in some cases selling access to content to consumers. Today, most B2C portals have incorporated commerce into their models. For example, Lycos.com provides shopping and auctions.

EXHIBIT 27–A.1

E-Business Models¹⁰

	Government	Business	Consumer	Employee
Government	G2G	G2B	G2C	G2E
Business	B2G	B2B	B2C	B2E
Consumer	C2G	C2B	C2C	

¹⁰ From *E-Business and the Accountant*, published by the International Federation of Accountants (IFAC) (March 2002). This document is available at <http://www.ifac.org/> by searching for the title. It was prepared by the IFAC's Information Technology Committee.

(b) B2B Business Model

B2B denotes the business-to-business model. The financial value of the activity in the B2B space significantly exceeds the financial value of the activity in the B2C space. An example of B2B is one organization purchasing its supplies from another organization electronically, such as organizations that purchase office supplies online from Staples.com.

In fact, B2B has existed for decades. In its earliest form, B2B occurred through Electronic Data Interchange (EDI). EDI is the electronic transmissions of business data according to standards.

A new standards initiative is underway called XML. XML stands for eXtensible Markup Language and is a standard language for formatting data so that all computers can read it. Essentially, the XML initiative seeks to establish a more flexible common framework for businesses to exchange data electronically. It will also resolve one key issue with EDI—the difficulty, in terms of cost and time, in deploying the EDI standards to smaller organizations. The benefits of using XML include its cost effectiveness and its ease of implementation by small and large companies alike.

Recently, there has been a lot of focus on the B2B space as new B2B models have emerged. For example, some companies use a third party such as FreeMarkets.com. This company creates business-to-business online auctions for buyers who are seeking industrial parts, raw materials, commodities, and other services. In this model, there is an intermediary, FreeMarkets.

In contrast, there is the exchange model of B2B, in which companies band together, without an intermediary, to conduct transactions over the Internet with their suppliers. The Big Three automakers, Ford, General Motors, and DaimlerChrysler, have formed such an exchange, which is called Covisint. As this exchange focuses on the automobile industry, it is said to be a vertical exchange. Vertical exchanges are formed by a group of homogeneous companies in a certain industry.

There also is the horizontal model of B2B. A horizontal exchange cuts across industries to offer goods and services that all industries need, such as human resources and the purchasing of office equipment and office supplies. FreeMarkets is an example of a horizontal portal. Dovebid.com is another example. This company focuses on corporate services and facilities. Today, there is a trend for vertical exchanges to partner with horizontal exchanges in order to be the one-stop exchange for a company.

The exchange model is maturing into the e-markets model. Although an exchange focuses primarily on the selling and buying of goods, an e-market is a more complex and robust model that includes strategic processes.

(c) B2E Business Model

B2E is the business-to-employee model. Such a model gives employees one access point—often through a portal—to information that is typically housed in disparate systems. Essentially, portals consolidate both internal and external information so that employees can perform their jobs more effectively. For example, Motorola has deployed a B2E portal. The portal gives employees a central point of access to, as Motorola describes, a set of services and information that helps them get some of the non-critical stuff out of the way so they can focus on their jobs. The portal also allows Motorola to personalize the services that are available to employees on their desktops.

Organizations including Ford, Staples, Procter & Gamble, the Ministry of Small Business, British Columbia, the American Institute of Architects, and the District of Columbia Public Schools also are using portals.¹¹

Increasingly, you will hear people define B2E as the business-to-everything model. More than a window that lets users see into other applications, a B2E portal is similar to one person talking over a fence with a neighbor. It lets employees as well as business partners and even customers share and exchange information as though they were physically nearby even when they are halfway around the world. B2E portals provide the following:

- A single channel for communicating with employees, business partners, and customers—instantly, consistently, globally
- A platform for a new way of doing business through access to information anywhere, any time
- A link to tools and work for employees, including internal teams, as well as customers and suppliers
- An approach that moves work to the Web, reduces work, slashes processing times, cuts costs, and increases revenues
- A foundation to deliver integrated, cross-functional information and services
- A vehicle that enables an organization to bring e-business inside for its employees

(d) C2B Business Model

There are two primary forms of C2B, which is the customer-to-business model. This first involves consumer demand aggregation. Under this model, consumers who want to buy new televisions, for example, can

¹¹ For one example, Plumtree.com's website, <http://www.plumtree.com/>.

band together to leverage their bulk purchasing power. For example, Accompany.com and Mercata.com are two sites that enable consumers to negotiate discounts through bulk purchasing.

The second model for C2B allows the consumer to offer a price to the business. This is known as a reverse auction. Priceline.com, the website on which consumers can submit prices for airline tickets, is one example of the C2B model.

(e) C2C Business Model

C2C is consumer-to-consumer e-business. One company using this model is eBay. eBay provides a marketplace for consumers to buy and sell goods to each other.

PayPal is one of the most common methods of payment in the C2C world and is also used in the B2C space. For example, PayPal accepts a credit card or check from the purchaser and can either send the seller a check, transfer the funds into the seller's bank account, or transfer the money into the seller's PayPal account.

CHAPTER TWENTY - EIGHT

Principal Tax Requirements

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This chapter discusses the types of organizations that are exempt and the general tax provisions of the rules governing such organizations as well as their tax reporting requirements.

Congress has imposed an income tax on all individuals and organizations, with few exceptions. Those organizations that are exempt from such tax are known as *exempt organizations*. Generally, not-for-profit organizations are exempt organizations if they meet certain specific criteria as to the purpose for which they were formed and if their sources of income are related to that purpose. But even an exempt organization can be subject to tax on certain portions of its income, and if the organization is a private foundation, it is subject to a number of very specific rules as well as certain excise taxes.

This discussion is intended only to give the reader a general understanding of the tax rules and reporting requirements and is not intended to be a complete discussion of the law and the tax regulations. Each organization should consult with its own tax accountant or attorney about its own status and any specific problems it may have.

28.1 ORGANIZATIONS EXEMPT FROM TAX

The Internal Revenue Code (IRC) provides exemption from tax for certain organizations that meet very specific requirements. The following exemptions are most widely applicable:

1. "Corporations, and any community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition ... or for the

prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation (except as otherwise provided in subsection h),¹ and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.” (§ 501(c)(3))²

2. “Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.” (§ 501(c)(4))
3. “Clubs organized for pleasure, recreation, and other nonprofit purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.” (§ 501(c)(7))
4. “Business leagues, chambers of commerce, ... not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.” (§ 501(c)(6))
5. “Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt.” (§ 501(c)(2))
6. “Corporations or trusts with no more than 35 shareholders and only one class of stock or beneficial interest formed to hold real property and remit income to its shareholders.” (§ 501(c)(25))
7. “Voluntary employees beneficiary associations providing for payment of life, sick, accident, or other benefits to the members of such association.” (§ 501(c)(9))

There are other categories of exempt organizations found in the IRC under §§ 501, 521, 526, 527, and 528, but the exemptions listed above cover the majority of not-for-profit organizations. This chapter focuses on the exemption requirements for the types of charities listed. Other categories of exempt organizations are not discussed here.

¹ The Tax Reform Act of 1976 allows a § 501(c)(3) organization to elect the § 501(h) safe harbor for the amount of lobbying activities in lieu of the subjective “no substantial part” test.

² References are to specific sections of the Internal Revenue Code of 1986, from which the quotations were taken. Exempt organizations often refer to the type of exemption they hold by the Code section under which they are exempt.

28.2 CHARITABLE ORGANIZATIONS

Most exempt organizations are categorized as charitable organizations or § 501(c)(3) organizations. There are four main purposes that organizations exempt under § 501(c)(3) may have: religious, charitable, scientific, or educational. This covers organizations such as churches, hospitals, schools, community funds, museums, medical research organizations, and YMCAs.

(a) Qualification

All § 501(c)(3) organizations must be “organized and operated exclusively for” one of the previously stated purposes in Section 28.1 of this chapter.

(i) Organizational Test. In order to meet the “organizational test,” an organization’s charter must limit its purpose to one or more of the exempt purposes allowed and must not expressly empower the organization to engage, other than as an insubstantial part of its activities, in activities that are not in furtherance of the organization’s exempt purpose(s). An organization’s charter must also contain certain language and restrictions to conform to the requirements for a § 501(c)(3) organization. For example, the charter must contain a clause that provides for the assets to pass to another charitable organization upon dissolution. (The Attorney General of the state in which the organization operates oversees any dissolution.) Organizations that contemplate application for recognition of exempt status under § 501(c)(3) should consult with qualified legal and tax counsel to ensure that the organizing documents meet the requirements of the organizational test.

(ii) Operational Test. An organization that meets the organizational test must actually operate within the boundaries established by its charter in order to meet the “operational” test. The operational test requires that organizations engage primarily in activities that further one or more exempt purposes. Also, in order to pass the operational test, organizations must serve a public, rather than private, interest; they must not engage in any political activity; must not attempt to influence legislation as more than an insubstantial portion of activities; and must not benefit a private stakeholder or individual.

(b) Private Inurement/Private Benefit

One of the essential requirements for many organizations seeking exemption is that they must be organized and operated in such a way that no part of their net earnings inures to the benefit of any private stakeholder or individual. The phrase “no part” means the level of such

inurement is not material; any inurement at all, no matter how small, could endanger an organization's tax-exempt status.

Private inurement is prohibited for many organizations. The term encompasses transactions that confer preferential treatment upon private stakeholders or individuals. The concept requires investigation of the transactions between the organization and its insiders—that is, those who can control the use of the organization's assets. Section 501(c)(3) allows exemption for an organization only if no part of the organization's net earnings inures to the benefit of any private stakeholder or individual. A private stakeholder or individual is a person or persons having a personal and private interest in the activities of the organization.

Organizations can lose their exempt status due to private inurement from unreasonable compensation or fringe benefits, personal use of an organization's assets, forgiveness of indebtedness owed by insiders, personal expenses being paid by the organization, low-interest or unsecured loans to insiders, unreasonable housing allowances, and other than arm's-length purchases or sales between the organization and insiders. Generally, however, the penalty will be the imposition of intermediate sanctions (see following section) rather than the loss of tax-exempt status.

To avoid the private inurement issue, many organizations try to avoid transactions with insiders that even remotely appear to unreasonably benefit the insider. This does not prohibit an organization from transacting business with members of its board of directors or paying competitive salaries. It does mean that certain guidelines need to be applied, and all transactions should be properly documented before relationships with insiders are formed. Full disclosure of these relationships also should be made on the organization's Form 990.

Private benefit occurs when transactions are engaged in with persons who are other than insiders at other than fair market value. Generally, whenever an organization contracts with a third party, the third party receives a benefit. Prohibited private benefit arises only when the benefit to the individual is disproportionate to the benefit received by the organization. Therefore, it is important that an organization transacts business at arm's length. The presence of substantial disproportionate private benefit could lead to the loss of tax-exempt status.

(c) Intermediate Sanctions

In 1996, Congress passed a bill generally referred to as the "Intermediate Sanctions" legislation. The change in legislation occurred because revoking the exempt status of an organization when an individual had been unjustly enriched harmed the organization's beneficiaries rather than the individual who had benefited. This law gives the Internal Revenue Service (IRS) power to assess monetary penalties against certain individuals

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who are unjustly enriched at the expense of the organization. Under the statute (§ 4958), these individuals are known as “disqualified persons” who, in general, are in a position of influence with respect to the organization. In addition, penalties may be assessed against those individuals who knew about the excess benefit received by the disqualified persons. These individuals are known as “organization managers.” Previously, the only effective sanction available to the IRS was revocation of exempt status, which the Service was understandably reluctant to impose except in cases of very serious violations. Lesser violations often went unpunished for lack of an appropriate level of punishment.

The provisions of the law apply to organizations exempt under § 501(c)(3) (not including private foundations) and (c)(4), and include penalties that, as previously stated, may be assessed against both the management of the organization and the individual responsible for an improper transaction. Examples of excess benefit transactions include excessive compensation and third-party business transactions at other than market value.

Another provision of the law requires organizations to provide a copy of their Form 990 (Return of Organization Exempt from Income Tax) and Form 1023 (Application for Exemption) to persons requesting it either in person or in writing; a reasonable charge may be made for copying. Penalties for failure to file a Form 990 or to make it available on request have been increased. “Violations of the Intermediate Sanctions” rules must be disclosed on Form 990.

28.3 TAX STATUS OF CHARITABLE ORGANIZATIONS: PUBLIC CHARITY OR PRIVATE FOUNDATION

(a) Public Charities

The Tax Reform Act of 1969 created two general categories of § 501(c)(3) organizations: private foundations and public charities (also referred to as publicly supported organizations). Each category is subject to different rules. All § 501(c)(3) organizations are assumed to be private foundations unless they meet a statutory public support test or are considered not to be private foundations under a specific statutory definition:

- Publicly supported organizations receive broad public support. An individual donor may normally deduct contributions to such organizations in amounts up to 50 percent of the donor’s adjusted gross income.
- Private foundations are organizations that do not receive broad public support but instead receive most of their support from a limited number of donors or from investment income. Private

28.3 TAX STATUS OF CHARITABLE ORGANIZATIONS

foundations are subject to many restrictions on their activities and are subject to certain excise taxes. Normally, an individual donor may deduct contributions to private foundations in amounts up to 30 percent of the donor's adjusted gross income. Gifts of capital gain property in certain circumstances may be limited to 20 percent of the donor's adjusted gross income.

A publicly supported organization is defined for this discussion³ as a "§ 501(c)(3) organization that is not a private foundation."⁴ There are four principal categories of organizations that are not private foundations:

1. Churches, educational institutions with a faculty and student body, hospitals, governmental units and medical research organizations related to a hospital. These organizations are not required to meet mechanical public support tests in order to maintain public charity status. (§ 509(a)(1))
2. Organizations formed exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports that normally receive a substantial portion of their support from direct or indirect contributions from the general public or from a governmental unit. Certain mechanical tests must be met to maintain public charity status. (§ 509(a)(1); § 170(b)(1)(A)(vi))
3. Organizations that meet both of the following mechanical tests, based on actual support during the previous four years (§ 509(a)(2)):
 - a. The organization receives not more than one-third of its support from gross investment income, and
 - b. The organization receives more than one-third of its support⁵ from a combination of:
 - i) Contributions, gifts, grants, and membership fees, except when such income is received from disqualified persons,⁶ and

³ Organizations exempt under another section of the law, such as social clubs, business leagues, and so on, are not private foundations.

⁴ Some organizations that are not private foundations do not receive broad public support. However, the organizations are subject to the same rules that organizations receiving broad public support are subject to; accordingly, to assist the reader in distinguishing between private foundations and other than private foundations, the title "publicly supported" organizations will be used throughout this discussion to refer to all § 501(c)(3) organizations that are not private foundations.

⁵ In determining the public support percentage, the numerator of the fraction includes any qualified support (as discussed in b.ii) and the denominator reflects all support.

⁶ A *disqualified person* is a substantial contributor, or a foundation manager, or a person (or a person's relatives) having a sizable interest in a corporation, partnership, estate, or trust that is itself a substantial contributor. A *substantial contributor* is a person who has contributed in either the current or a prior year aggregate amounts exceeding \$5,000, if that amount at the time of the contribution was 2 percent or more of total contributions received since formation of the foundation. A *foundation manager* is any officer, director, or trustee of the foundation.

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- ii) Gross receipts from admissions, sale of merchandise, performance of services, or furnishing facilities, all of which must be derived from an activity related to the organization's exempt purpose. Excluded from gross receipts are any amounts from any one person, governmental unit, or company in excess of \$5,000 or 1 percent of total support (whichever is greater) and amounts received from disqualified persons.
4. Organizations organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purpose of a publicly supported charity, or to perform a charitable purpose in support of a § 501(c)(4), § 501(c)(5), and/or a § 501(c)(6) organization (§ 509(a)(3)). These organizations are called *supporting organizations*. They are not required, themselves, to meet either public support test as long as the organization that is supported meets one of the support tests discussed above. When the supported organization is a § 501(c)(4), § 501(c)(5), or § 501(c)(6) organization, the supported organization must meet the support test under § 509(a)(2), a test to which the supported organization would not normally be subject.

The law and regulations provide mathematical tests for public support. The tests are very technical and are different depending on whether the organization must meet the test under 2 or 3 above. A detailed discussion of the two different public support tests is beyond the scope of this book.

In general, the test under § 509(a)(1) & § 170(b)(1)(A)(vi) requires that one-third of an organization's support come from the general public.⁷ The test under § 509(a)(2) requires that at least one-third of an organization's support come from a combination of program service revenues and support from the general public and not more than one-third of its support come from gross investment income. Support is calculated over an aggregated four-year period and the calculations are performed on the cash basis.

Excluded from the calculation under each test are unusual grants. Unusual grants are defined in the regulations under § 509. A grant must meet the following requirements before it may be excluded from the public support calculation as an unusual grant:

- The grant must be a substantial contribution from a disinterested party.
- The grant was attracted by reason of the publicly supported nature of the organization.

⁷ In determining public support the numerator of the fraction excludes contributions from donors other than government units or publicly supported organizations to the extent they exceed 2 percent of all contributions received by the organization during the previous four-year period. The denominator of the fraction includes all contributions.

28.4 OTHER CONCERNS FOR CHARITIES

- The grant was unusual or unexpected in respect to the amount.
- The grant would, by reason of its size, adversely affect the organization's public support test.

This provision enables organizations to receive infrequent large amounts from generous donors without losing public support status.

Organizations exempt under § 501(c)(3) must file Schedule A of Form 990. Schedule A includes a schedule for certain organizations to complete regarding the support they received for the four years prior to the current taxable year. The IRS performs additional mathematical calculations on the information provided in the schedule to confirm that the organization has met the public support test to which it is subject.

This discussion shows generally how these rules are applied. There are a number of exceptions to these rules, and each organization should consult with legal counsel or a tax professional to determine exactly how these rules affect it. Also, keep in mind that this mechanical test is applied over a rolling four-year period. Organizations that have been in existence for more than one tax period will complete the test for as many tax periods as they have existed. However, the IRS may allow an organization to retain its public charity status if it fails the mechanical tests but can demonstrate that its public support is increasing and that it is likely to meet the tests in the future.

(b) Private Foundations⁸

Private foundations are charitable organizations that do not meet one of the tests for public charity status. They are subject to specific rules and taxes that do not apply to publicly supported organizations. The most important provisions that apply to private foundations follow:

- Payment of an excise tax on investment income
- Distribution of at least a minimum amount of income (as defined by statute and regulations)
- Disposition of excess business holdings
- Avoidance of certain prohibited transactions
- Filing a complex annual information return

28.4 OTHER CONCERNS FOR CHARITIES

(a) Unrelated Business Income

Virtually every exempt organization, including churches and clubs, is subject to normal corporate taxes on its unrelated business income.

⁸ See detailed discussion of private foundations in Sections 28.5 and 28.6.

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(i) **Definition.** There is always difficulty in knowing exactly what is unrelated business income. Here is the way the law reads:

The term “unrelated trade or business” means ... any trade or business the conduct of which is not substantially related ... to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption ... [§ 513(a) of the Internal Revenue Code].

... [t]he term “unrelated business income” means the gross income derived by any organization from any unrelated trade or business ... regularly carried on by it, less the deductions ... which are directly connected ... (§ 512(a)(1) of the Internal Revenue Code).

There are three key phrases in these definitions. The first is *unrelated*, the second is *trade or business*, and the third is *regularly carried on*. All three criteria must be present for an activity to be categorized as an unrelated trade or business activity. It is not difficult to determine whether the business in question is “regularly carried on,” but it is difficult to know what is truly unrelated, and it is sometimes difficult to ascertain what is a trade or business. The burden is on the exempt organization to justify exclusion of any income from this tax.

According to Regulation § 1.513-1(d), unrelated business income results within the meaning of § 513(a) if the conduct of the trade or business that produces the income is *not substantially related* (other than by providing funds) to the purposes for which exemption is granted. The presence of this requirement means that organizations must distinguish between the business activities that generate the particular income in question (the activities, that is, of producing or distributing the goods or performing the services involved) and the accomplishment of the organization’s exempt purposes. In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function that they purport to serve.

The term *trade or business* has the same meaning as in IRC § 162,⁹ and generally includes any activity carried on for the production of income from the sale of goods or performance of services. In general, any activity of an otherwise exempt organization carried on in a commercial fashion that is similar to a trade or business and that, in addition, is not substantially related to the performance of the organization’s exempt function is sufficiently close to the concept of a trade or business to be taxable.

According to the regulations under § 1.513-1(b), the primary objective of adopting the unrelated business income tax rules was to eliminate a source of unfair competition by placing an unrelated business activity on the same basis with its for-profit counterparts. On the other hand, if an

⁹ IRC § 162 allows a deduction for federal income tax purposes for ordinary and necessary trade or business expenses including but not limited to reasonable salaries, travel expenses, and rental payments for the use of property.

activity does not possess the characteristics of a trade or business within the meaning of IRC § 162—such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions—the unrelated business income tax does not apply because the organization is not in competition with taxable organizations.

According to Regulation § 1.513-1(c), the regularly carried-on requirement must be applied in light of the purpose of the unrelated business income tax to place exempt organization business activities upon the same tax basis as the nonexempt business endeavors with which they compete. Hence, for example, specific business activities of an exempt organization will ordinarily be deemed to be regularly carried on if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of nonexempt organizations. Keep in mind that this requirement has to be applied in light of the purpose of the unrelated business income tax to place a trade or business on the same tax basis as the business endeavors with which it competes.

(ii) Exceptions and Modifications. There is an enumerated list of exceptions from and modifications to this tax (§§ 512(b) and 513(a)). The term unrelated business income does not include any trade or business:

1. In which substantially all the work is performed for the organization without compensation;
2. That is carried on by the organization primarily for the convenience of its members, students, patients, and so on; and
3. That involves the selling of merchandise, substantially all of which has been donated as gifts or contributions to the organization.

Modifications include, among others, income from research activities in a hospital, college, or university and research performed for the government. There are special rules for social clubs, which are discussed later in this chapter, and other special types of exempt organizations not discussed here.

In addition, items that are generally excluded from unrelated business income include passive investment income such as dividends, interest, royalties, rents from real property, and gains on the sale of property. However, rents that are based on a percentage of the net income of the property are considered unrelated. Also, income (passive investment income and rent) from assets acquired by incurring debt (debt-financed property) and rent from personal property may be considered unrelated business income in whole or in part.¹⁰ Private foundations must still pay the excise tax on these items of passive income.

¹⁰ The debt-financed income rules contain certain exclusions for schools and pension trusts that rent real property.

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(iii) Advertising Income. One example of a widespread activity that is generally considered an unrelated business activity is advertising. Many exempt organizations publish magazines that contain advertising. Although this advertising helps to pay the cost of the publication, advertising is nevertheless considered to be unrelated business income. The advertising revenue is not directly part of the organization's exempt function and therefore is taxable. The fact that the revenue from the activity helps support the tax-exempt functions is not enough. To be tax-free, it must be itself part of the exempt function. This is the distinction that must be made. The IRS has adopted tough rules with respect to the tax-ability of advertising income. The rules are complex, and professional advice should be sought concerning their application.

(iv) Corporate Sponsorship. The characterization of revenue, as charitable contributions or as advertising, received from corporations that anticipate various forms of acknowledgment in return has been a source of controversy. The Taxpayer Relief Act of 1997 added a provision (§ 513(i)) that states "qualified sponsorship payments" are not considered unrelated business income from advertising. Qualified sponsorship payments are given without expectation of a substantial return benefit other than acknowledgment through the use of the name, logo, and addresses (including Web addresses) of such person's trade or business or display of their products. Final regulations interpreting these provisions were issued in 2001.

(v) Investments in Partnerships. The investment in a limited partnership by a tax-exempt organization may give rise to unrelated business income, regardless of the tax status of the other partners. The test, as in all other unrelated business income determinations, goes to the nature of the activity pursued by the partnership. If the partnership is involved in an activity that would be an unrelated trade or business activity if the tax-exempt organization carried it on directly, the participation by the tax-exempt organization in such partnership does nothing to change the character of the activity carried on by the partnership. Therefore, an institution's allocable share of gross income from a partnership pursuing an unrelated activity constitutes unrelated business income. Even though a partnership's revenue may be merely from investments, if the investment is debt-financed, a percentage of income may be unrelated. Further, organizations need to assess the state tax implications of these investments. In addition, if the tax-exempt organization invests in foreign partnerships, there may be other reporting obligations.

(vi) Trade Shows. The Tax Reform Act of 1976 provided an exclusion from unrelated business income for certain organizations, such as business

leagues, that hold conventions or trade shows as a regular part of their exempt activities. In order for the exclusion to apply, the convention or trade show must stimulate interest in, and demand for, an industry's product in general. The show must promote that purpose through the character of the exhibits and the extent of the industry products displayed.

(vii) Allowable Expenses in Computing Unrelated Business Income. Once an organization identifies an unrelated business activity within its operations and quantifies the revenue generated by the activity, it then must adopt a reasonable method of allocating costs to the activity. The result is the net income from the activity that will be subject to income tax.

The organization is allowed to deduct the costs normally associated with the unrelated business. This places a burden on the organization to keep its records in a manner that will support its business deductions. Overhead can be applied to most activities, but the organization must be able to justify both the method of allocation and the reasonableness of the resulting amount. Also keep in mind that if, after all expenses and allocation of overhead, the organization ends up with a loss, it will have to be able to convincingly explain why it engages in an activity that loses money. Logically, no one goes into business to lose money, and if there is a loss after considering direct expenses, the business purpose of the activity may be suspect.

To be deductible from gross revenue generated from unrelated business activities, expenses must be ordinary and necessary business expenses. When computing unrelated business taxable income, items such as expenses and depreciation must qualify as deductions allowed under IRC §§ 162 and 167, and must be directly connected with the carrying on of the unrelated trade or business.

- *Direct expenses.* To be considered directly connected to the unrelated business activity, the expense must bear a proximate and primary relationship to the conduct of that business. The expenses must be causally related to the production of income. Expenses—including salaries of individuals employed in the unrelated activity, depreciation, and similar items attributable to the conduct of an unrelated business—are proximately and primarily related to that business if they are expended to generate revenue from that activity.
- *Allocable expenses.* The expenses of facilities and personnel used to conduct both exempt function and unrelated business activities must be allocated between the two uses on a reasonable basis. To maximize the amount allocated to the unrelated business activity, most organizations prefer to allocate facility expenses based on the ratio of time the facility is used for unrelated business activities versus the total time the facility is actually used. However, the IRS

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has consistently maintained that it is unreasonable to allocate the fixed costs of operating a dual-use facility based on actual days of use. Instead, the IRS believes such costs should be allocated based on the total days the facility is available for use.

Organizations should ensure that they are using a defensible and complete method of allocating expenses to their unrelated business activities in order to minimize their unrelated business income tax liability and minimize the risk of adjustment in the event of an IRS audit.

(viii) Tax Rates on Unrelated Business Income. Unrelated business income of incorporated tax-exempt organizations (IRC § 511(a)) is taxed at the same rates as net income for corporations. Tax-exempt organizations that are formed as trusts are taxed at trust rates (IRC § 511(b)). All exempt organizations having gross income from unrelated business activities of \$1,000 or more are required to file Form 990-T within four and one-half months of the end of the fiscal year (May 15 for calendar-year organizations). The returns for pension trusts are due one month earlier. Two three-month extensions are available. Organizations may be required to pay estimated taxes on a quarterly basis.

(ix) Need for Competent Tax Advice. From the above discussion, it should be obvious that taxes on unrelated business income may be substantial and can apply to most organizations. It must be emphasized that every organization contemplating an income-producing activity should consult with a competent tax advisor to determine the potential tax implications of that activity.

(b) E-Commerce

E-commerce continues to introduce new types of transactions that raise tax issues for not-for-profit organizations. The IRS and various states have indicated that they are currently evaluating e-commerce issues with the intention of providing guidance in the future. Until further guidance is provided, e-commerce issues should be resolved using existing tax principles.

In addition, with regard to unrelated business income, there are many questions about what sponsorship is and what advertising revenue is when it comes to the use of Internet links and banners. In 2002, final regulations were published that addressed the tax treatment of corporate sponsorships. Within those regulations was a discussion pertaining to whether an Internet hyperlink constitutes an acknowledgement or advertising through two examples. The examples show that posting a sponsors' Internet address, even as a hyperlink from the exempt organization's website to the sponsors website, constitutes an acknowledgement, not advertising.

However, if the hyperlink to the sponsor's website contains an endorsement by the charity of the sponsor's product and the charity has approved the endorsement before it was posted on the sponsor's website, the hyperlink will be considered advertising.

(c) Lobbying and Political Activity

IRC § 501(c)(3) organizations are prohibited from engaging in political activities. Political activity is the participation or intervention in any political campaign on behalf of or in opposition to any candidate for political office. A § 501(c)(3) organization may engage in a limited amount of lobbying. Lobbying cannot become a substantial part of its activities. IRC § 501(c)(4) organizations are not limited in the amount of lobbying activity that they are able to engage in. The definition of what constitutes lobbying is not precise. In general, lobbying includes attempts to influence legislation either through direct contact with legislators or by influencing public opinion. An election can be made by an organization under § 501(h). If an organization chooses to make this election, it is subject to a more specific definition of what is lobbying as well as specific dollar limitations on permitted lobbying.¹¹

It should be noted that there are several excise taxes related to lobbying and political activities that are imposed on organizations under certain circumstances. The following provides a short summary of each tax:

- *Excess expenditures to influence legislation.* IRC § 4911 imposes a 25 percent excise tax on the excess lobbying expenditures (including grassroots lobbying expenditures) of an organization that has elected to be covered under IRC § 501(h). The election under § 501(h) provides qualifying organizations with a safe harbor for their lobbying and grassroots expenditures. In any year in which the organization's lobbying expenses exceed the safe-harbor amounts, the organization must pay the excise tax under IRC § 4911.
- *Tax on disqualifying lobbying expenditures of certain organizations.* If an organization loses its status under IRC § 501(c)(3) because of making more than an insubstantial amount of lobbying expenditures,

¹¹ The amount of lobbying expenditures for an electing organization is based on a percentage of its program service expenditures. The maximum amount of permitted lobbying is \$1,000,000. This limit is reached when an organization has at least \$17,000,000 of program service expenditures (§§ 501(h) and 4911). Electing organizations need not include the dissemination of nonpartisan analysis; provision of technical advice to a governmental body or committee; appearances before or communication to any legislative body with respect to matters that might affect the existence of the organization, its tax-exempt status, or the deduction of contributions (self-defense lobbying); communication with its members with respect to proposed legislation that is of direct interest to its members; and any communication with a government official or employee provided that a principal purpose is not to influence legislation (§§ 501(h) and 4911(d)).

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IRC § 4912 imposes excise taxes on the organization and its management. The tax on the organization is 5 percent of the lobbying expenditures in the taxable year in which IRC § 501(c)(3) status is revoked. A separate 5 percent excise tax is imposed on the management of the organization if the management agreed to the expenditures while knowing the organization might lose its exemption. This excise tax does not apply to private foundations or organizations that elect the safe harbor of IRC § 501(h). (Note that organizations that lose their IRC § 501(c)(3) status when more than an insubstantial portion of their activities is lobbying may not become exempt under IRC § 501(c)(4).)

- *Political expenditures of IRC § 501(c)(3) organizations.* IRC § 501(c)(3) organizations are forbidden from participating or intervening in any political campaign on behalf of or in opposition to any candidate for public office. IRC § 4955 imposes a two-level excise tax on the organization that participates in prohibited activities and on its management. The first level of tax is imposed on the organization at the rate of 10 percent of the amount of the expenditures, and on the management at the rate of 2.5 percent of the expenditures if the management agreed willfully to the expenditures. If the organization does not correct the political expenditure by obtaining a refund of the amounts spent, a second-level tax of 100 percent and 50 percent of the expenditure is imposed on the organization and management, respectively. (Note that if a private foundation makes political expenditures and pays the tax imposed by this section, then the expenditures will not also be taxed under IRC § 4945 as taxable expenditures.)

(d) Charitable Contributions

(i) **Contribution Disclosures.** Contributions other than cash are subject to special reporting by both donors and recipient charities. Contributors must attach Form 8283 to their tax returns to support noncash charitable contributions of \$500 or more to the same donee. In certain circumstances, the form requires an appraisal by a competent, independent appraiser, and the recipient organization also is required to sign the form. The signature of the recipient organization merely signifies receipt and does not signify that the organization agrees with the donor's valuation. If the recipient organization is required to sign the form, and disposes of the property within two years of the date of the gift, then the organization must file Form 8282 with the Internal Revenue Service within 125 days of the disposition. The organization must also supply the donor with a copy of Form 8282. By requiring this reporting, the IRS is better able to monitor sizable charitable deductions on individual returns.

(ii) Contribution Acknowledgments. For single charitable contributions of property and/or cash of \$250 or more, donors will need an acknowledgment from the charity to substantiate a charitable tax deduction. A canceled check is not sufficient in this case. Charities should be prepared to acknowledge gifts to assist their individual and corporate donors with substantiation of these deductions.

(iii) Solicitation Disclosures. When an organization gives a donor something in return for a contribution—for example, a dinner or a raffle ticket—the amount given may not constitute a charitable contribution. A portion of the payment—or the total—may be payment for receipt of a benefit, and not a gift to the organization. Revenue Ruling 67-246 and Revenue Procedure 90-12 provide guidance to organizations that offer a benefit to donors in conjunction with solicitation of funds.

Organizations must inform their donors, in clearly stated language, how much, if any, of the payment is deductible as a charitable contribution if the total received is greater than \$75. An example of this is an organization that sponsors a fundraising dinner. A comparable dinner in a restaurant would cost a donor \$50. In order to attend the dinner, donors pay \$200. In this case, the organization must inform donors that \$150 of their \$200 payment is deductible as a charitable contribution. Charities should print this information on the donors' tickets or receipts, thereby providing donors with documentation for the charitable deductions they claim on their tax returns.

There are exceptions for low-cost items that are distributed as part of a fund-raising effort. The dollar limits for low-cost items are updated annually. Charitable organizations should consult the Revenue Ruling and Revenue Procedure and ensure that their solicitation materials comply. The Internal Revenue Service is empowered to impose penalties in cases of failure to comply with the notification requirements.

At the end of 2004, Congress passed the "American Jobs Creation Act of 2004," which made changes to the Internal Revenue Code regarding the substantiation of vehicle donations, reporting requirements of non-cash donations, patents and similar property. These changes were enacted as a result of perceived abuses regarding the valuation of non-cash property donations made to charitable organizations. The reporting requirements found in the Internal Revenue Code are in effect for years beginning January 1, 2005. Charitable organizations should familiarize themselves with these new reporting requirements if they receive non-cash contributions.

(iv) Summary of Individual Tax Deductions. Charitable organizations depend to a very large extent on individual contributions for support. To the extent that a contributor receives a tax deduction for a contribution, there

PRINCIPAL TAX REQUIREMENTS

may be more inclination to be generous in the contribution. Accordingly, the tax deductibility of a contribution is of real importance. Exhibit 28.1 summarizes the general rules applicable to common types of contributions.

As the exhibit indicates, the amount of deduction allowed in any year is limited to a percentage of the donor's adjusted gross income. Contributions limited in this manner may be carried forward for five years until fully utilized. The adjusted gross income limitation depends on the type of donee organization, the type of property donated, and whether the organization will use the property in pursuit of its exempt purpose (related) or will use the property in a way unrelated to its exempt purpose (such as selling the property).

Gifts of appreciated property may have additional tax implications to the donor. In addition, the "American Jobs Creation Act of 2004" added new rules with regard to the tax deductibility of certain non-cash donations. Because the charitable contribution rules are somewhat complex, donors should consult with their tax advisors before making a large contribution to any organization. Exhibit 28.1 is intended to be a general guide only.

(v) Tax Consequences of Gifts of Securities to a Private Foundation. On investments received by gift subsequent to December 31, 1969, the contributor's tax basis is the basis that the foundation must use when calculating taxable gain. For investments received prior to December 31, 1969, the basis is the higher of fair market value at December 31, 1969, or the contributor's tax basis. In most instances, the fair market value is higher. Thus, a private foundation must obtain from the donor, at the time a gift of securities is received, a statement of tax basis. This is very important, and great care should be taken to obtain this information promptly upon receipt of the gift. At a later date the donor may be difficult to locate or may have lost the necessary tax records. Because donated securities are recorded for accounting purposes at fair market value at date of receipt, the foundation must keep supplementary records of the donor's tax basis.

Here is an illustration of how two gifts of the same marketable security can have different tax consequences to the private foundation. Both gifts made in 2000 involve 100 shares of stock A.

Gift 1—Very Low Basis: Mr. Jones acquired his 100 shares of stock A in 1933 when the company was founded. His cost was only 10 cents a share, and therefore his basis for these 100 shares was only \$10. Market value on the date of gift was \$90 a share, or a total of \$9,000. The tax basis to Mr. Jones of \$10 carries over to the private foundation. If the foundation later sells the stock for \$10,000, it will pay a tax (assuming a 2% rate) on \$9,990 (\$10,000 sales proceeds less \$10 tax basis), or a tax of \$199.80.

EXHIBIT 28.1

Deductibility of Charitable Contributions

CHARITABLE CONTRIBUTION TABLE			
Type of Property	Factors		AGI Limitation
	Type of Organization	Use by Organization	
Cash	Public	Any	Actual amount
	Private	Any	Actual amount
Long-term capital gain (LTCG): Intangible or real property	Public	Any	FMV ¹
	Private	Any	FMV less LTCG ²
	Public	Related	FMV
Tangible personal property	Private	Unrelated	FMV less LTCG
		Related	FMV less LTCG
	Public	Unrelated	FMV less LTCG
Ordinary income (01) property	Public	Any	FMV less 01
	Private	Any	FMV less 01
Loss (ordinary or capital loss property)	Public	Any	FMV
	Private	Any	FMV

Key

AGI—Adjusted Gross Income

FMV—Fair Market Value

Public—50 percent type charities including private operating foundations

Private—30 percent type charities including private nonoperating foundations

¹ Taxpayer may elect to decrease the amount of the deduction to fair market value less long-term gain potential and to increase the AGI limitation to 50%

² In the case of a contribution of “qualified appreciated stock” to a private nonoperating foundation, the full FMV is deductible

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Gift 2—Very High Basis: Mr. Smith acquired his 100 shares of stock A in 1990 at a cost of \$110 a share or a total of \$11,000. The market value on the date of his gift was also \$90 a share, or a total of \$9,000. If the private foundation later sells this stock for \$10,000 it will have neither a taxable gain nor loss. In this instance the donor's basis of \$110 a share carries over to the foundation for purposes of calculating taxable gain, but for purposes of calculating loss, the fair market value at date of gift (\$90 a share) becomes the tax basis. Because the sales price (\$100) is more than the fair market value at the date of gift (\$90) but less than the donor's cost (\$110), no gain or loss is recognized.

As can be seen from this example, in one instance the private foundation had to pay a tax of \$199.80 and in the other instance had no tax.

Rather than sell appreciated stock and pay excise tax on the gain, a foundation might consider distributing the stock to a publicly supported organization and letting the distributee organization sell it. The distributee organization would not incur tax on the gain because capital gains are exempt from unrelated business taxable income and publicly supported organizations are not subject to the excise tax on net investment income. To the extent that a private foundation has capital losses, they can be offset against capital gains in the same year. If there are no capital gains to offset such losses, the losses cannot be offset against investment income. Capital losses cannot be carried over to another year.

(e) Corporate Responsibility and Disclosure

As part of governmental efforts to combat abusive tax shelters, the U.S. Treasury Department, in February 2003, issued final regulations for the disclosure of reportable transactions. Although tax-exempt organizations were not previously included as organizations that were subject to these rules, the final regulations added tax-exempt organizations to those covered by the new regime.

The regulations are complex, difficult to apply, and wide ranging. The reporting of transactions under the new regulations will enable the IRS to move more quickly to identify tax shelter transactions used to minimize or avoid federal taxes. The regulations require organizations to disclose transactions that fall under the following six categories:

1. Listed or substantially similar transactions
2. Confidential transactions
3. Transactions with contractual protection
4. Loss transactions

5. Transactions with significant book-tax differences
6. Transactions with brief asset holding periods

The driving force behind these regulations is a perceived need for strong anti-tax-avoidance rules to discourage transactions that might satisfy the technical requirements of the tax statutes and administrative rules but that are conducted for little or no purpose other than to generate tax or financial statement benefits. The fact that a transaction is subject to disclosure does not mean that the tax results will be disallowed. However, it is highly probable that the IRS will review the transaction in detail.

In general, each reportable transaction must be disclosed on Form 8886, "Reportable Transaction Disclosure Statement." There are significant penalties for failure to disclose.

28.5 PRIVATE FOUNDATIONS

Private foundations are subject to a number of excise taxes that are not imposed on public charities. These taxes ensure that the private foundation distributes a sufficient portion of its assets and does not act in a manner that personally benefits its donors.

(a) Excise Tax on Investment Income

The Tax Reform Act of 1969 established an excise tax on net investment income.¹² Net investment income includes dividends, interest, rents, royalties, and net capital gains.¹³ For purposes of calculating gain on investments acquired prior to December 31, 1969, the tax basis of the property is the higher of the fair market value at December 31, 1969, or the cost. In calculating net investment income, reasonable expenses directly related to the production of investment income can be deducted.

Also, income that is subject to unrelated business income tax is not included in the calculation of net investment income. This would include items of income such as interest or dividends from debt-financed stocks and bonds and capital gains from the sale of debt-financed assets. An example of the excise tax applied to a private foundation that had stocks and bonds that were acquired both before and after December 31, 1969, follows:

¹² This excise tax was originally established at the rate of 4 percent but was reduced to 2 percent in 1977. When a private foundation makes qualifying distributions that equal or exceed the sum of (1) the fair market value of the foundation's assets multiplied by the foundation's average payout ratio for the five prior years; and (2) 1 percent of the foundation's net investment income, the foundation qualifies for a 1 percent excise tax rate for that year.

¹³ Capital losses can be offset only against capital gains and not against investment income.

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	Taxable Income
Dividends and interest	\$10,000
Sale of stock A for \$45,000 purchased in 1967, at a cost of \$20,000, but having a market value at December 31, 1969, of \$30,000	
Proceeds	\$45,000
December 31, 1969, value	(30,000)
Gain	15,000
Sale of stock B for \$20,000 purchased in 1968 at a cost of \$15,000, but having a market value at December 31, 1969, of \$25,000	
Proceeds	\$20,000
December 31, 1969, value	(25,000)
Difference not recognized for tax purposes; no loss is recognized if using the December 31, 1969, market value creates a loss	\$(5,000)
Sale of stock C for \$15,000 purchased in 1970 at a cost of \$20,000	
Proceeds of sale	\$15,000
Cost	(20,000)
Loss	(5,000)
Net	20,000
Less investment advisory fees and other expenses	(2,000)
Net investment income	\$18,000
Tax at 2 percent	\$360

It is important to keep accurate accounting records of the cost basis for all investments, as well as an accurate segregation of any expenses applicable to investment income. With respect to investments acquired prior to December 31, 1969, it is also important to keep a record of the fair market value as of December 31, 1969.

Foundations may be required to pay estimated excise taxes on a quarterly basis.

(b) Distribution of Income

A private foundation is required to make qualifying distributions of at least the "distributable amount" by the end of the year following the current taxable year. Qualifying distributions are those amounts paid to accomplish the exempt purposes of the foundation. If the foundation fails to distribute the required amount, it may be subject to taxes that ultimately have the effect of taxing 100 percent of any amount not distributed. Starting in 1982, the distributable amount is defined as the minimum investment return, less the excise tax and, where applicable, less the unrelated business income tax.

The minimum investment return is 5 percent of the fair market value of all the foundation's assets that are not used in directly carrying out the organization's exempt purpose. Cash equal to 1.5 percent of the total foundation's assets is deemed to be used in carrying out the exempt purpose and is deducted for this calculation. This means that if a foundation has marketable

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securities and cash with a market value of \$1,000,000, it must make minimum qualifying distributions of 5 percent of \$985,000 (\$1,000,000 less 1.5 percent of \$1,000,000) or \$49,250, regardless of its actual income. If, for example, actual investment income were only \$30,000, the foundation would still have to make qualifying distributions of \$49,250.

Note that contributions and gifts received are included in the calculation of the distributable amount only to the extent that they increase the fair market value of the foundation's assets.

This means that the private foundation will not have to make qualifying distributions out of principal provided the foundation's investment income plus contributions and gifts equal the distributable amount. In the preceding example, if contributions to the foundation were, say, \$50,000, the distributable amount would still be \$49,250. These requirements will have little effect on private foundations that receive continuing contribution support.

The illustration below shows how these calculations work. Using the condensed financial statements of the A.C. Williams Foundation, the distributable amount is calculated as follows:

A.C. Williams Foundation	
Receipts:	
Contributions	\$ 140,000
Investment income	<u>50,000</u>
	\$ 190,000
Expenditures:	
For exempt purposes	70,000
Excise tax	<u>1,000</u>
	71,000
Net	\$ 119,000
ASSETS	
Cash	\$ 30,000
Marketable securities	<u>970,000</u>
Net assets	\$1,000,000
CALCULATION OF DISTRIBUTABLE AMOUNT:	
Investment income	\$ 50,000
Minimum investment return:	
Average fair market value of securities and cash ¹⁴	\$1,000,000
Less 1½ percent of above amount for cash deemed to be used in carrying out the exempt purpose	<u>(15,000)</u>
Net, subject to stipulated minimum investment return	985,000
Stipulated rate of return	5%
	<u>\$49,250</u>
Distributable amount:	
Minimum investment return	\$ 49,250
Less—Excise tax	(1,000)
	<u>\$ 48,250</u>

¹⁴ The regulations under § 4942 provide guidance with regard to the methods to be used in calculating the fair market value of a foundation's assets. It would be extremely unusual if the fair market value of a foundation's assets calculated for the distributable amount equaled the fair market value of a foundation's assets as of the balance sheet date.

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Thus, the distributable amount is \$48,250. Qualifying distributions were \$70,000, which amount exceeds the distributable amount by \$21,750, and the requirement has thus been met. This excess can be carried over for five years to meet the requirements of a year in which there is a deficiency. Where there is such a carryover, the order of application of the amounts distributed would be (1) current year, (2) carryover from earliest year, (3) carryover from next earliest year, and so forth.

(c) Excess Business Holdings

A private foundation will incur an excise tax if it owns stock interest in a corporation and the stock it owns, together with the stock owned by disqualified persons,¹⁵ would exceed 20 percent of the voting stock. The provision also applies to holdings in partnerships and joint ventures and beneficial interests in trusts.

Example: Mr. Scotty owns together with his family 15 percent of the voting stock in the A.M. Scotty Company, and he is a substantial contributor to the Scotty Foundation and thus is a disqualified person. The maximum amount of stock that the Scotty Foundation can own is 5 percent (20 percent maximum less 15 percent). There are several minor exceptions to this general rule, and there is a transitional period for foundations to dispose of their pre-1969 excess holdings. The transition rule for disposition of excess pre-1969 holdings allowed a 10-, 15-, or 20-year period for initial reduction in excess business holdings depending on the percentage of ownership by the foundation and disqualified persons at May 26, 1969. Private foundations are given an additional 15 years to further reduce excess business holdings to allowable limits.

Failure to comply with these rules will result in taxes that can be as high as 200 percent of the value of the excess stock held.

(d) Prohibited Transactions

There are several categories of transactions in which private foundations may not engage. They cannot engage in "self-dealing," make investments that jeopardize their exempt function, or make expenditures for certain prohibited purposes (called taxable expenditures). There is an excise tax on both the foundation and the foundation manager who engages in these prohibited transactions.

(i) **Self-Dealing.** The law prohibits private foundations from engaging in certain transactions with disqualified persons or foundation managers. These prohibited self-dealing transactions include selling, leasing, or lending property or money, furnishing goods or services on a basis more

¹⁵ A *disqualified person* is defined in footnote 6 of this chapter.

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favorable than that granted to the general public, or paying unreasonable compensation. Disqualified persons may continue to support the foundation by lending money without charge and providing goods and services for charitable use without charge. The prohibition against self-dealing prevents disqualified persons from receiving a benefit from their relationship with a foundation but does not generally prevent the foundation from receiving a benefit from the disqualified person.

All transactions involving a disqualified person should be examined very closely to make absolutely certain they do not involve self-dealing.

(ii) Investments that Jeopardize Exempt Function. The law provides that the foundation may not make investments that jeopardize the exempt function of the foundation. The foundation is expected to use a prudent trustee's approach in making investments. An example of investments that probably would not be prudent would be investments that have a high level of risk.

(iii) Prohibited Expenditures. The law provides that a foundation may not make expenditures to carry on propaganda to influence legislation or the outcome of a public election. It also prohibits making a grant to an individual for travel or study without prior Internal Revenue Service approval of the grant program. The law also provides that no grant shall be made to another private foundation or to any noncharitable organization unless the granting foundation exercises expenditure control over the grant to see that it is used solely for the purposes granted. Finally, the law prohibits a private foundation from making any grant for any purpose other than a charitable purpose.

28.6 PRIVATE OPERATING FOUNDATIONS

Private operating foundations are private foundations that actively conduct charitable program activities that are the exempt function for which the organization was founded. This is in contrast to private foundations that act only as conduits for funds and have no operating programs as such. Private operating foundations have most of the characteristics of publicly supported organizations but do not meet the public support tests outlined for such organizations that were discussed earlier in this chapter.

(a) Qualifying Tests

In addition to expending substantially all (85 percent) of its income directly for the active conduct of its exempt function, a private foundation,

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to be a private “operating” foundation, must meet one or more of the following tests:

- It devotes 65 percent or more of the fair market value of its assets to direct use in its exempt function.
- Two-thirds of its minimum investment return is devoted to its exempt function and used chiefly by the foundation to accomplish that function.
- It derives 85 percent or more of its support, other than investment income, from the general public and from five or more exempt organizations, no one of which provides more than 25 percent. In addition, not more than 50 percent of its total support is from investment income.

(b) Advantages

There are several advantages to being a private operating foundation. The minimum distribution rules imposed on private foundations do not apply to private operating foundations, and donors are allowed to deduct up to 50 percent of the donors’ adjusted gross income versus the 30 percent of donors’ adjusted gross income limitation on contributions to private non-operating foundations.

28.7 NONCHARITABLE EXEMPT ORGANIZATIONS

(a) Social Welfare Organizations and Civic Leagues

A social welfare organization or civic league must meet two basic requirements in order to qualify for tax-exemption: (1) the organization must operate exclusively to further the common good and general welfare of the people of the community (such as bringing about civic betterment and social improvements) rather than merely benefiting the organization’s members or a select group of individuals or organizations; and (2) will not be involved in activities that primarily constitute carrying on a business with the general public in a manner similar to organizations which are operated for profit.

Social welfare organization or civic leagues are often advocacy organizations. These organizations are often involved in attempts to influence legislation. These organizations may draft legislation, present petitions for purposes of having legislation introduced, and circulate speeches, reprints, and other material concerning legislation. In contrast to tax-exempt charitable organization these organizations can carry on activities that influence legislation as a substantial part of its activities. However, they are similar to tax-exempt charitable organizations in that they are

prohibited from participating or intervening in any political campaign on behalf or in opposition to any candidate for public office.

Contributions to a social welfare organization or civic league are generally not deductible for income tax purposes. However, there are exceptions, such as a donation to a volunteer fire company that may qualify for deductibility if the contribution is made for exclusively public purposes.

(b) Social and Recreation Clubs

Another type of organization that is granted exemption from tax is a club “organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.”¹⁶ Social and recreation clubs are exempt as long as substantially all their activities are for members. Income derived from nonmember activities, such as investment income and nonmember use of the club, can have significant implications for the social club.

(i) Exempt Status. Significant use of the club by nonmembers can result in loss of the club’s tax exemption. The congressional committee reports of the Tax Reform Act of 1976 indicate that a social club will retain its exempt status if no more than 35 percent of its gross receipts are from investments and nonmember use of facilities. Within this 35 percent, no more than 15 percent can be derived from nonmember use of facilities.

Gross receipts include receipts from normal and usual activities of the club, including charges, admissions, membership fees, dues, assessments, investment income, and normal recurring gains on investments, but excludes initiation fees and capital contributions.

Gross receipts from nonmembers are the amounts derived from nonmember services such as investment income and amounts paid by members involving non-bona fide guests. Amounts paid by a member’s employer can, depending on the situation, be considered as paid by a member or as paid by a nonmember.

The problem of determining whether someone using the club is a bona fide guest of a member has proved troublesome. Most clubs adopt rules that limit use of the facilities to members and their guests. The Internal Revenue Service has taken the position that, in many situations, the member’s participation in, or connection with, a function is so limited that the member is merely using the membership to make the club facilities available to an outside group. In many instances the member is viewed merely as acting as a sponsor.

¹⁶ IRC § 501(c)(7).

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If an employer reimburses a member's charges, the income will be member income if the event is for a personal or social purpose of the member, or due to a direct business objective of the employer. Otherwise, the reimbursement will be considered nonmember income. The distinction is whether the member has a direct interest in the company function, as contrasted with a situation in which the member is merely serving as a sponsor to permit the company to use the facilities.

There are also guidelines to help determine whether group functions hosted by members at which guests are present constitute member or nonmember receipts. In groups of eight or fewer individuals, it is assumed that all nonmembers are guests. In larger groups, it is assumed that all nonmembers are bona fide guests, provided 75 percent of the group are members. In all other situations the club must substantiate that the nonmember was a bona fide guest. In the absence of adequate substantiation it will be assumed such receipts are nonmember receipts, even though paid for by the members.

(ii) Substantiation Requirements. In order to rely on the assumptions regarding group functions, clubs must maintain certain records. Where the "eight or fewer" rule or the "75 percent member rule" is used, it is necessary to document only the total number in the party, the number of members in the party, and the source of the payments. For all other group occasions involving club use by nonmembers, even where a member pays for the use, the club must maintain records containing the following information if it wishes to substantiate that such receipts are not "nonmember" receipts:

- Date
- Total number in the party
- Number of nonmembers in the party
- Total charges
- Charges attributable to nonmembers
- Charges paid by nonmembers

In addition, the club must obtain a statement signed by the member indicating whether the member will be reimbursed for such nonmember use and, if so, the amount of the reimbursement. Where the member will be reimbursed, or where the member's employer makes direct payment to the club for the charges, the club must also obtain a statement signed by the member indicating (1) name of the employer; (2) amount of the payment attributable to the nonmember use; (3) nonmember's name and business or other relationship to the member (or if readily identifiable, the class of individuals, e.g., sales managers); and (4) business, personal, or other purpose of the member served by the nonmember use.

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Recordkeeping requirements for other activities such as providing guest rooms, parking facilities, steam rooms, and so on, have not been specifically set forth. Clubs must be careful to ensure that their recordkeeping procedures provide information regarding member and nonmember use of these facilities. All social clubs must be extremely careful not to receive, even inadvertently, nonmember income in excess of allowable limits.

(iii) Unrelated Business Income. In addition to jeopardizing its exempt status, receipts from nonmembers have other tax implications for a social club because such receipts constitute unrelated business income. Social clubs are subject to tax at regular corporate tax rates on their unrelated business income. This is calculated on a somewhat different basis than for other types of exempt organizations. The total income of the club from all sources except for exempt function income (dues, fees, etc., paid by the members) is subject to tax. This means that income from nonmembers, as well as investment and other types of income, is subject to tax. Deductions are allowed for expenses directly connected with such income, including a reasonable allocation of overhead. As with other exempt organizations, a specific deduction of \$1,000 is allowed.

It is possible for a social club to have an overall loss but still have a substantial amount of unrelated business income. Here is an example of a country club where this is the case:

	Exempt	Unrelated	Total
Interest on taxable bonds	—	\$ 10,000	\$ 10,000
Membership fees	\$ 100,000	—	100,000
Golf and other fees	40,000	20,000	60,000
Restaurant and bar	<u>200,000</u>	<u>50,000</u>	<u>250,000</u>
Total income	340,000	80,000	420,000
Direct Expenses	(320,000)	(30,000)	(350,000)
Overhead	<u>(60,000)</u>	<u>(20,000)</u>	<u>(80,000)</u>
Net income (loss)	\$ (40,000)	\$ 30,000	\$ (10,000)

This club will have taxes to pay on \$30,000 of income, which at the corporate tax rates is \$4,350.¹⁷

One of the real burdens for social clubs is to keep their bookkeeping records in such a manner that it is possible to not only determine direct expenses associated with nonmember income but also provide a reasonable basis of expense allocation between member and nonmember activities. Even the largest of corporations has difficulty in making allocation

¹⁷ \$30,000 less \$1,000 special exclusion, taxed at 15 percent on the first \$50,000 of taxable income.

of overhead between functions, so the problems of allocation for social clubs should not be passed over lightly.

Many social clubs charge nonmembers enough to cover the direct costs of the services provided but consistently incur overall losses on nonmember income when they allocate overhead and indirect expenses to nonmember income. This loss enables a club to offset investment income and other unrelated business income when calculating the tax it must pay. The Internal Revenue Service has taken the position that an activity that consistently generates losses does not have the requisite profit motive needed for a trade or business. Under this position, the Service contends that the activity is not an unrelated trade or business and the losses from the activity may not be used to offset other types of unrelated income. In *Portland Golf Club v. Commissioner*, 90-1 USTC | 50,332, the Supreme Court agreed with the IRS's position. Social clubs should reevaluate their cost allocations and the amounts they charge nonmembers and should consider whether the activity is pursued with a motive for profit.

(c) Trade Associations

Another example of an exempt noncharitable organization is a trade association exempt under § 501(c)(6). Trade associations are membership organizations that function for the common business purpose of their members. The activities of a trade association must be directed toward the improvement of business conditions as opposed to performing particular services for individual persons or members.

Contributions or dues paid to a trade association are not deductible as charitable contributions. Most members, however, are entitled to deduct dues and other fees paid as a business deduction.

(i) Lobbying Expenses. Expenses paid after December 31, 1993, for lobbying activities—that is, activities engaged in with the intent to influence legislation—are not deductible for tax purposes. The nondeductibility of lobbying expenses is extended to the portion of business dues paid to trade associations allocable to the trade association's lobbying activities. Trade associations must either notify members as to the portion of member dues that are not deductible or pay a "proxy tax" equal to the highest corporate income tax rate on amounts expended for lobbying purposes. The provisions governing member notification and payment of the "proxy" tax are complex, and trade associations should consult with their professional advisors on this issue.

(ii) Unrelated Business Income. Trade associations are taxed on net unrelated business income the same way that charitable organizations are taxed. Interest, dividends, rents, and royalties are exempt as long as the property that generates the income is not debt-financed. Membership

dues and meeting and convention receipts are also not income from an unrelated trade or business.

(d) Title Holding Companies

Generally, IRC § 501(c)(2) and § 501(c)(25) provide exemptions for corporations that merely hold title to real property, collect the income from it, and remit the net income to another exempt organization annually. These entities are commonly referred to as real property holding companies. Section 501(c)(25) organizations may not hold indirect interests in real property, such as through partnerships, but are permitted to hold interests in “qualified subsidiaries.” A qualified subsidiary is one that is a wholly owned corporation. Real property holding companies are allowed exempt status because of their relationship to the parent exempt organization. Possible abuse situations are avoided by requiring these organizations to remit net income from the property to the exempt parent (§ 501(c)(2) organizations) or one or more of the shareholders or members (§ 501(c)(25) organizations). They are prohibited from participating in any activity except holding title to property.

Because §§ 501(c)(2) and 501(c)(25) organizations are forbidden from any activity other than holding property, the only source of unrelated business income they might have is income from debt-financed property under § 514 or rental of more than an insubstantial amount (10%) of personal property in connection with the rental of real property. However, only § 501(c)(25) organizations are afforded the same exclusions for debt-financed income from real property as schools and pension trusts (§ 514(c)(9)).

(e) Voluntary Employees’ Beneficiary Associations

Section 501(c)(9) provides exemption for “voluntary employees’ beneficiary associations (VEBAs)” formed to provide payment of life, sick, accident, or other benefits to members of such associations and their families. VEBAs are generally funded with contributions by or on behalf of its members. The rules surrounding the determination of unrelated business income for a VEBA are complex. Generally, income earned on contributions in excess of those used for or actuarially set aside for payment of claims is unrelated business income. However, exceptions for certain plans, such as those negotiated by labor unions, exist.

28.8 REGISTRATION AND REPORTING

(a) Initial Registration

All charitable (IRC § 501(c)(3)) organizations, except churches and certain charitable organizations having annual gross receipts of less than \$5,000,

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must comply with Internal Revenue Service notification requirements before they may be considered exempt from income tax. Charitable organizations comply with these notification requirements by submitting Form 1023 to the Internal Revenue Service District Director within 15 months of the start of their operations. If the application is approved, the Internal Revenue Service will send the organization a determination letter that recognizes the organization's exempt status and publicly supported (or private foundation) status under one of the law's provisions.

Organizations must file the application within 15 months of the start of business in order to have exempt status apply to the organization's entire period of existence. An automatic 12-month extension (for a total of 27 months) is available for organizations applying under Treasury Regulation § 301.9100-2.

Organizations that anticipate they will meet one of the public support tests are given an advance-determination letter. This letter allows the organization up to 60 months to meet the public support test without being classified as a private foundation. If, at the end of the 60 months, or the advance-determination period, the organization fails to meet the support test, it will be characterized as a private foundation retroactive to the date operations began.

Exempt organizations other than § 501(c)(3) charities may apply for recognition of exempt status by submitting Form 1024. Some noncharitable organizations are required to apply for recognition of exempt status, for example, Voluntary Employee Benefit Associations (§ 501(c)(9)).

In addition, there may be additional state registration requirements based upon the activity of the organization within that particular state.

(b) Annual Returns—Public Charities

Almost all exempt organizations are required to file annual information returns. The principal exceptions to this reporting requirement are churches and their integrated auxiliaries, and certain organizations normally having gross receipts of \$25,000 or less. Most organizations must file Form 990, "Return of Organization Exempt from Tax." Organizations with gross receipts of less than \$100,000 for the taxable year and total assets at year-end of less than \$250,000 may file Form 990-EZ.

These information returns must be filed by the fifteenth day of the fifth month after the end of the fiscal year (May 15 for calendar-year organizations). There is a penalty for failure to file the return on time. Extensions of time for filing can usually be obtained if there is good reason why the return cannot be filed on a timely basis, but application for extension must be made before the filing deadline. Two three-month extensions are available. These returns do not require certification by an outside auditor. However, some states require that a certified financial statement be filed with the state tax filings.

In addition, all exempt organizations having gross unrelated business income of \$1,000 or more must file a separate tax return (Form 990-T) and pay taxes at regular corporate rates on all taxable income more than \$1,000. The return must be filed by the fifteenth day of the fifth month after the end of the fiscal year. A six-month extension of time to file is available if the return cannot be filed on a timely basis. Section 28.9 of this chapter discusses the annual reporting forms used by exempt organizations.

(c) Annual Returns for Private Foundations

The annual information return for a private foundation (Form 990-PF) filed with the Internal Revenue Service is considerably longer and more complex than the Form 990 filed by most other not-for-profit organizations. All private foundations must file Form 990-PF, without exceptions. Section 28.9 of this chapter discusses this annual return.

(d) Return Inspection

All organizations exempt from tax under IRC § 501(a) must make their Forms 990 (or 990-PF) available for public inspection. Under final disclosure regulations under § 6401(d), effective June 8, 1999, Form 990 must be made available at the organization's place of business¹⁸ to anyone who requests to see the form within three years of the date it was filed with the Internal Revenue Service. Requests may be made either in person or in writing. Form 990 includes all schedules, attachments, supporting documents, and compensation information, whether required by statute or by regulations, but excludes Schedule B that has the names and addresses of certain substantial contributors to the organization. In addition to the organization's three most recent annual information returns, its exemption application, such as Forms 1023 and 1024—including all supporting documents and any letter or document issued by the IRS in connection with the application—must be disclosed. The IRS may assess penalties for failure to comply with such a request.

The final regulations provide that an organization is not required to comply with requests for copies if the organization has made Form 990 widely available. For example, an organization meets this requirement if it posts the Form 990 on its website on the Internet. The posting of Form 990 on another's website (e.g., <http://www.guidestar.org>) does not satisfy the requirement of making the return widely available.

The IRS has issued regulations under IRC § 6104(d) extending to private foundations the same requirements for disclosure of annual information returns and exemption applications as imposed on public charities

¹⁸ Generally, including any regional or district office with paid full-time or part-time employees who normally work in total at least 120 hours per week.

and certain other tax-exempt organizations. However, unlike other tax-exempt organizations, a private foundation must additionally disclose to the general public the names and addresses of its contributors.

28.9 FEDERAL INFORMATION AND TAX RETURN FILING REQUIREMENTS

While not-for-profit organizations may be exempt from most federal taxes, they must file annual information returns with the Internal Revenue Service. With few exceptions, all exempt organizations other than private foundations are required to file Form 990 annually. Private foundations are required to file Form 990-PF. Most exempt organizations having “unrelated business” income must also file Form 990-T. Organizations that anticipate incurring a tax liability must pay estimated taxes in quarterly installments. This chapter discusses the three principal returns and comments on some of the less obvious points that the preparer must be aware of while completing these forms.

It is important to note that Form 990 and Form 990-PF are not just returns to file with the IRS. They are public documents available on the Internet and are scrutinized by each state attorney’s general and the general public.

(a) Form 990: Return of Organization Exempt from Income Tax

(i) Who Must File. All not-for-profit organizations exempt from income tax must file Form 990 except the following:

- Churches, and certain other religious organizations
- Organizations that are part of a federal, state, or local governmental unit
- Most employee benefit plans
- Organizations other than private foundations with average annual gross receipts normally \$25,000 or less
- Private foundations (they file Form 990-PF)

Gross receipts means the total income recognized during the year, including contributions, investment income, proceeds from the sale of investments, and sale of goods, before the deduction of any expenses or costs including the cost of investments or goods sold.

This means that most not-for-profit organizations, including social clubs, educational institutions, and membership organizations, must file this return. The return is due not later than the fifteenth day of the fifth month after the end of the fiscal year (May 15 for calendar year organizations), and there is a penalty for failure to file unless it can be shown that

there was a reasonable cause for not doing so, or shown that due diligence was exercised. Two three-month extensions may be requested from the IRS and are routinely granted. Continued failure to file can also result in personal penalties imposed on responsible persons associated with the organization.

(ii) **Filing a Complete Form 990.** Filing a complete return generally consists of three parts.

1. *Form 990*—must be completed by all filing organizations, except that some organizations may omit certain sections.
2. *Schedule A*—must be completed by all § 501(c)(3) publicly supported organizations.
3. *Schedule B*—must be completed by all organizations that receive contributions from a single donor that exceeded \$5,000 or in certain circumstances 2 percent of total contributions.

The IRS is planning to revise Form 990 in FY2005. All forms mentioned above may be obtained by visiting the IRS website at <http://www.irs.treas.gov>.

The following subsections provide an overview of the reporting requirements of certain relevant line items on the returns.

(iii) **Form 990, Heading.**

- **Fiscal year end**—The first fiscal year must end within 12 months of the date of inception. The organization can choose any month as its fiscal year. Once the election is made it can be changed once within a 10-year period without prior IRS consent. If the organization wishes to change its year-end more than once within 10 years, it must notify the IRS and, in some instances, receive IRS approval in advance.
- **Employer identification number**—is a number assigned by the Internal Revenue Service upon request by any organization. This number will be used on all payroll tax returns and on all communications with the IRS. It serves the same identification function that a Social Security Number serves for an individual. The preparer of a return should always be careful to use the correct number. An employer identification number should be requested by an organization on Form SS-4 as soon as it is formed (even if it has no employees). If the organization must file a return before the number is received, it should put “applied for” in this space.
- **Organization type**—refers to the section of the Internal Revenue Code under which the organization was granted exemption. This

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reference will be in the “determination letter.” Request for exemption should be made as soon as the organization is incorporated by filing Form 1023 for exemption under § 501(c)(3)) or Form 1024 (for other organizations). If an organization has applied for but not yet received exempt status, the box indicating “application pending” should be checked.

- **Gross receipts**—means total receipts, including total proceeds from the sales of securities, investments, and other assets before deducting cost of goods sold or the cost of the securities or other assets. Gross receipts for the filing requirement test is not the same as total income. Total income normally would not include the gross proceeds from the sale of assets, but only the net profit or loss on such sale. The concept of gross receipts used in this return is a tax and not an accounting concept. If gross receipts are normally under \$25,000, the rest of the return need not be completed.
- **Schedule B filing requirement**—this box should be marked if the organization received no contributions, or if the contributions do not need to be reported because they are less than \$5,000 or 2 percent of total contributions.

(iv) Revenue, Expenses, and Changes in Net Assets or Fund Balances, Contributions, Gifts, and Grants.

- **Direct public support**—includes all contributions, grants and bequests that the organization received from the public. This includes noncash items such as donated vehicles, securities, real property, and other similar items. Donated services, free use of materials, equipment or facilities are not to be included as contributions.
- **Indirect public support**—includes amounts received from United Way or similar federated fundraising organizations, and from organizations affiliated with the reporting organization where the original source of the money is public contributions.
- **Government contributions**—not every payment received from the government is a grant. The payment may be for services that have been provided to the government. A key component is to determine whether the primary beneficiary of the service benefits the public or the payer. If the payer is the primary beneficiary, the grant may be considered a contribution. Otherwise, the grant may be considered program service revenue. This determination is important for certain organizations in determining its proper support percentage.

- **Program service revenue**—exempt function income, as well as, “Gross sales” and “Gross rent” should be reviewed to determine if the organization has received income from an unrelated trade or business. If the organization had “unrelated business income” during the year it may have to file Form 990-T and should answer in “Other Information” in the Form 990 appropriately.
- **Rental income**—Income from investment property that is generally disclosed on financial statements is shown net of expenses. Organizations must disclose gross income from the investment property and direct expenses related to the property. Rental income that is related to either the reporting organization’s exempt function or received from an affiliated exempt organization should be reported as program service revenue.
- **Sales of assets other than inventory**—The “Cost or other basis and sales expenses” of assets sold includes the original cost of securities or other assets. If the assets were acquired as a donation and sold at a gain, their basis is the same as it was in the hands of the donor. If the donated property is sold at a loss, the organization’s basis is the lesser of the donor’s basis or the fair market value of the property when the donation was received. A detailed schedule is required showing the type of asset sold, cost, to whom sold, and so on. The instructions must be carefully followed to be sure that all the required information is shown.
- **Special fundraising events**—Amounts reported on this line will be those resulting from fundraising events such as dinners, dances, concerts, and sales of merchandise (e.g., meals) where the attendee or buyer pays more than a fair market price for the item received. Organizations that participate in fundraising events in which the donor receives a benefit may need to inform those who buy tickets or merchandise what portion of the selling price is allowable as a tax deduction on the buyer’s personal income tax return. See IRS Publication 526 for more information.
- **Sale of inventory**—“Cost of goods sold” refers to the cost of actual merchandise or goods that were sold, but not selling expenses. Selling expenses are shown in the “Statement of Functional Expenses”. In the case of a country club, cost of goods sold would include the direct cost of food and drink sold and direct labor. A profit motive for the activity is important.
- **Expenses**—A summary of expenses incurred for the organization’s exempt purpose, should be shown, including applicable overhead expenses. It is important to remember that the IRS is scrutinizing expenses to determine whether the organization is

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spending sufficient amounts of its income for its exempt purpose to justify continuation of the organization's exempt status. Potential donors also examine these lines to determine what percentage of their contributions would be spent on charitable programs based on past history.

- **Payments to affiliates**—This line is used by organizations that are affiliated with other charitable organizations to report amounts remitted to or paid on behalf of the affiliated organization. For example, a local branch of a national charity may be required to pass through to the national office a certain percentage of all contributions, or the national office may allocate certain amounts to its local chapters. This line is not intended to be used for reporting allocations by a federated fundraising organization such as United Way to its member agencies.
- **Other changes in net assets**—used to generally report the following types of transactions.
 - a. Unrealized changes in the market value of investments reported at market value (only realized gains are reported in the revenue section)
 - b. “Capital additions” as defined in the AICPA’s guide, *Not-for-Profit Organizations*.
 - c. Changes in beneficial interest in trusts
 - d. Changes in accounting Principles
- **Net assets**—amounts shown as net assets or fund balances at the beginning of the year and at the end of the year should correspond to the appropriate lines on the “Balance Sheet” section of Form 990.

(v) **Statement of Functional Expense.** The statement of Functional Expenses shows an allocation of expenses among “Program Services,” “Management and General,” and “Fundraising.” This part is very important because the method and amounts of allocation among these three categories become fixed once the return has been filed, and it is very difficult to go back and subsequently change it. Furthermore, this section is important because it tells potential donors where and how their donations may be spent. Note that this section of Form 990 is required for all IRC § 501(c)(3) and IRC § 501(c)(4) organizations and IRC § 4947(a)(1) trusts. Allocating expenses is optional for all other exempt organizations.

- **Grants and allocations**—A detailed schedule is required (with an exception for educational institutions) showing, among other things, to whom grants were paid, the relationship to the reporting organization, and the purpose and amount of the grant. The

instructions should be carefully followed to be sure that all of the required information is shown.

- **Compensation of officers, directors, etc.**—information requested here should agree to information disclosed in the “List of Officers, Directors, Trustees, and Key Employees” section of Form 990.
- **Depreciation, depletion, etc.**—A schedule must be attached showing details of depreciation. Form 4562 can be used (this is a schedule giving the details requested) or the required information may be presented on a supplementary schedule.
- **Joint costs**—costs from a combined educational and solicitation campaign must be detailed here, including the total costs of the campaign and the amounts separately allocated to the educational, fundraising, and management and general portions of the campaign. If the organization follows SOP 98-2, *Accounting for Costs of Activities of Not-for-Profit Organizations and State and Local Government Entities That Include Fundraising*, this box should be checked. SOP 98-2 requires costs of joint activities that are identifiable with a particular function to be charged to that function, and joint costs should be allocated between fundraising and the appropriate program or management and general function.

(vi) **Statement of Program Service Accomplishments.**

- **Primary purpose**—requires a brief description of the organization’s primary exempt purpose.
- **Program service accomplishments**—are related to the activities carried out by the organization that forms the basis for the organization’s exempt status. Extensive details need not be given, but the descriptions should be informative enough that a person who knows nothing about the organization will obtain a basic understanding of the organization’s programs. Many organizations choose to treat this section as a report card of their accomplishments and a window into their organization.

(vii) **Balance Sheet.**

- **Investments—securities**—Organization’s that have investments in securities, must disclose whether they are presented at cost or fair market value. Generally, publicly traded securities do not have to be listed individually. A schedule attached to the return may disclose the type of securities (U.S. government obligations, corporate stock, etc).
- **Net assets or fund balances**—This section allows an organization to report its net assets using the same method in which its records

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are kept. If an organization follows SFAS 117 they must check the appropriate box and complete the lines pertaining to net assets that are classified as unrestricted, temporarily restricted, and permanently restricted. Organizations using fund accounting and not following SFAS 117 should check the appropriate box. Fund accounting is a method of maintaining an organization's financial records in which its assets, liabilities, and equity are segregated into several groups or funds. Each fund reflects whether it is subject to restrictions. Amounts on the total net assets or fund balances line must equal the amounts reflected in the "Revenue, Expenses, and Changes in Net Assets of Fund Balances" section of Form 990.

(viii) Reconciliation with Audited Financial Statement. This section is completed to reconcile the organization's financial statement revenue and expenses with the revenue and expenses reported on Form 990. If an organization's financial statements are not audited, indicate that the section is not applicable on the return.

(ix) List of Officers, Directors, Trustees, and Key Employees.

- **Title, and average hours per week**—The IRS requires that an organization report the title and the hours per week each individual devotes to his position. "As needed" and similar responses are no longer acceptable.
- **Compensation, contributions to employee benefit plans, and expense allowances**—Generally, all compensation paid to or on behalf of the employee must be included in one of the columns provided. Wages, base salary, and bonuses are included in the Compensation column.

Contributions to employee benefit plans (health, dental, etc.) including nonqualified plans (§ 457) should be included in the Employee Benefit column. In addition to life insurance, and so on, benefits include all forms of deferred compensation and future severance payments. Reasonable estimates are permissible.

Not all reimbursed expenses are reported in the Expense Allowance column; rather, only those for which the recipient did not account to the organization under the "accountable plan" rules.

If the organization compensates any other person, such as a management services company, or if a related organization provides personnel for the services provided by any of its officers, directors, or key employees, the organization must report the compensation, benefits, and expense accounts in this section as if it had paid the officers, directors, or key employees directly.

(x) **Other Information.**

- **Political expenditures**—Membership organizations should enter the total amount of direct and indirect expenses for political purposes. § 501(c)(3) organizations must not participate in political activity, or they risk revocation of their exempt status. They can, however, participate in limited lobbying activities.
- **Donated services**—The value of donated services may not be reported as revenue or expense in the “Revenue, Expenses, and Changes in Net Assets of Fund Balances” or the “Statement of Functional Expense” section of Form 990, but may, if the organization wishes, be reported on this line.
- **Public inspection**—Organizations must disclose their exemption application and their three most recent annual information returns to the public upon request.
- **Lobbying activity for § 501(c)(4), (5), or (6) organizations**—In this series of questions, the IRS obtains information about the organization’s compliance with the disallowance of lobbying expenses provisions. §§ 501(c)(4), 501(c)(5) (except for labor unions) and 501(c)(6) organizations must either notify their members about the portion of member dues that are not deductible or must pay a proxy tax on their lobbying expenditures. There are limited exceptions to this provision. Organizations that lobby should consult with tax or legal advisors with regard to these complex requirements.

(xi) **Analysis of Income-Producing Activities.** This section requires a complete and detailed analysis of an organization’s revenue from all sources except contributions, gifts, and grants. Organizations should be extremely careful when completing this portion of the form, since the information inserted will constitute the organization’s tax position with regard to its income. Revenue entered in this section should agree to revenue on the “Revenue, Expense, and Change of Net Assets of Fund Balance” section of Form 990. All revenue must be separated into three categories:

1. *Unrelated Business Income.* Unrelated business income dollar amounts are entered on the appropriate line. The business code that most closely corresponds to the type of revenue received must also be entered in the appropriate column. Business codes are listed in the instructions for Form 990 as well as on the last page of the instructions to Form 990-T. Gross revenue should agree to the gross revenue on the organization’s Form 990-T except for unrelated business income from rental of property, which is shown net of expenses in this part of Form 990.

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2. *Excluded by §§ 512, 513, or 514.* Income that is exempt from unrelated business income because of a specific statutory exclusion is entered in this column on the appropriate line. The exclusion code that corresponds to the statutory exclusion should also be entered. These exclusion codes may be found in the instructions for Form 990.
3. *Related or Exempt Function Income.* Income related to the exempt purpose of the organization is entered in this column on the appropriate line. The exempt purpose for all income entered in this column must be explained in "Relationship of Activities to the Accomplishment of Exempt Purposes" of Form 990. This portion of the form establishes the organization's tax position with regard to its income. It also forms the basis for the organization's disclosure of its unrelated and related activities.

Adequate disclosure is required on a return in order to avoid penalties for understatement of tax. The requirements for adequate disclosure are complex. Organizations are well advised to supplement the information on section of the 990 with a schedule explaining their tax positions if those positions are not supported by substantial authority.

(xii) Information Regarding Taxable Subsidiaries and Disregarded Entities. This section requests information regarding taxable subsidiaries. This part of the form enables the IRS to monitor reporting of taxable income pursuant to § 512(b)(13). This code section states that interest, annuities, royalties, and rents (items of income usually exempt from unrelated business income tax) will constitute unrelated business income if received from a 50 percent controlled subsidiary. This portion of the form will also allow the IRS to evaluate the extent to which organizations have taxable subsidiaries, in the event that Congress wishes to require exempt organizations to aggregate their activities.

(xiii) Information Regarding Transfers Associated with Personal Benefit Contracts. An organization must answer questions regarding transfers associated with personal benefit contracts. If the organization answers either question in the affirmative, it must also complete Forms 8870 and 4720 and pay an excise tax equal to premiums paid. A personal benefit contract, generally, is any life insurance, annuity, or endowment contract that benefits, directly or indirectly, the transferor, a member of the transferor's family, or any other person designated by the transferor other than a charitable organization.

(b) Form 990, Schedule A

Schedule A is prepared by all § 501(c)(3) organizations that must file Form 990. The following subsections provide an overview of the reporting requirements of certain relevant line items on Schedule A.

(i) Statement about Activities. This section attempts to determine whether the organization is engaging in any number of activities which, in certain circumstances, are improper. The section includes a request for information regarding transactions with substantial contributors as well as those who are affiliated with the organization. An affirmative response may indicate potential intermediate sanction violations that should be examined by the organization and resolved, if necessary.

(ii) Reason for Nonprivate Foundation Status. This section is the place where an organization states specifically why it is not a private foundation. The previous sections discuss the various categories of publicly supported organizations—that is, nonprivate foundation organizations. An organization can determine how it should be classified by either looking at its Form 1023 or its IRS Determination Letter.

- **§ 509(a)(1) and § 170(b)(1)(A)(iv)**—This category of a publicly supported organization is the most common. See the previous section for a discussion of the support test these organizations must meet.
- **§ 509(a)(2)**—This category of a publicly supported organization must meet the second mechanical test of public support discussed in the previous section.
- **Public support percentage**—The test to determine whether an organization satisfies the public support percentage for a § 509(a)(1) or (2) type organization is mechanical. For 509(a)(1) organizations, excessive contributions that are given during a four year period are excluded from the public support calculation. For 509(a)(2) organization, year to year amounts received from disqualified persons are excluded.

(iii) Private School Questionnaire. This section is completed only by schools. Several questions must be answered related to discrimination and financial aid. Schools must maintain records of the racial composition of the student body, faculty, and administrative staff.

(iv) Lobbying Expenditures. There are two sections for lobbying activities. Those entities that have made an election under § 501(h) to be covered under the safe harbor lobbying activity provisions for publicly supported charities must complete the top section.

Nonelecting public charities must complete the bottom section. In addition, the charity must also attach a statement providing a detailed description of the lobbying activities.

(v) Information Regarding Transfers to and Transactions and Relationships with Noncharitable Exempt Organizations. This section explores the relationship between the reporting charitable organization and noncharitable exempt

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organizations and political organizations. Transactions with noncharitable exempt organizations and political organizations must be aggregated through the tax year. If certain transactions with any noncharitable exempt organization exceed \$500, then the transactions must be disclosed in this section of Schedule A.

(c) Form 990, Schedule B—Schedule of Contributors

This form is to be filed by all organizations unless they certify they do not meet the filing requirements. Schedule B consists of four parts. The first part is self-explanatory. Part I requires information on the contributors who contributed either \$5,000 or more than 2 percent of total contributions if the organization meets the one-third support test of IRC § 509(a)(1). If any of the donor's contribution was of noncash property, the organization must complete Part II, detailing the property and its value. Lastly, if the organization is considered an IRC § 501(c)(7), (8), or (10) organization, it must complete Part III. The names of the donors listed on Schedule B, Part I is not open to public inspection unless the organization is classified as an IRC § 527 political organization or a private foundation.

(d) Form 990-PF: Return of Private Foundation

All private foundations must file Form 990-PF by the fifteenth day of the fifth month after the end of the fiscal year (May 15th for calendar year private foundations) and there is a penalty for failure to file, unless it can be shown that there was a reasonable cause for not doing so. Most private foundations would be well advised to have a competent professional prepare this form for them. The comments indicated below—while undoubtedly helpful—cannot substitute for the direct assistance of a qualified professional knowledgeable in the foundation's particular circumstances.

The following subsections provide an overview of the reporting requirements of certain relevant line items on the Form 990-PF.

(i) Form 990-PF, Heading.

- **Fair market value of assets**—at the end of the year can differ from the net worth as shown in the Balance Sheet of Form 990-PF because many foundations carry their investments at cost rather than at fair market value.

(ii) Analysis of Revenue and Expenses. In this section the foundation reports its revenue and expenses as recorded in its books. Then income and

expenses are allocated to arrive at certain key amounts that the foundation must use to determine the amount of its excise tax and distributable income.

- **Revenue and expenses per books**—is exactly what it says it is, and the foundation should record its book revenue and expenses in this column. Record all the figures in this column before attempting to complete the other three columns. The foundation can keep its records on either the cash or the accrual basis of accounting and the amounts shown in this column will be the amounts on whichever basis is used.

The net gain or loss from sale of assets will be the book amount of the capital gains or losses from the sale of investments. As noted in the previous section, book gain or loss may or may not be the same as taxable gain or loss. The taxable gain will be reported only in the “Net Investment Income” column.

- **Net investment income**—the income and expenses shown in this column are those amounts which are used to arrive at net investment income. Income from interest, dividends, capital gains and other similar Income is subject to an excise tax. There are a number of shaded areas in this section. (No figures should be recorded in these shaded areas on the return). For example, contributions, gifts, and grants are not subject to excise tax and therefore the corresponding lines have been shaded.

Taxable gain on sale of investments is calculated in “Capital Gains and Losses for Tax on Investments” section of the form and the calculation on that page must be completed before a figure can be entered in this column. Note that net capital losses will not carry to the “Net Investment Income” section.

The expenses to reduce the taxable amount are those that have been paid or incurred to produce the investment income. Federal excise taxes can not be used to reduce investment income. The last line in this column is the amount of net investment income subject to the excise tax. The tax is calculated in the “Excise Tax Based on Investment Income” section of the Form 990-PF.

- **Adjusted net income**—Net investment income and adjusted net income are not the same and should not be confused. In general, private nonoperating foundations that do not derive income from the direct conduct of charitable activities are not required to complete this column. All other private foundations must complete this column.
- **Distributions for charitable purposes**—is used to report the amount of expenditures made for an exempt purpose, including a reasonable allocation of administrative and overhead expenses. Note however, that the amounts included in this column must be

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the amounts actually disbursed during the year (i.e., the cash basis). Therefore, if a foundation keeps its books on an accrual basis, it must adjust the deductions in this column to the cash basis.

(iii) Balance Sheet.

- **Investments**—Unlike public charities, securities should be listed individually. Both book and fair market value of assets is required.
- **Net assets or fund balances**—This section allows an organization to report its net assets in whatever way its records are kept. If an organization follows SFAS 117 they must check the appropriate box and complete the lines pertaining to net assets that are classified as unrestricted, temporarily restricted, and permanently restricted.
- **Organizations using fund accounting and not following SFAS 117**—should check the appropriate box. Fund accounting is a method of maintaining an organization's financial records in which its assets, liabilities, and equity are segregated into several groups or funds. Each fund reflects whether it is subject to restrictions. Amounts on the Total net assets or fund balances line must equal the amounts reflected in the "Analysis of Changes in Net Assets of Fund Balances" section of Form 990-PF.

(iv) **Analysis of Changes in Net Assets or Fund Balances.** This section reconciles the fund balance at the beginning of the year to the fund balance at the end of the year. In many instances the amount reported on the first page as the excess of revenue over expenses will be the only reconciling item. If the foundation carries its securities at market value, the unrealized change in market value during the year will be shown in this section.

(v) **Capital Gains and Losses for Tax on Investment Income.** One of the major bookkeeping problems created by the Tax Reform Act of 1969 is that the foundation must determine the donor's basis on all gifts acquired after December 31, 1969, and all prior gifts when the fair market value at December 31, 1969, was less than the donor's tax basis. Gains from the sale of donated property are based on the donor's original tax basis. As was illustrated in the previous section, if the donor's tax basis is very low, the foundation could have substantial gain and this gain would be subject to the excise tax on investment income.

Private foundations are not subject to tax on the gain accrued on securities through December 31, 1969. For computing gain on the sale of securities, the foundation uses the higher of its adjusted basis or the fair market value on December 31, 1969.

The net capital gain is taxable, but, if there is a net loss, the loss is not deductible from investment income to determine the amount of income subject to excise tax, nor it cannot be carried forward or back under a strict interpretation of the regulations. Treasury Reg. § 3.4940-1(f)(3).

(vi) Qualification Under Section 4940(e) for Reduced Tax on Net Investment Income. Private foundations may qualify for the 1 percent reduced excise tax on net investment income. The calculation, as presented in the Form 990-PF, is based on the average payout ratio of the foundation's five prior years. Generally, a private foundation may qualify for the 1 percent excise tax rate if the current year qualifying distribution exceeds the historical giving percentage of the private foundation. If the foundation qualifies to pay the reduced tax, the amount of the reduction in tax from 2 percent to 1 percent is subtracted from the foundation's qualifying distributions in the "Qualifying Distributions" section.

(vii) Excise Tax Based on Investment Income. This section calculates the excise tax on net investment income. Private foundations that anticipate a tax liability of \$500 or more must estimate its tax liability for the current year and make quarterly estimated tax payments. Organizations are subject to penalties for underpayment of these taxes if they are not paid on a timely basis.

(viii) Statements Regarding Activities. This section must be answered very carefully because it investigates whether any of the many rules affecting private foundations have been violated. If the answer to any of the questions results in filing Form 4720, the foundation should consult with its tax advisor since the foundation and its manager may be subject to escalating taxes.

- **Substantial contraction**—is defined as disposition of more than 25 percent of the fair market value of the foundation's assets (as distinguished from book value).
- **Requirement of IRC § 508**—The 1969 Tax Reform Act required foundations to put certain restrictive language in their governing instruments, or, alternatively, the state legislature could effectively amend these governing instruments for all foundations within the state through legislation. Many states did so, thus eliminating the need for individual foundations to amend their governing instruments. The question is designed to make sure that either state legislation was enacted or the foundation amended its governing instruments as appropriate.
- **Attorney General filing**—All private foundations must submit a copy of Form 990-PF to the attorney general in *each* state in which it is registered or otherwise doing business.

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- **Substantial contributors**—The only substantial contributors who need be listed in the schedule required are those who became substantial contributors in the current taxable year.
- **Public inspection**—Organizations must disclose their exemption application and their three most recent annual information returns to the public upon request.

(ix) **Statements Regarding Activities For Which Form 4720 May Be Required.** Questions in this section are designed to determine whether the foundation is engaged in any “prohibited” transactions that may require a Form 4720 filing with the IRS.

- **Self dealing**—In general, all direct and indirect financial transactions are prohibited between a private foundation and disqualified persons. Potential self dealing include any of the following transactions with a disqualified person: sale or exchange or leasing of property; lending of money or other extension of credit; furnishing of goods, services or facilities; payment of compensation or payment or reimbursement of expenses; or transfer or use of income or assets. There are certain exceptions to what is considered self-dealing under IRC § 4941 and the preparer of the return should be familiar with the exceptions described in the regulations.
- **Jeopardizing investments**—A foundation is expected to follow a “prudent man” approach to investments. However, this does not preclude a foundation from making “program-related” investments. Typically these investments involve a high element of risk and probably would not meet the “prudent man” test. The distinguishing feature of a program-related investment is that it is made to accomplish the exempt function of the organization and not for the purpose of generating income. In reality, these investments are in the nature of a grant.
- **Expenditure responsibility**—The question asking whether the foundation has made a grant to an organization other than a publicly supported organization. Where grants are made to other than publicly supported organizations, the foundation is required to exercise “expenditure responsibility” to ensure that the grant is actually spent for the charitable purpose for which it was granted. Expert tax advice should be obtained to ensure that the procedures followed by the foundation to exercise this expenditure responsibility are adequate to meet the requirements.
- **Information Regarding Transfers Associated with Personal Benefit Contracts**—An organization must answer two questions regarding transfers associated with personal benefit contracts. If

the organization answers either question in the affirmative, It must also complete Forms 8870 and 4720 and pay an excise tax equal to premiums paid. A personal benefit contract, generally, Is any life Insurance, annuity, or endowment contract that benefits, directly or indirectly, the transferor, a member of the transferor's family, or any other person designated by the transferor other than a charitable organization.

(x) Minimum Investment Return. See the prior section for a complete discussion of this calculation.

(xi) Distributable Amount. See the prior section for a complete discussion of this calculation.

(xii) Qualifying Distributions. Qualifying distributions is fairly straightforward. Program-related investments may be included as qualifying distributions. Very few foundations will have qualifying distributions that conform to the requirements for "Amounts Set Aside for Specific Charitable Projects." A foundation that wishes to set aside funds for future use and have those funds qualify as a current qualifying distribution must obtain the agreement of the Commissioner of the Internal Revenue Service prior to setting the amounts aside.

(xiii) Undistributed Income. This section contains a complex schedule that requires patience on the part of the preparer. The purpose of the schedule is to determine whether the foundation has made the proper required distributions. Failure to distribute a sufficient amount may result in excise taxes.

The first step in filling out this section is to record the distributable amount from the "Distributable Amount" section. If the amount was not paid within the current year, the foundation has the next fiscal year to distribute this amount without paying excise taxes for failure to distribute.

The next step is to record the excess or deficit distributions for the prior years. These amounts should be carried over from the prior year's return. Note that excess distributions may be carried forward up to five years.

(xiv) Private Operation Foundations. This section is completed by private operating foundations. The previous section discusses the general requirements for classification as a private operating foundation and the advantages of that status.

(xv) Supplementary Information. This schedule is for "Grants and Contributions Paid during the Year or Approved for Future Payment" and should provide all the information requested.

(xvi) **Analysis of Income-Producing Activities.** See comments for Form 990.

(xvii) **Information Regarding Transfers To and Transactions and Relationships with Noncharitable Exempt Organizations.** See comments for Form 990.

(e) Form 990-T: Exempt Organization Business Income Tax Return

Form 990-T must be filed if an exempt organization has unrelated business income and the gross (not net) income was \$1,000 or more. Unrelated trade or business income was discussed in Chapter 28, and it was noted that all exempt organizations are subject to this tax. Form 990-T is due the 15th day of the fifth month after the end of the fiscal year (May 15 for calendar-year organizations).

The complete Form 990-T is four pages long. Several schedules may need to be completed based on the type of unrelated business income produced by the organization. The schedules are listed below.

- Schedule A—Cost of Goods Sold
- Schedule C—Rent Income (From Real Property and Personal Property Leased With Real Property)
- Schedule E—Unrelated Debt Financed Income
- Schedule F—Interest, Annuities, Royalties, and Rent From Controlled Organizations
- Schedule G—Investment Income of a § 501(c)(7), (9), or (17) Organization
- Schedule I—Exploited Exempt Activity Income, Other Than Advertising Income
- Schedule J—Advertising Income

Information disclosed on these schedules generally flow to the first page of the 990-T. The first page also provides for direct expenses, indirect expenses and overhead (such as heat, light, building costs) to be deducted from unrelated business income to determine taxable income. A specific deduction of \$1,000 is available for all exempt organizations.

An organization with gross taxable income of \$1,000 or more is still required to file Form 990-T even if taxable income after deductions is zero. Unless the exempt organization is taxable as a trust, its unrelated business taxable income is subject to regular corporate rates. Entities that anticipate a tax liability of \$500 or more must estimate its tax liability for the current year and make quarterly estimated tax payments. Organizations are subject to penalties for underpayment of these taxes if they are not paid on a timely basis.

Organizations now have the option of having the IRS discuss the return directly with the organization's tax return preparer, if necessary. Simply check the box in the signature section.

28.10 STATE INFORMATION AND TAX REPORTING ISSUES

In addition to federal filing requirements, most states also require not-for-profit organizations to register with and submit financial reports to one or more agencies of the state government. Some counties and cities have similar requirements. These requirements usually fall into one or more of three areas:

1. Registration requirements for organizations soliciting funds within the state
2. Registration of not-for-profit organizations (including trusts) holding property in the state
3. Registration of organizations doing business in the state

These requirements are basically concerned with legal matters and may vary significantly from state to state. If an organization has operations in, or intends to do business in, a state, it should consult with its tax advisors to get competent advice.

(a) Registration for Organizations Soliciting Funds

A number of states have laws requiring not-for-profit organizations to register with a regulatory agency (or obtain operating licenses or permits) prior to soliciting any funds within the state. Most states make no distinction between resident and nonresident organizations and, in most instances, an organization soliciting funds by mail or through advertisements would have to register, even though it has no office or employees in that state. This registration often requires yearly renewals, as well as a requirement that an annual financial report be filed. Since 1982, most states accept a copy of IRS Form 990 as the basic financial statement. Form 990 EZ has not gained wide acceptance among the states. The financial statements included in this report must sometimes include an opinion of an independent public accountant, and in some instances the state will even specify the accounting principles to be followed. Where an organization must provide this type of information, particularly where the organization is not a resident in that state, considerable planning is required. These annual reports are usually due between three and six months after the end of the organization's fiscal year.

Most states exempt certain classifications of not-for-profit organizations from their registration and reporting requirements.

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An Internet site produced by The National Association of State Charity Official provides information with regard to individual state registration and reporting requirements. The website location is: <http://nasconet.org>. The information is contained under "Multi-State Filer Project."

(b) Registration for Organizations Having Assets within a State

In addition to the registration of organizations soliciting funds, some states also have laws requiring all not-for-profit organizations or charitable trusts to register with a state agency if they have assets or are residents within the state, even if they do not solicit funds. Each organization must be careful to comply with these requirements. Sometimes a different agency of the state is involved, and the reporting requirements may be different from the requirements under the solicitation law.

As with the requirements for organizations soliciting funds, an organization may be required both to register initially and to file an annual report. The principal interest of the state is the proper administration and disposition of assets held by the organization. Moreover, the Internal Revenue Code and regulations provide that every private foundation is required to submit a copy of its Form 990-PF to the attorney general of each state in which it conducts activities. The intent of this requirement is to encourage state officials to oversee the activities of this type of exempt organization.

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29.1 BASIC REQUIREMENTS

In 1997, the Office of Management and Budget (OMB) issued Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (the “Circular” or “A-133”). The Circular establishes the requirements for organization-wide audits of financial statements and of compliance with laws and regulations, to be performed normally annually¹ for organizations that expend \$500,000 or more in federal funds in a given year. Audits can be performed on federal programs standing alone or on the

¹ Annual audits are required if the organization’s financial statements are audited annually; if the financial statements are audited every other year, then biennial audits of federal awards are permitted.

organization as a whole (“single audit”), depending upon the amount of federal funds recorded in a given year and upon the number of federal programs run by the organization.

(a) Historical Context

In response to criticism from the General Accountability Office (GAO) in the 1970s, which cited a laxity of control over not-for-profits’ use of taxpayers’ money, OMB issued attachments to Circulars A-110 (for not-for-profit organizations) and A-102 (for state and local governments) that tried to establish uniform audit requirements for organizations receiving federal funds. Unfortunately, these attachments did not mandate specific procedures or reporting to be followed and were enforced with differing levels of zeal by different federal agencies. Meanwhile, as the result of a small number of highly publicized problems in the not-for-profit sector, the public and Congress began to bring further pressure for accountability by not-for-profit organizations, particularly those receiving and using federal funds.

In addition, it became quite clear that the audit process mandated by Circulars A-102 and A-110 was inefficient and insufficiently implemented by federal agencies. Consequently, Congress passed the Single Audit Act (the Act) in 1984, and amended it in 1996. The Act’s principal aims were to eliminate the excessive duplication of effort built into the then current audit process and to make more uniform the reports required by different federal agencies. OMB was charged with implementing the requirements of the Act and it responded with Circular A-128 (A-128), *Audits of State and Local Governments*. The Act and A-128 pertained only to audits of state and local governments. However, OMB made a commitment to Congress to extend the concept to non-governmental entities receiving federal funds. The result was the issuance of OMB Circular A-133 and the revision of OMB Circular A-128. OMB Circular A-133 is applicable to all non-Federal Not-for-Profit and governmental entities receiving Federal awards. The latest version of OMB Circular A-133 can be accessed at the OMB website at <http://www.whitehouse.gov/omb/>.

(b) The Single Audit Concept

Prior to the Act and A-133, audits of federally funded programs were carried out on a grant-by-grant basis. To an organization receiving multiple awards covering different programs, this often meant that auditors representing each of the funding agencies would shuttle in and out of the organization’s doors, each monitoring its own program in its own way. The consequent repetitiveness and confusion over standards and methods required basic changes in how these audits were performed. The Act

29.2 REQUIREMENTS AND DEFINITIONS

and both circulars approach the accountability problem from the premise that the organization receiving funding is a single entity, is governed by a single board, and has a unified management structure. As such, much of the organization's internal control structure and many of the applicable laws and regulations are common to its various programs and, therefore, can be audited in a single, more efficient effort.

(c) Objectives

Even though A-133 anticipates that this audit will be coordinated with the audit of an organization's financial statements (and usually performed by the same auditor), the objectives of the two audits are not the same.

(i) **Financial Statement Audits.** An audit of an organization's financial statements, performed in accordance with generally accepted auditing standards (GAAS), requires that the auditor gather audit evidence sufficient to express an opinion as to whether the financial statements present fairly the financial position and results of operations (or for not-for-profits, their changes in net assets) when taken as a whole. Such an audit usually results in a single report issued by the auditor. This report confines itself to the amounts and disclosures expressed in the financial statements and whether or not they are fairly stated. It is concerned more with data reported than with the system that operated them. Although separate reports on an organization's internal or administrative controls are often issued along with this report, these additional reports are not a required part of a GAAS audit.

(ii) **A-133 Audits.** An A-133 audit, on the other hand, is much more concerned with how the numbers were generated than with the numbers themselves. Although the auditor is required to issue a report on the financial statements and the schedule of expenditure of federal awards, the auditor must also report on the internal control structure and on the organization's compliance with a wide variety of laws and regulations that will be discussed in more detail later in this chapter. This focus on process rather than results could be unfamiliar to many not-for-profit organizations.

29.2 REQUIREMENTS AND DEFINITIONS

A-133 audits must be performed on any organization that expends \$500,000 or more in federal awards in a given year. Federal awards, sometimes referred to as federal financial assistance, can take any of a number of forms:

- Grants
- Cooperative agreements

AUDITS OF FEDERALLY FUNDED PROGRAMS

- Loan guarantees
- Interest subsidies
- Direct appropriations
- Contracts
- Loans
- Property or commodities
- Insurance
- Other noncash assistance

Federal financial assistance does not include direct federal assistance to individuals such as through Aid to Families with Dependent Children (AFDC), crop subsidies, Medicaid, or Medicare, nor does it include procurement contracts awarded to not-for-profit organizations as vendors of goods or services to the federal government.

(a) Pass-Throughs and Subrecipients

Federal awards do not always come directly from a federal agency. Assistance will often be given in bulk to a single organization along with the responsibility for managing the distribution and monitoring of the funds through a network of subrecipients. In such a case, it is the responsibility of the primary recipient to notify each subrecipient that it has received federal funds and what its responsibilities are as a subrecipient of federal financial assistance. These responsibilities are exactly what they would have been had the subrecipient received the assistance directly from the federal agency plus whatever additional requirements the primary recipient decides to impose. The same thresholds and audit requirements apply.

A primary recipient assumes responsibility to monitor the compliance of its subrecipients with the administrative and audit requirements of A-133 and with the other requirements imposed by the grant, contract, or other agreement covering the assistance. In order to accomplish this, the primary recipient must have an internal control structure in place to accomplish this monitoring function. This must include collecting and reviewing any applicable A-133 reports completed on subrecipients by their independent auditors, if any are prepared. The monitoring function may also have to include further procedures performed by the primary recipient throughout the year depending upon the complexity of the subrecipient structure. If an organization is faced with such a situation, open discussion with the program officers and inspector general at the organization's funding agency and the primary recipient can help plan, in

advance, how to satisfy the monitoring requirements of such a grant or contract.²

(b) Major and Nonmajor Programs

Under A-133, all “major programs” must be tested for compliance. A major program is defined in the Circular as those programs (an individual award or group of awards with the same *Catalog of Federal Domestic Assistance*³ [CFDA] number) determined by the auditor or the federal agency to require testing. The determination is a complex one, taking into consideration the size and assessed risk of each program. Further guidance in this regard is provided in the AICPA’s Audit Guide, *Government Auditing Standards and Circular A-133 Audits*. Expenditures should include only those provided by the federal funding. The organization’s own matching funds should be excluded.

The CFDA number is important because an organization may receive funding, either pass-through or direct, from different sources supporting the same program. Grants with the same CFDA number should be grouped together as one “program” for the purposes of A-133 audits.

Some programs have many common attributes and when audited, are grouped together such that each separate program is audited as part of a unified audit of the group, which is referred to as a “cluster.” Examples of clusters include various student aid grants and loans that can be grouped collectively as a student financial aid cluster, or certain research and development grants that can be grouped as a research and development cluster. The OMB *Compliance Supplement* provides guidance as to which programs should be grouped together as a cluster for audit purposes.

For the purposes of calculating the threshold for determining a major program, loans, loan guarantees, and insurance programs may be ignored if in the auditor’s judgment the inclusion of such items will skew the major program determination to larger programs only. Noncash awards, including commodity and property awards, should be recorded at fair value.

(c) The Schedule of Expenditure of Federal Awards

A-133 requires that the Schedule of Expenditure of Federal Awards (see Exhibit 29.1 for an example) cover the same period as the financial statements that are filed with it is part of the overall report required by A-133.

² Additional guidance can be found in the AICPA’s Audit Guide, *Government Auditing Standards and Circular A-133 Audits*.

³ The *Catalog of Federal Domestic Assistance* is published by the Government Accountability Office of the U.S. government. It lists all domestic assistance programs and assigns a unique number to each. The identifying number has the format XX.XXX.

EXHIBIT 29.1

Sample Schedule of Expenditure of Federal Awards

SAMPLE NOT-FOR-PROFIT ORGANIZATION
 SCHEDULE OF EXPENDITURE OF FEDERAL AWARDS
 FOR THE YEAR ENDED JUNE 30, 20XX

Federal Grantor/Pass-Through Grantor/Program Title	Federal CFDA Number	Agency of Pass-Through Number	Federal Expenditures	Note
U.S. Department of Health and Human Services Headstart	93,600	05CH5560/07	\$ 156,327	Note A
	93,600	05CH5560/08	<u>150,000</u>	
			306,327	
Passed-through from State Department of Human Services Community Services Block Grant Weatherization	93,792	K1578	356,456	
	93,818	K4599	<u>—</u>	Note B
			662,783	
U.S. Agency for International Development Biden-Pell Grant Program	None	OTR-0230-G-SS-9192-00	246,123	Note C
Department of Education Passed-through from City Dept. of Education	84,151	KLHN456898	<u>78,000</u>	
			<u>\$ 986,906</u>	

Note A: Although not required, this breakout by grant will facilitate review and make the report more meaningful to users.

Note B: A program can be open without monies having been received or expended during the period under audit. Such programs should be included in the schedule.

Note C: CFDA numbers will not necessarily be available for all programs.

29.3 RESPONSIBILITIES OF THE RECEIVING ORGANIZATION

The basis of accounting should be consistent with that used in the organization's federal grant reports, which means that the schedule may not be consistent with the organization's financial statements. In this case the schedule should be reconciled to the financial statements. The basis of accounting should be disclosed in a footnote to the schedule. The schedule must show (at a minimum) the following:

- Each program, or program cluster, separately, noting the program or grant title, CFDA number, and the name of the federal awarding agency
- Other awards not having a CFDA number (such as grants from the U.S. Agency for International Development)
- Total federal expenditures for each federal award program
- Federal noncash assistance should be included at its fair market value at the date received
- Amounts of federal loans, loans subject to federal guarantees, and insurance programs either in the notes to the schedule or on the face of the schedule
- Federal funds passed through a nonfederal organization should be so identified, including the name of the awarding organization, the awarding organization's identifying number, and the CFDA number
- Federal funds passed through to subrecipients by program

Some additional information, though not required under A-133, may be useful, such as:

- Federal program revenue
- Program or grant periods and/or total granted amounts
- Opening and closing advanced (asset) or deferred (liability) balances
- Nonfederal expenditures used for matching, although this should be clearly separated from the federal funds expended (note that the organization's accounting records must be able to segregate the use of federal and nonfederal funds)
- For organizations with loan programs, the opening and closing outstanding balances along with the new and matured loan activity during the year
- Matching contributions raised

29.3 RESPONSIBILITIES OF THE RECEIVING ORGANIZATION

By accepting any donations from individuals or organizations that have attached restrictions to the donation, an organization incurs a legal and

moral obligation to adhere to the restrictions imposed by the donor. The clear alternative is not to accept the donation. A federal agency is no different in this respect. The receipt of federal funds in any of the forms noted earlier implicitly acknowledges acceptance of grant-imposed responsibilities. Ignoring or inadequately adhering to these requirements may cause the agency to refuse further funding or even require the return of the federal funds granted.

The responsibilities assumed by the organization fall into two categories, both of which will be reported on by the A-133 auditor: (1) compliance with laws, regulations and other matters; and (2) the maintenance of an internal control structure sufficient to ensure that such compliance takes place and the funds granted to the organization are adequately safeguarded.

(a) Compliance with Laws, Regulations, and Other Matters

An exhaustive analysis of the requirements imposed on an organization receiving federal funds is beyond the scope of this book. We will give general background on the kinds of requirements that an organization may find itself subject to and offer some direction for how to determine conclusively what the organization must do in meeting the requirements imposed on it.

The A-133 auditor will, in most cases, issue two reports on compliance, one of which pertains to the organization as a whole, and the other of which pertains specifically to compliance with the requirements imposed by the receipt of federal funding. The auditor performs certain specific procedures (in this case those laid out in the *Compliance Supplement* published by OMB) and, in the report, states what he or she has found. The second report is an opinion on the organization's compliance with the requirements of each of its major programs. The areas of testing are as follows:

- A.** *Activities Allowed or Unallowed.* There are specific requirements for activities allowed or unallowed that are unique to each Federal program and are found in the laws, regulations, and the provisions of the contract or grant agreements pertaining to the program. This type of compliance requirement specifies the activities that can or cannot be funded under a specific program.
- B.** *Allowable Costs/Cost Principles.* Costs charged to federal programs must be reasonable and necessary, allocable to the program, receive consistent accounting treatment, and conform to laws, regulations, and sponsored agreements. Costs must be net of all applicable credits and must be documented in accordance with federal requirements, specifically in accordance with OMB Circulars A-21, A-87 and A-110.

29.3 RESPONSIBILITIES OF THE RECEIVING ORGANIZATION

- C. *Cash Management.* OMB Circular A-110 prescribes certain methods for and limitations on receiving federal cash. For instance, there are very strict limitations on the period of time federal funds can be held by an organization prior to disbursement and on how interest earned on those held funds may be treated and used.
- D. *Davis–Bacon Act.* The Davis–Bacon Act requires that mechanics and laborers working for contractors on federally funded construction projects be paid regionally prevailing wages.
- E. *Eligibility.* Some federal programs are subject to unique eligibility requirements, which can be found in the laws, regulations, and provisions of the contract pertaining to the program.
- F. *Equipment and Property Management.* Equipment purchased with federal funds or properties purchased or managed with federal funds have specific compliance requirements related to their reporting and management.
- G. *Matching, Level of Effort, Earmarking.* Some contracts provide specific requirements that nonfederal funds be used, or matched, with the federal funding that is received. Federal funds may not be used to supplant, or take the place of, other funding sources, but instead must be used in addition to preexisting nonfederal funding to ensure that federal funds supplement other resources. Also in certain cases, funds may be allocated, or earmarked for specific purposes or participants in a program.
- H. *Period of Availability of Federal Funds.* Most federal awards are limited to a specific length of time in which the grantee may expend the federal funds. Funds not expended during that time must be returned to the funding source.
- I. *Procurement and Suspension and Debarment.* Federal funds expenditures must conform to procurement procedures that conform to federal law and are identified in OMB A-110. In addition to those requirements, the federal government has identified certain contractors with whom it will no longer contract. All recipients of federal awards are also prohibited from contracting with these companies. A listing of these companies can be found on the Excluded Parties List System which can be accessed on the Internet at <http://epls.arnet.gov>.
- J. *Program Income.* Program income is gross income that is directly generated by the federally funded project during the grant period. Program income can be fees for services, rental income, sales of commodities directly related to the program, and payments of principal and interest on loans made with grant funds. Program income is usually deducted from grant expenditures; however, one should look to the specific grant guidance for specific instructions for accounting for any income derived from the grant.

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- K.** *Real Property Acquisition and Relocation Assistance.* Federal law requires that appropriate assistance be provided to persons displaced by federally-assisted programs from their homes, businesses, or farms. All property acquired must be appraised by qualified independent appraisers to ensure that payments to displaced individuals are fair and equitable.
- L.** *Reporting.* Expenditures of federal awards, and results of federal programs must be accounted for and reported to the proper funding agency. Many grants are reported on standard forms for ease of reporting and processing. If a standard form is not used, the awarding agency will specify the manner that financial and operating results are to be reported.
- M.** *Subrecipient Monitoring.* Organizations that receive federal awards, and in turn, awards the funds to another organization, the subrecipient organization, must monitor the subrecipient organization to ensure that all program compliance requirements are being followed. This monitoring process usually takes the form of a full or limited-scope audit engagement, performed either by the awarding organization or by an independent CPA.
- N.** *Special Tests and Provisions.* There are specific requirements for special tests and provisions that are unique to each federal program that are found in the laws, regulations, and provisions of the grant governing the program. Larger programs may have these requirements listed in the *Compliance Supplement*. If not, a determination of the provisions must be made by an examination of the grant contract.

There are a number of sources that can be reviewed to determine what requirements a program is subject to:

- *The grant or contract document.* The first place to look for these requirements is the grant document itself. Because all of these requirements are imposed by contract (as opposed to being a matter of law), they should all be incorporated into the grant or contract either directly or by reference.
- *Standard attachments to the grant.* Many grants or contracts will be quite brief, but will refer to standard attachments that are incorporated by reference into every grant issued by a given agency.
- *The Compliance Supplement.* The supplement, noted above, also includes many of the specific requirements that pertain to many of the largest federally-funded programs. It is organized by federal agency by program.

29.4 WHAT TO EXPECT FROM THE AUDIT

- *Other OMB circulars and publications.* OMB has issued a number of circulars that may be incorporated completely or partially by reference in a grant or contract. Some of the more important circulars are:
 - A-110—*Uniform Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Nonprofit Institutions*
 - A-21—*Cost Principles for Educational Institutions*
 - A-122—*Cost Principles for Nonprofit Organizations*

These circulars establish the principles to be used in determining the costs of grants and contracts, including the basic principles of allowable and unallowable costs and the mechanics involved in establishing indirect cost rates.

(b) Internal Controls

A-133 requires that the auditor issue two reports, one on the organization's overall internal control structure over financial reporting and a second on the internal control structure surrounding the organization's use of federal funds. Chapter 23 discusses internal accounting controls, their importance, and some of the procedures that an organization can implement in order to protect the organization's assets and help to ensure that the organization's resources are utilized only as authorized by the board, but also notes that internal controls often extend beyond those matters relating directly to the functions of the accounting and financial departments.

Internal controls, as envisioned by A-133, extend also to ensuring that the requirements imposed by the receipt of federal funds, both general and specific, are complied with. This will include many matters not normally encompassed in accounting or finance. For example, the organization must have a structure in place to ensure that the applicable compliance requirements are met, and that nonfinancial grant-specific requirements, such as specific use of personnel or qualitative grant progress reports, are submitted.

29.4 WHAT TO EXPECT FROM THE AUDIT

(a) How Is It Different from a Financial Statement Audit?

We noted earlier some of the differences between a financial statement and an A-133 audit. The focus of the two is very different: The former concentrates on financial statement balances and disclosures, while the latter concentrates on internal accounting controls and on compliance with laws, regulations and other matters.

AUDITS OF FEDERALLY FUNDED PROGRAMS

By reading the reports issued, one will note that the audit is performed in accordance with Government Auditing Standards (GAS) issued by the GAO. These auditing standards incorporate all of the generally accepted auditing standards (GAAS) and extend certain of the auditor's reporting and quality control requirements. GAS also emphasize the importance of compliance with laws and regulations.

In addition, the testing performed by the auditor will be somewhat different in scope and in objective. Items tested will normally extend beyond those usually covered by a financial statement audit to include the nonfinancial specific requirements of major grants or contracts. In addition, the concept of materiality changes from the financial statement to the A-133 audit. Because tests of compliance focus on whether or not a requirement was followed, not on attempting to support a given account balance, they usually result in either a "did" or "didn't" comply report, with less regard for the amounts, if any, that are involved.

In 2003, GAO issued several revisions to GAS to strengthen and streamline these auditing standards and provide for consistent application of GAS to the various types of audits such as financial, performance, and attestation. The 2003 revisions include significantly expanded standards related to auditor independence, particularly as they relate to performance of audit and nonaudit services. Visit the GAO website for up-to-date information concerning GAS at <http://www.gao.gov>.

(b) What Will Be Included in the Report?

The report package can consist of several reports, including the audit opinion usually expressed by the organization's auditor on the organization's financial statements and footnotes, plus additional sections, as follows.

- Report on the Financial Statements (1) including:
- Report on the Schedule of Expenditure of Federal Awards (3)
- Report on the Entity's Internal Control Structure and the Entity's Compliance with Laws, Regulations and Other Matters Based upon an Audit Performed in Accordance with Government Auditing Standards (2)
- Report on the Internal Control Structure over Federal Awards and compliance with the Requirements of Major Programs (3)
- Report on Illegal Acts (if any are noted) (2)
- Current Findings, Questioned Costs, Recommendations (3)
- Status of Prior Findings and Recommendations (5)

- Management's Views and Corrective Action Plan (3), (4)
- Data Collection Form (3)

Where (1) means required by generally accepted auditing standards (GAAS); (2) required by Government Auditing Standards (GAS); (3) required by OMB Circular A-133; (4) may be submitted by management separately. In many cases certain pairs of these reports can be combined into a single document; and (5) required by OMB Circular A-133.

This package of reports must be submitted by the organization to the Data Clearinghouse within one month after being received from the auditor, but in no case more than nine months after the close of the year being reported on.

(c) What Does an Organization Do if the Auditor Finds Something?

A-133 requires that certain findings of noncompliance and internal control recommendations be reported in the schedule of findings and questioned costs ("the schedule"). The schedule contains three parts:

Part I—summarizes the types of audit opinions issued (qualified or unqualified), the types of findings (if any) identification of major programs, and a statement on whether the organization qualified as a low-risk auditee.

Part II—contains findings related to the financial statements that are required to be reported in accordance with "Government Auditing Standards."

Part III—contains findings and questioned costs for federal awards.

Government Auditing Standards and OMB A-133 contain criteria that the auditor uses to determine if a finding must be reported. The criteria allow room for the auditor to exercise some judgment when applying the criteria to a specific finding, however the threshold for determining a questioned cost has been established by the government at \$10,000 actual or projected costs.

A well-written finding will include several elements, including the criteria or specific requirements being addressed, conditions found, and their effect, questioned costs (if any) and recommendation for corrective action and management's views. Findings should be written in such a way as to give the reader the proper prospective or context of the finding.

Findings that in the auditor's judgment need not be included in the schedule can be communicated to management orally, such as at an exit conference or in the form of a separate written communication such as a memo or exit conference agenda.

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The final package component, Management's Corrective Action Plan, is required to be submitted to the cognizant or oversight agency as part of the report package and must include a plan of corrective action taken or planned to address the findings and recommendations noted by the auditor.

The plan of corrective action taken or planned must be well written and include enough detail so as to communicate that the auditee has taken the results of the audit seriously (management's views) and intends to take reasonable corrective actions as quickly as possible. The plan of corrective action must include the name(s) of a contact person responsible for corrective actions and the anticipated completion date as well as the specific corrective action planned. If the auditee disagrees with the audit findings and recommendations, an explanation of the auditee's position should be included.

29.5 CONCLUSION

If an organization receives funds from a federal agency, as with any provider of restricted funding, it must adhere to the requirements imposed. An organization can best minimize the trouble and the possibility of adverse consequences by fully understanding the requirements and working with its funding agency and with its auditor to find the most efficient and expeditious way to meet the requirements.

P A R T S I X

**Setting Up and Keeping
the Books**

CHAPTER THIRTY

Cash-Basis Bookkeeping

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Bookkeeping is the process of recording, in a systematic manner, the transactions that have taken place. It is that simple. There is nothing mysterious or complicated about bookkeeping. It is simply maintaining records in a manner that will facilitate summarizing them at the end of a period in the form of financial statements. For small cash-basis organizations there is little need to know a great deal about accounting theory. Common sense will dictate the records that must be kept. The purpose of this chapter is to discuss bookkeeping in its simplest form—where everything is recorded on a cash basis.¹

30.1 THREE STEPS IN A BOOKKEEPING SYSTEM

There are basically only three steps involved in any bookkeeping system, whether a simple cash system or a more involved accrual basis system:

1. *Recording each transaction in a systematic manner when it occurs.* In a simple cash-basis system only cash transactions are recorded. This recording could be on the checkbook stub or, for organizations with many transactions, it might be an entry in either the “cash

¹ Cash-basis accounting and financial statements were discussed in Chapters 3 and 12.

disbursement record” or the “cash receipts record.” In accrual basis bookkeeping, transactions not involving cash are also recorded.

2. *Summarizing transactions so that all “like” transactions are grouped together.* This summarizing can be informally done on a simple columnar worksheet, or it can be more formally handled in a system in which transactions are posted to a formal book called the “general ledger.” In either case, the objective is to bring “like” transactions together.
3. *Preparing financial statements from the “summary” prepared in Step 2.* These financial statements can be a simple listing of all the major categories in the summary or they can involve some rearrangement of the figures into a more meaningful presentation. In either case, the financial statements are the end product of the bookkeeping system.

Bookkeeping is truly a matter of common sense. With some thought, a simple bookkeeping system can be devised that will meet the needs of a small, cash-basis organization. The best way to illustrate this is by showing how two organizations keep their records. The first is the Cromwell Hills Swim Club and the second is All Saints Church. The financial statements of both organizations were illustrated in Chapter 10. The Cromwell Hills Swim Club uses the checkbook system of bookkeeping. All Saints Church uses a somewhat more formal system utilizing a cash receipts book, a cash disbursements book, and a general ledger.

30.2 CHECKBOOK SYSTEM

Most people are familiar with the first step in checkbook recordkeeping because almost everyone keeps a personal checkbook. This can be done manually or can be automated. The process of recording each check and each deposit on the checkbook stub is the first step in a checkbook system of bookkeeping—the step of initially recording the transaction. The checkbook becomes the “book of original entry.” It is important to write down enough description on the stub to properly identify what the receipt or disbursement was for. In the case of disbursements, there is usually reference to a vendor’s invoice or some supporting documents. It is also important to keep track of receipts by noting whose checks are included in each deposit, perhaps using the back of the check stub if there is not room on the front. Or, alternatively, this information can be put on the copy of the deposit slip which can then be kept with the bank statement or in a separate file. Since the checkbook becomes the source of all bookkeeping entries, it is important that all receipts be deposited intact and all disbursements be made by check. This will ensure that a

30.2 CHECKBOOK SYSTEM

EXHIBIT 30.1

Example of a Checkbook Stub

1472		BAL. BRO'T FOR'W	16,103	56
JUNE 8, 20 X1				
TO COMMUNITY HARDWARE				
FOR POOL SUPPLIES - PURCHASED		DEPOSITS		
IN MAY - SEE BILL FOR MAY				
TOTAL			16,103	56
AMOUNT THIS CHECK			378	00
BALANCE			15,725	56
1473				
JUNE 10, 20 X1				
TO CROMWELL WATER CO.				
DUES { SMITH		DEPOSITS	100	00
{ HUBER			100	00
FOR				
TOTAL			15,925	56
AMOUNT THIS CHECK			93	66
BALANCE			15,831	90

record is established of all transactions. Exhibit 30.1 shows an example of a checkbook stub.

(a) Worksheet Summary

The second step of summarizing all the transactions for the period is almost as easy. Most organizations use a worksheet that has many columns, one for each major category of income or expense. Exhibit 30.2 shows a worksheet for the Cromwell Hills Swim Club. On this worksheet, each month's transactions have been summarized from the checkbook stubs and entered in total. However, each individual transaction could have been entered on this worksheet. If this were done, the worksheet would have been many pages long, depending on the number of transactions. However, if an organization has many similar transactions in a period, the bookkeeper can probably run an adding machine tape of

EXHIBIT 30.2

Worksheet Summarizing Checkbook Stubs by Month

Date	Assets		Liabilities		Equity		Other		Account
	Check	Balance	Check	Balance	Retained Earnings	Contributions	Other	Other	
January									
February									
March									
April									
May									
June									
July									
August									
September									
October									
November									
December									
Total									
Reconciliation of Cash Balance at Beginning of Year Total Deposits Less: Withdrawals Balance at End of Year									

all like items and enter only the total each month from the checkbook stubs, which would be faster than copying each transaction onto the worksheet. Either approach, or even a combination, is appropriate and is a matter of preference.

Notice the reconciliation of the cash account at the bottom of this worksheet. This is the bookkeeper's proof that a mistake has not been made in summarizing the transactions on this worksheet. While this is shown for the entire year, in practice the worksheet would be totaled either every month or every time financial statements were prepared. At that point, the bookkeeper would want to prove the cash position in this manner. This reconciliation should not be confused with the bank reconciliation, which should be prepared monthly to prove out the checkbook balance. Of course, an alternative to the use of a manual checkbook with a spreadsheet summary is a simple automated checkbook. There are now many such software packages available including many provided by the bank with which institutions maintain their checking accounts.

(b) Payroll Register

The payroll presents a problem because the club must also keep track of the payroll taxes it has to withhold, and it must pay these amounts plus the employer's share to the government, through the local bank. Exhibit 30.3 shows a typical payroll register. Often additional applications can be purchased at nominal expense to process payroll. Since the club is following cash-basis accounting, no attempt is made to record the liability for the unpaid payroll taxes between the date they were "withheld" and the date they were actually paid. In our example, employees are paid their summer wages in two equal installments on July 25 and September 5. Notice on the worksheet in Exhibit 30.2 that the net payroll of \$5,294.30 is shown as the payroll expense in July. The payroll tax deductions of \$1,705.70 are not shown since they were not paid until August. In August, when these withheld taxes are paid, the club will also have to pay employer FICA taxes of \$535.70. This is also recorded when paid in August.

(c) Unpaid Dues

The club will also need to keep track of which members have paid their dues. This can be handled by simply keeping a list of members and indicating the date "paid" after each member's name when payment is received. This commonsense approach should be used with any other type of information that the club must keep.

EXHIBIT 30.3

Payroll Register

Name of Employee	Wages			Employee Deductions					Net Amount Payable
	Regular	Overtime	Total Wages	FICA	Fed.	Other With.	Total Deduct.		
					With. Tax				
Jones, W. (Pool Mgr.)	\$1,000.00	—	\$1,000.00	\$ 76.50	\$ 170.00	—	\$ 246.50	\$ 753.50	
Smith, J. (Lifeguard)	750.00	—	750.00	57.40	125.00	—	182.40	567.60	
Brown, J.	750.00	—	750.00	57.40	125.00	—	182.40	567.60	
Samuels, A.	750.00	—	750.00	57.40	125.00	—	182.40	567.60	
McNair, S.	750.00	—	750.00	57.40	125.00	—	182.40	567.60	
Williams, A.	750.00	—	750.00	57.40	125.00	—	182.40	567.60	
Huber, W.	750.00	—	750.00	57.40	125.00	—	182.40	567.60	
Miller, C.	750.00	—	750.00	57.40	125.00	—	182.40	567.60	
McDonald, W.	750.00	—	750.00	57.40	125.00	—	182.40	567.60	
Total	\$7,000.00	—	\$7,000.00	\$535.70	\$1,170.00	—	\$1,705.70	\$5,294.30	

(d) Financial Statements

The third step in the bookkeeping system is preparing financial statements. They can be prepared directly from the worksheet summary of the checkbook stubs (Exhibit 30.2) or generated by the software package for an automated checkbook. Look at the Statement of Cash Receipts, Disbursements, and Cash Balance shown in Chapter 10. This statement agrees with the totals on this worksheet. This worksheet becomes, in essence, the general ledger. This, in conjunction with the checkbook and payroll register, would become the “books” of the club.

(e) Advantages and Disadvantages

The manual checkbook system of recordkeeping is very satisfactory for many organizations, but it has limitations on the number of transactions it can handle before it becomes more cumbersome than useful. This system has the disadvantage that it is not a recognized or formal system of bookkeeping and while it may work perfectly well for one treasurer, the next treasurer may find it awkward and too informal. Further, the use of worksheets to summarize the period’s transactions has the disadvantage that they are just worksheets, and are likely to get lost or destroyed. When an organization starts to have any volume of financial activity, it should start to consider a more conventional and formal set of records. The computerized checkbook system can be satisfactory for many organizations as it can assist with the grouping of the transactions and summarize information more efficiently. In addition, it can also help in reducing mathematical errors. Back-up can be made to assist in mounting historical information. This method can also be performed manually, as discussed in the following pages, but for minimal expense, accounting software can be purchased to assist in recording the transactions. The only difference between the manual system and the automated system is that it allows for both sides of transaction to be recorded concurrently. The automated system also facilitates updating balances in the trail balance for the transaction as well as ensure that records are in balance.

30.3 CASH-BASIS SYSTEM

The basic difference between the checkbook system and a more formal cash-basis system is that, in the latter, transactions are recorded and summarized in a more formal manner. Otherwise the bookkeeping process is the same.

(a) Basic Records

In the checkbook system we had only the checkbook stubs, worksheets summarizing transactions, and a payroll register. In a more formal cash-basis system, we would have the following records.

- *Cash disbursement book*, in which each check disbursed is recorded in almost the same manner as on a checkbook stub
- *Cash receipts book*, in which each cash receipt is recorded in almost the same manner as on a checkbook stub
- *General journal*, in which certain noncash transactions are recorded. The principal noncash entry is the entry to close the books at the end of the year
- *General ledger*, in which all transactions are summarized
- *Trial balance*, which lists all accounts in the general ledger and proves that the total of the “debits” and “credits” in the general ledger is equal²

Each of these five records is discussed and illustrated below. Before beginning this discussion, however, it is necessary to discuss briefly the concept of a “double entry” bookkeeping system and to introduce the terms “debits” and “credits.”

(b) Double Entry System

There are five major categories of accounts a bookkeeping system keeps track of: expense accounts, income accounts, asset accounts, liability accounts, and the net assets (net worth) of the organization. For the moment, only the first four will enter into our discussion. The principle of double entry bookkeeping is that every transaction affects two accounts and usually two of these four categories of accounts. For example:

- *An organization spends \$100 to pay a secretary.* The two categories affected are assets and expenses. The asset account is the cash balance (it is decreased) and the expense account is payroll expense (it is increased).
- *An organization receives a contribution of \$50.* The two accounts affected are contribution income (it is increased) and cash account (it is increased).

² Actually, the trial balance is not part of the “set of books.” Rather, it is something prepared from the books. However, because it is important that the trial balance be prepared, it is considered part of the books for this discussion.

30.3 CASH-BASIS SYSTEM

- *An organization spends \$10 for stationery supplies.* The two accounts affected are stationery supplies expense (it is increased) and cash (it is decreased).
- *An organization borrows \$100 from the bank.* The two accounts affected are cash (it is increased) and loans payable (it is increased). (Note: not used in cash accounting, only used in forms of accrual accounting, as discussed in following chapters.)
- *An organization provides Jones with \$100 of service that Jones agrees to pay for at the end of next month.* The two accounts affected are the income account—sales of services—(it is increased) and accounts receivable from Jones, an asset account (it is increased). (Note: not used in cash accounting, only used in forms of accrual accounting, as discussed in following chapters.)
- *Jones pays the organization the \$100 owed.* The two accounts affected are cash (it is increased) and accounts receivable (it is decreased). (Note: not used in cash accounting, only used in forms of accrual accounting, as discussed in following chapters.)

Every transaction affects *two* accounts. This is why the words “double entry” bookkeeping are used. Each bookkeeping entry must affect two accounts.

(c) Debits and Credits

The words “debit” and “credit” are bookkeeping terms that refer to the two sides of a transaction. Asset accounts and expense accounts normally have debit balances. Liability accounts and income accounts normally have credit balances. To increase an asset or expense account, one would add a debit amount (i.e., the account would be “debited”); to increase an income or liability account, one would add a credit amount (i.e., the account would be “credited”). Here is a summary that shows these debit and credit rules.

Category of account	To increase you would add a	To decrease you would add a	Balance is normally a
Assets (cash, accounts receivable, inventory, prepaid expenses, fixed assets)	debit	credit	debit
Liabilities (accounts payable, accrued liabilities, bank loan payable, long-term debt)	credit	debit	credit
Net assets	credit	debit	credit
Income (contributions, sales, receipts)	credit	debit	credit
Expenses (salaries, supplies, cost of goods sold, taxes)	debit	credit	debit

30.3 CASH-BASIS SYSTEM

have a "debit" balance. Notice that the beginning balance is a debit. The increase in cash from receipts is also a debit. The decrease in cash from expenditures is a reduction of a normally debit account and therefore must be a credit. The final column is merely a running balance to aid the bookkeeper.

Some general ledgers do not have this "balance" column and are set up on a somewhat different format. Exhibit is the same general ledger account in this other form. This form of general ledger is a little more difficult for the inexperienced person to work with primarily because a running balance is more difficult to obtain. For this reason, it is not recommended. However, either form is equally acceptable. That is all you must know about the theory of double entry bookkeeping. The rest follows from these relatively straightforward rules. Do not try to figure out logically why assets and expenses are debits, or why liability and income accounts are credits. These are the rules by definition.

With the foregoing explanation about double entry bookkeeping, and debits and credits, let us now turn to the set of books that would be kept by an organization that keeps its records on a simple cash basis. The two principal books that will be substituted for the "checkbook stub" are the cash disbursements book and the cash receipts book. As the names indicate, one is for recording cash disbursements and one for recording cash receipts.

(i) **Cash Disbursements Book.** The cash disbursements book is a book that provides a place to record all disbursements. Usually this is a wide book with 10 to 15 columns, each column of which represents one of the major categories of expense. As each check is written it is recorded in

EXHIBIT 30.5

General Ledger, 2-Column Format

General Ledger									
Cash Account									
Date 19-21	ITEMS	FOLIO	✓	DEBITS	Date 19-21	ITEMS	FOLIO	✓	CREDITS
Jan 1	Bal. beginning			100 00	Jan 31	Expenditures			200 00
31	Receipts			300 00	31	To balance			200 00
	total			400 00		total			400 00
31	Balance			200 00					

the cash disbursements book. The amount of the check is “posted” in two places.³ The first is in the total column which at the end of the month will be “footed” and then posted to the cash account in the general ledger to reduce the cash balance.⁴ The second posting will be in the column showing the category of expense the disbursement represents. At the end of the month each of these expense category columns is footed to get the total disbursements for that particular category. These totals, in turn, are posted to the general ledger. Normally, at the start of each month, a new cash disbursements page is started.

Exhibit 30.6 shows an example of a cash disbursements book for All Saints Church. If a computerized checkbook or disbursement book is used as accounts are entered they are automatically accumulated in accounts that would be the equivalent of the “10 to 15 columns” referred to above—obviously a much less labor intensive exercise. The same observation would be true for the Cash Receipts Book discussion in the following subsection.

(ii) Cash Receipts Book. The cash receipts book is very similar to the cash disbursements book and is used in the same manner. It also has a number of columns to provide for direct posting to the appropriate category of income. Exhibit 30.7 shows an example of a cash receipts book for All Saints Church. Notice that there is a miscellaneous column for those items of receipts that do not fit into one of the income categories for which there are columns. At the end of the month the bookkeeper can either post all of these amounts in total to a miscellaneous category of income in the general ledger, or alternatively can analyze this column and then post to individual general ledger accounts based on this analysis. It should be observed that there is a similar column in the cash disbursements book for expenses that do not fall under one of the other categories.

(iii) General Journal. There are occasions in which an entry that must be made does not involve cash. While this is not often necessary for cash-basis organizations, there are times when adjustments must be made or when the books are “closed” at the end of the year. A general journal is merely a separate journal (or even a separate section of the cash receipts or cash disbursements book) in which all noncash entries are made. These entries are made in traditional bookkeeping fashion showing the name of the account being “debited” and the name of the account being

³ The word *post* means to record or to transfer an amount from one record to another. In this instance, the check is “posted” or recorded initially in the cash disbursements book. At the end of the month, the column totals are posted or “transferred” in total to the general ledger.

⁴ *Footed* means added together.

EXHIBIT 30.6

Simple Cash Disbursements Book

All Saints Church		Cash Disbursements Book																			
January 2011		2		3		4		5		6		7		8		9		10		11	
Date	Page	Check No.	Disbursements	Chry	Misc	Education	Church Office	Buildings	Admin	Misc	Account	Description									
Jan. 3		125	181.56																		
1		126	11.50																		
5		127	11.583																		
6		128	10.070																		
7		129	20.85																		
7		130	5.0100																		
10		131	23.56																		
11		132	21.815																		
13		133	57.580																		
15		134	15.800																		
15		135	21.825																		
15		136	10.326																		
17		137	18.290																		
17		138	22.413																		
20		139	23.030																		
20		140	18.820																		
21		141	18.225																		
21		142	18.290																		
23		143	1.245																		
24		144	1.245																		
28		145	1.245																		
31		146	23.25																		
31		147	17.646																		

CASH-BASIS BOOKKEEPING

EXHIBIT 30.7

Simple Cash Receipts Book

		All Saints Church Cash Receipts Book January 2001 Page 1					
Date	Description	Total Deposited	Plate Collections	Envelopes & Pledges	Special Gifts	Nursery School	Miscellaneous
Jan. 1	Plate Collection	896.25	896.25				
3	Envelope & Pledges	5,109.66		5,109.66			
10	Plate Collection	7,610.00	7,610.00				
10	Envelope & Pledges	5,639.66		5,639.66			
10	Gift of Song Books	1,500.00					1,500.00
10	Plate Collection	5,811.75	5,811.75				
17	Envelope & Pledges	5,466.66		5,466.66			
17	Envelope & Pledges	1,135.10		1,135.10			
17	Gift of John C. Smith	2,000.00				2,000.00	
17	Nursery School Fees	2,400.00				2,400.00	
17	Plate Collection	950.00	950.00				
18	Gift of Mr. & Mrs. Jones	2,500.00			2,500.00		
20	Gift of Thomas Brown	2,500.00			2,500.00		
20	Gift of the Murray Family	1,500.00			1,500.00		
24	Envelope & Pledges	1,135.20		1,135.20			
24	Nursery School Fees	500.00				500.00	
24	Collection	3,075.00	3,075.00				
24	Night	1.00					1.00
24	Balance	13,000.00					
24		3,875.00					3,875.00
31	Plate Collection	800.27	800.27				
31	Envelope & Pledges	1,111.00		1,111.00			
31	Plate Collection	4,830.00	4,830.00				
31	Gift of the Choir	5,000.00			5,000.00		
		47,276.64	28,520.00	20,726.64	10,400.00	5,800.00	4,300.00

“credited,” the amounts involved, and then some explanation of the purpose of the entry. The general ledger account involved is then posted directly from this general journal entry. Here is an example of a journal entry that is being made to correct a misposting in the previous month’s cash disbursements register, which had already been posted to the general ledger when the mistake was discovered:

February 28
Entry #1

Debit Education expense	\$500.00	
Credit Music expense		\$500.00

To correct error made in posting to the cash disbursement register in January. Music books purchased for the nursery school were charged to music expense instead of education expense.

Journal entries follow a prescribed format:

1. They are dated and consecutively numbered for identification purposes.

2. The name of the account being debited is entered first and is shown at the left margin. The amount is entered in the left-hand column of the two columns. If there is more than one account being debited, all debit entries would be entered before entering the credits. All debit amounts on the page should line up in the same column.
3. The name of the account being credited is indented to the right of the left margin to distinguish it from a debit. The amount is likewise entered in a column to the right of the debit column.
4. A brief narrative explanation is given describing the purpose or reason for the entry.

An example of a general journal entry to close the books at the end of the year is illustrated in Exhibit 30.10. This journal entry has a number of debit and credit amounts within the same entry.

For computerized methods, the General Journal is also used to make entries that would not be made through either cash receipt or cash disbursements. For example, interest received on a bank account or fees charged to a bank account.

(iv) General Ledger. The general ledger is a book or ledger in which all categories of transactions are summarized by specific account. The general ledger will contain a separate page for each of the various asset, liability, income, and expense accounts. Transactions are posted to the general ledger from the cash disbursements and cash receipts books and from the general journal entries at the end of each month.

The general ledger will also have an account called "net assets," "fund balance," or "net worth" which will represent the cumulative net worth of the organization. The income and the expense accounts are closed out at the end of each year into this "net assets" account. This is discussed next. New ledger sheets are started at the beginning of each year.

(e) Trial Balance

A "trial balance" is a listing of the balance in each account taken from the general ledger at the end of each month after the cash disbursements book, the cash receipts book, and individual entries from the general journal have been posted to the general ledger. The trial balance is shown with the debit balance amounts in one column and the credit balance amounts in the other. Again, the debit column is on the left side, and the credit is on the right side. Exhibit 30.8 is an example of a trial balance.

After the trial balance is prepared, the two columns should be footed. If everything has been posted correctly, the debit and credit columns should be equal. If they are not, it is because an entry has been

CASH-BASIS BOOKKEEPING

EXHIBIT 30.8

Sample Trial Balance

ALL SAINTS CHURCH		
TRIAL BALANCE		
JANUARY 31, 20X1		
	<u>Debits</u>	<u>Credits</u>
Cash	\$3,859.18	
Net assets (January 1)		\$4,300.00
Plate collections		585.20
Nursery school fees		580.00
Envelopes and pledges		2,077.64
Special gifts		1,000.00
Other income		83.00
Clergy expense	950.00	
Music expense	1,131.63	
Education expense	518.07	
Church office expense	841.83	
Building maintenance	908.32	
Missions	—	
Other expenses	<u>416.81</u>	
Total	<u>\$8,625.84</u>	<u>\$8,625.84</u>

misposted, or perhaps because there is an arithmetical error in arriving at the balance on an individual ledger account.

The trial balance is the bookkeeper's check to make sure that everything has been properly posted and summarized. Once it "balances"—that is, the debits and the credits in total are in agreement—the bookkeeper can then prepare financial statements directly from the trial balance.

(f) Closing the Books at the End of the Year

One of the bookkeeping chores that can cause a great deal of confusion is how to close the books at the end of the year. It is not difficult. Exhibit 30.9 shows the December 31, 20X1, trial balance for All Saints Church before the books are closed. The process of closing the books is simply the transferring of the balances in each of the income and expense accounts to the "net assets" account. The effect is to transfer the net income into the net assets. To make the transfer, the debit balance expense accounts must be reduced to zero by "crediting" them in the same amount. This is done for every expense account. The same process is followed with the income accounts, but since they have a credit balance in them, they are "debited." The difference between the aggregate debits and credits will be the

30.3 CASH-BASIS SYSTEM

EXHIBIT 30.9

Trial Balance before Closing the Books

ALL SAINTS CHURCH PRECLOSING TRIAL BALANCE DECEMBER 31, 20X1		
	<u>Debits</u>	<u>Credits</u>
Cash	\$ 5,307.00	
Net assets (January 1)		\$ 4,300.00
Plate collections		4,851.00
Nursery school fees		30,516.00
Envelopes and pledges		5,038.00
Special gifts		5,800.00
Clergy expense	14,235.00	
Music expense	8,610.00	
Education expense	6,850.00	
Church office expense	5,890.00	
Building maintenance	4,205.00	
Missions	2,000.00	
Other expenses	3,318.00	
Total	<u>\$50,505.00</u>	<u>\$50,505.00</u>

amount of excess of income for the year and would be “credited” to the net assets account.

While separate entries could be made to accomplish this transfer, usually a single journal entry is prepared. Using the trial balance above, the entry would look as shown in Exhibit 30.10. Each debit and credit above, once posted, would reduce the income and expense account to zero and the accounts would be “closed out.” The net assets account after posting the net income of \$1,007.00 would then show a balance of \$5,307.00, which is the net worth of the organization at December 31, 20X1, on a cash basis.

(g) Other Records

As with the checkbook system discussed earlier, a payroll register must be kept in order to keep track of employees’ gross salaries, deductions, and withholdings. The same type of payroll register used with a checkbook system of bookkeeping should also be used. In addition, there are forms on which to record such items as employees’ salaries and deductions, needed to facilitate preparation of the quarterly payroll tax returns and the annual W-2 statement of wages given to each employee for tax purposes. These forms also can be obtained from stationery suppliers.

CASH-BASIS BOOKKEEPING

EXHIBIT 30.10

Close the Books for the Year 20X1 by Closing out All Income and All Expense Accounts into the Fund Balance Account

DECEMBER 31, 20X1		
Entry 1		
Debit Plate collections	\$ 4,851.00	
Debit Nursery school fees	30,516.00	
Debit Envelopes and pledges	5,038.00	
Debit Special gifts	5,800.00	
Credit Clergy expense		14,235.00
Credit Music expense		8,610.00
Credit Education expense		6,850.00
Credit Church office expense		5,890.00
Credit Building maintenance		4,205.00
Credit Missions		2,000.00
Credit Other expenses		3,318.00
Credit Net assets (excess of income over expenses for year)		1,007.00

This chapter has not discussed some of the supporting information the bookkeeper should maintain, giving details of disbursements and receipts. Some organizations follow the practice of making a “voucher” package for each disbursement and assigning it a consecutive number which is cross-referenced on the cash disbursement register. The voucher would contain the vendor’s invoice, receiving reports, or other supporting information to show any interested person why the disbursement was made. Other organizations merely file the paid invoices by vendor name, or in check order sequence. A bank reconciliation must, of course, be prepared promptly upon receipt of the monthly bank statement. The internal controls surrounding bank reconciliations were discussed in Chapter 23.

30.4 CONCLUSION

The cash-basis of bookkeeping, either manual or computerized, is simple and easy to understand and is appropriate for small organizations. Cash-basis bookkeeping is basically a very simple way of keeping records since the only transactions entered into the records are those affecting cash. The principal records in such a system are the records of disbursements and receipts. These records can be informal (as in the checkbook system) or can be more formal (as with the cash receipts and cash disbursements books). What is important is that systematic records be kept and that they be summarized into meaningful classifications. Both the checkbook system and the more formal set of cash-basis records presented in this chapter meet these requirements.

CHAPTER THIRTY - ONE

Simplified Accrual-Basis Bookkeeping

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Many not-for-profit organizations keep their records on a cash basis—but record accrual entries at the end of each reporting period to convert these records to an accrual basis. These accrual entries are recorded by these organizations because they recognize that their financial statements would be distorted if unpaid bills or uncollected income at the end of the month were not recorded. At the same time, they want to keep their

records as simple as possible. They do this by using what is referred to in this chapter as a simplified accrual-basis system. It combines much of the simplicity of cash-basis bookkeeping with the advantages of accrual-basis reporting. This chapter discusses such a simplified accrual-basis system of bookkeeping. This approach will be appropriate for many small or medium-sized organizations that need accrual bookkeeping with a minimum of sophistication.

Once again, these books can be maintained manually. However, with the many inexpensive accounting software applications now available, most organizations utilize these programs for ease of maintaining the records. These software applications also assist in the accuracy of the math.

The following discussion, based on the manual method, will allow for a better understanding of the automated transaction.

31.1 BOOKS AND RECORDS

The following records constitute a “set” of books under the simplified accrual-basis system discussed in this chapter.

- *Cash disbursements book.* The same basic format discussed in the previous chapter (Exhibit 30.6) is used. A separate payroll register is used to record payroll expenses and withholding amounts.
- *Cash receipts book.* The format for this book is identical to the one illustrated in Chapter 30 (Exhibit 30.7). The number of columns for the various categories of income can be expanded as appropriate.
- *General journal.* The same format illustrated in Chapter 30 is followed. In this accrual system, a number of general journal entries will be made at the end of each month.
- *General ledger.* The format illustrated in Chapter 30 is used. However, because of the greater number of general ledger accounts, the account structure is formalized through a “chart of accounts,” discussed below.
- *Payroll register.* The format of this register differs from that illustrated in the previous chapter in that this register now records directly the cash disbursement of payroll tax and withholding obligations. This will be discussed and illustrated in this chapter.
- *Fixed-asset and depreciation ledger.* This is a summary of all fixed assets and related depreciation. Fixed assets and depreciation cause some bookkeeping problems; these are also discussed below.
- *Investments ledger.* This is a summary of all investments.

Most of these records were discussed in the previous chapter on cash-basis accounting. The simplified accrual system is not much more

31.2 CHART OF ACCOUNTS

complicated than the cash-basis system. To a large extent, the simplified accrual system is the worksheet adjustment approach. However, in the system discussed in this chapter, the adjustments are formally entered in the records.

The handling of cash receipts and disbursements is not discussed in this chapter. The reader should refer to the previous chapter to see the general format of the cash receipts book and the cash disbursements book and the mechanics of their use. In this chapter, only records and procedures not discussed in the previous chapter will be covered.

31.2 CHART OF ACCOUNTS

A chart of accounts is a formal listing of all the different accounts being used by the organization. Usually the chart of accounts has numbers assigned to each account to facilitate account identification and to more readily locate the account in the general ledger. Every account in the general ledger is listed in the chart of accounts—all assets, liabilities, income, and expenses. The chart of accounts is an index to facilitate bookkeeping. In Chapter 11, the financial statements of Camp Squa Pan were presented to illustrate simple accrual-basis financial statements. The chart of accounts for Camp Squa Pan is shown in Exhibit 31.1. This is a simple and straightforward chart of accounts. It uses a two-digit number, and each type of account is grouped together. Thus, all assets are shown in numbers 1–30, liabilities in numbers 31–40, and so forth.

For organizations that anticipate large growth, using a larger range of number is suggested, as redoing an organizations chart of accounts can be a large project and can cause difficulty in preparing financial statements—for example:

- 100–1999 assets
- 2000–2999 liabilities
- 3000–3999 net assets

Some numbers are skipped within each grouping; for example, Account 1 is cash in bank, but there is no Account 2. Instead, it skips to Account 3. The reason for this is to allow for future expansion of the chart of accounts as the organization expands. If Camp Squa Pan opens up a second bank account, Account 1 might be for the original bank account and Account 2 could then be used for the new bank account. Notice that there are more accounts in the chart than there are accounts listed on the financial statement. This is so detail can be maintained for internal purposes. There is no reason to burden the reader of the financial statements with more details than are needed since they may detract from an overall understanding of the financial picture. There is no magic way to develop

SIMPLIFIED ACCRUAL-BASIS BOOKKEEPING

a chart of accounts. The important thing is to sit down and think about the financial statement structure, the accounts that will be shown, and the detailed information that might be desired in the books. Then it is a simple matter to group like accounts together and assign numbers to them. The end product of an accounting system is the financial statements, and if the chart of accounts is properly put together, it should be possible to prepare the statements directly from the general ledger without numerous reclassifications.

EXHIBIT 31.1

Simple Chart of Accounts for an Accrual-Basis Organization

CAMP SWUA PAN, INC.	
CHART OF ACCOUNTS	
Assets (1–30)	34 Accrued expenses
1 Cash in bank	36 Bank loans payable
3 Petty cash	38 Camp deposits
4 U.S. Treasury bills	39 Deferred compensation payable
5 Marketable securities	
7 Accounts receivable from campers—20X3	Net assets (41–50)
8 Accounts receivable from campers—20X4	41 Original contribution
9 Employee accounts receivable	42 Retained earnings
10 Other accounts receivable	Income (51–60)
11 Prepaid insurance	51 CAMP FEES
12 Other current assets	55 Interest income
13 Food inventory	56 Other income
15 Land	57 Gain or loss on sale of assets
16 Buildings	
17 Furniture and fixtures	Expenses (61–99)
18 Automobiles	61 Salaries—counselors
19 Canoes	62 Salaries—food
20 Other camp equipment	63 Salaries—camp director
21 Accumulated depreciation—building	64 Salaries—office
22 Accumulated depreciation—furniture and fixtures	65 Salaries—other
23 Accumulated depreciation—automobiles	69 Payroll taxes
24 Accumulated depreciation—canoes	70 Food
25 Accumulated depreciation—other camp equipment	75 Repair and maintenance—buildings
	76 Repair and maintenance—automobiles
	77 Repair and maintenance—equipment
Liabilities (31–40)	80 Horse care and feed
31 Accounts payable	90 Insurance
32 Accrued salaries payable	91 Advertising and promotion
33 Withholding and employer taxes payable	92 Depreciation
	95 Miscellaneous expenses

31.3 MONTHLY ACCRUAL ENTRIES

A chart of accounts can obviously be changed from time to time but it is difficult to make major changes in the middle of the year without creating chaos. New accounts can always be added by assigning the new account a number not previously assigned. Examples of more complex charts of accounts are shown in Chapters 32 and 33.

31.3 MONTHLY ACCRUAL ENTRIES

The basic approach to this simplified accrual-basis system is to keep all records on the cash basis during the month in the manner discussed in the previous chapter but at the end of the month to make adjustments to record accrual items.¹ These adjustments are made through general journal entries following the format discussed in the previous chapter. For most small or medium-sized organizations, there will be 6 to 15 recurring journal entries each month. The recurring journal entries most commonly recorded are:

1. An entry to record unpaid bills
2. An entry to record unpaid salaries, related taxes, vacation and other benefits
3. An entry to record uncollected income from the sale of goods or services
4. An entry to record uncollected pledge income
5. An entry to record depreciation expense
6. An entry to record inventory and prepaid expenses
7. An entry to adjust the value of marketable securities to current market value

Each of these entries and the mechanics involved in determining the amount of the “accrual” are discussed below. For some organizations, only two or three of these entries will be appropriate. If the amounts involved are not material, no adjustment need be made.

(a) Accrual for Unpaid Bills

An estimate must be made at the end of the month as to the amount of all unpaid bills. This is not difficult to do since most bills from vendors are received around the first of the month. Large expenditures of an unusual nature are usually known well in advance and bills for recurring services such as water, electricity, and so on can normally be estimated. The bookkeeper should gather all of this information together and summarize the total of these unpaid amounts, and the expense accounts to be charged.

¹ If financial statements are prepared less frequently than monthly, the accrual entries suggested here would be made only at the end of the period covered by the financial statements.

SIMPLIFIED ACCRUAL-BASIS BOOKKEEPING

The accrual entry itself is straightforward. The expense accounts for the estimated or actual bills should be debited and “accounts payable” should be credited for the total. Here is an example using the chart of accounts for Camp Squa Pan. The bookkeeper will post each of these amounts directly to the general ledger from this journal entry.

July 31 Entry No. 1*	
Debit No. 70 Food	\$485.00
76 Repairs—automobile	116.89
80 Horse care and feed	259.00
95 Miscellaneous	184.62
17 Furniture and fixtures	250.00
19 Canoes	485.00
20 Other camp equipment	618.46
Credit No. 31 Accounts payable	\$2,398.97

To record the liability for unpaid bills at the end of July and to charge the appropriate expense and asset accounts.

*Journal entries can be numbered consecutively from the beginning of the year, from the beginning of the month, or, as here, by the individual date. In this instance, if there were 6 entries dated July 31, they would be numbered from 1 to 6.

(b) Reversal of Accrual

The related problem is how to handle the actual disbursement when the bills are paid. Since the expense account has already been “charged” as a result of this accrual entry, it cannot be charged a second time when the bill is actually paid. To avoid this double charging, the accrual entry is reversed at the beginning of the following month. In this way, all bills can then be paid and recorded in the usual manner on the “cash” basis. The effect of these accrual entries and the reversal in the following month is to record the accrual only for financial statement purposes. To reverse the accrual entry shown above, the entry’s debits and credits are reversed. Here is how the reversal entry would look:

August 1 Entry No. 1	
Debit No. 31 Accounts payable	\$2,398.97
Credit No. 70 Food	\$485.00
76 Repairs	116.89
80 Horse care and feed	259.00
95 Miscellaneous	184.62
17 Furniture and fixtures	250.00
19 Canoes	485.00
20 Other camp equipment	618.46

To reverse accrual entry No. 1 set up at July 31.

31.3 MONTHLY ACCRUAL ENTRIES

If, at the end of August, several of the bills from July are still unpaid, these bills should be added to the new unpaid bills and recorded as an August 31 accrual. During August, when paying bills, no distinction is made between bills that were accrued at the end of July and bills that relate only to August.

Here is the general ledger page for account No. 70, Food Expense. It shows both the accrual at the end of each month and the reversal of the accrual at the beginning of the month. Note that actual expenditures for food are posted directly from the cash disbursements book.

		Food Expense—Account No. 70		
		(Debit)	(Credit)	(Balance)
June	30	Cash disbursements	\$ 6,151.00	\$ 6,151.00
	30	Accrual of unpaid bills	315.00	6,466.00
	30	To record inventory of food*		\$4,000.00 2,466.00
July	1	Reversal of accrual		315.00 2,151.00
	1	Reversal of food inventory	4,000.00	6,151.00
	31	Cash disbursements for July	13,163.00	19,314.00
	31	Accrual of unpaid bills	485.00	19,799.00
	31	To record inventory of food		5,000.00 14,799.00
August	1	Reversal of accrual		485.00 14,314.00
	1	Reversal of food inventory	5,000.00	19,314.00
	31	Cash disbursements for August	10,161.00	29,475.00
	31	Accrual of unpaid bills	1,156.00	30,631.00
	31	To record food inventory		1,000.00 29,631.00

* The entries to record food inventory are discussed below.

In a full accrual system, the organization would use a somewhat different approach that would not require this type of reversal of the accrual entries each month. However, that type of system is more complex. The full accrual system is discussed in Chapter 32.

(c) Accrual for Unpaid Salaries

The easiest way to avoid having to record accruals for unpaid salaries is to pay salaries on the last day of the month. To do this, all employees would have to be paid on a monthly or semimonthly payroll basis. This should be done, when practical, to avoid the bookkeeping problem of setting up an accrual. This is not always possible, and where it is not, an accrual entry should be set up at the end of the month for the unpaid portion of salaries.

There is usually no problem in determining the amount of the payroll accrual. By the time the bookkeeper is ready to make this accrual, the payroll

SIMPLIFIED ACCRUAL-BASIS BOOKKEEPING

covering the last week in the month will probably have been paid and the actual expense known. Unless there were unusual payroll expenses during that period, a simple proration based on the number of workdays is all that is needed. For example, Camp Squa Pan pays its employees every other Monday covering the two weeks ending on that date. The last pay date in July was on the 22nd and the first one in August was on the 5th; therefore 9 days of the 14 days paid on August 5 are applicable to July. If the August 5 payroll totaled \$14,000, the 9/14, or \$9,000, would be applicable to July and should be recorded in an accrual entry.

The accrual entry that would be made to record this payroll would be:

July 31	
Entry No. 2	
Debit No. 61 Salaries—counselors	\$6,000
62 Salaries—food help	1,000
63 Salaries—office	1,000
64 Salaries—other	1,000
Credit No. 32 Accrued salaries payable	\$9,000
To record accrued salaries payable at July 31, $\frac{9}{14}$ of the August 5 payroll is applicable to July.	

As with the accrual entry for unpaid bills, this entry should be reversed in August. The August 5 payroll should be recorded in the same manner as any other payroll. Withholding taxes and the employer's share of payroll taxes are special problems that can cause difficulty. They are discussed in Section 31.4 in this chapter.

(d) Accrual for Vacation

In addition to unpaid salaries, if employees are eligible to earn vacation, a vacation account for any unpaid vacation should be made at the end of the year. The account is the amount of the unpaid vacation for each employee at their current rate of pay. The entry is a debit to salary expenses, as well as a credit to the liability account, accrued vacation.

(e) Accrual for Uncollected Income

The accrual for uncollected income is made in the same manner as the accruals for unpaid bills and salaries. The bookkeeper must accumulate the appropriate information to determine the estimated amount of uncollected income. In the case of Camp Squa Pan, there are always a few campers who sign up for the first two weeks of the camp season but then stay on for additional weeks. The parents are billed for these additional amounts as soon as they decide to let their children stay for additional periods, but there is often a delay before payment is received. At the end

31.3 MONTHLY ACCRUAL ENTRIES

of July, there was a total of 15 campers who had been scheduled to leave on July 15 but had stayed through July 31, and whose fees were still unpaid. Camp fees are \$100 a week, so each camper owes \$228.57—and a total of \$3,428.55 should be recorded as income:

July 31 Entry No. 3	
Debit No. 8 Accounts receivable—campers	\$3,428.55
Credit No. 51 Camp fees	\$3,428.55
To record unpaid camp fees at July 31 arising from extended camp periods.	

This accrual should also be reversed in August, and all receipts from these campers' parents should be handled in the same manner as all other receipts. A formal accounts receivable subsidiary ledger is not suggested.² Instead, an informal system should be used, keeping a copy of the unpaid bill sent to the parent in a folder until paid. Once paid, the bill should be filed with the paid copies of campers' bills.

(f) Accrual for Pledges

As discussed in Chapter 8, accrual-basis organizations should record all significant pledges. Pledges are not applicable to Camp Squa Pan, but if they were, the entry to record the pledge would be made in exactly the same manner as the other accruals discussed above. All payments received on the pledges would be treated as a reduction of the receivable.

(g) Accrual to Record Depreciation

If depreciation is a significant expense for the organization, it should be recorded on a monthly basis. If it is not, depreciation can be recorded every six months, or even annually.

The easiest way to determine the amount of depreciation that should be recorded is to calculate the annual amount at the beginning of the year and then divide by 12 to get the amount to record each month.³ This method ignores depreciation on fixed-asset purchases during the year. Unless purchases or disposals are sizable, they can be ignored on a monthly basis; at the end of the year an adjustment should be made for such items. The calculation of depreciation itself is discussed in Section 31.5 of this chapter.

² An accounts receivable subsidiary ledger is discussed in Chapter 32.

³ In the case of Camp Squa Pan, depreciation would be recorded over the camp season of two months rather than over 12 months.

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The accrual entry that should be made monthly would be as follows:

July 31			
Entry No. 4			
Debit No. 92	Depreciation	\$6,600	
Credit No. 21	Accumulated depreciation—building		\$1,200
22	Accumulated depreciation—furniture and fixtures		600
23	Accumulated depreciation—automobiles		3,000
24	Accumulated depreciation—canoes		1,200
25	Accumulated depreciation—other camp equipment		600
To record depreciation for the month of July.			

This entry, unlike others discussed so far in this chapter, is not reversed in the following month. Instead, depreciation continues to accumulate until such time as it is equal to the cost of the fixed asset, or until the asset is sold. The entries to record the sale of depreciable assets are discussed later in this chapter.

(h) Accrual for Inventory and Prepaid Expenses

Some organizations purchase inventory for use or resale, part of which may still be on hand at the end of the period. Other organizations prepay certain categories of expenses, such as insurance premiums. The disbursement for these items should be treated as any other category of expense in the cash disbursement book. This means that the full amount is “expensed” at the time it is paid for. At the end of each month, it is necessary to record the amount of any remaining inventory, and the unexpired portion of insurance or similar expense. The entry that should be made would be similar to this:

July 31			
Entry No. 5			
Debit No. 11	Prepaid insurance	\$2,800	
13	Food inventory	5,000	
Credit No. 90	Insurance expense		\$2,800
70	Food expense		5,000
To record as an asset prepaid insurance premiums and food inventory at July 31.			

This entry should be reversed in the following month in the same manner as the other accruals discussed above.

(i) Adjustment of Marketable Securities to Current Market Value

Organizations that own marketable securities covered by the FASB standard, discussed in Chapter 6 of this book, will have to adjust the

31.4 PAYROLL TAXES

recorded value up or down each period as the value of the investments fluctuates with the securities markets. Note that this entry is required whether or not any investments were actually disposed of during the period. The entry to record an increase in value is:

July 31		
Entry No. 6		
Debit No. 5	Marketable securities	\$2,745
Credit No. 57	Gain or loss on sale of assets	\$2,745
To record increase in market value of investments during the month of July.		

As discussed in Chapter 6, the gain is reported in the unrestricted class of net assets, regardless of whether the investments relate to an unrestricted or restricted fund, unless the gain is considered to be legally restricted because of an explicit donor stipulation, or provisions of applicable state law.

If the investments had declined in value, the entry would be reversed:

July 31		
Entry No. 7		
Debit No. 57	Gain or loss on sale of securities	\$2,745
Credit No. 5	Marketable securities	\$2,745
To record decrease in market value of investments during the month of July.		

31.4 PAYROLL TAXES

Probably the most difficult “accrual” that has to be made for an organization trying to keep its books on a simple accrual basis is the entry to record payroll taxes. In the previous chapter, it was recommended that payroll taxes be handled strictly on a cash basis. These taxes were recorded when they were paid and not before, and the amount recorded as salary expense on payday was the net amount of payroll after withholding deductions. At the later date, when the withholding and payroll taxes were paid, this additional amount was recorded as salary expense.

This is awkward because most organizations split their payroll into two or more categories of salary expense. If payroll withholding taxes and the employer’s share of taxes have to be allocated between salary categories, it is easier to do this at the time the payroll is prepared than at the end of the month in an accrual entry, or in the following month when the taxes are actually paid. In the simplified accrual system recommended in this chapter, a separate payroll disbursement register is used that is designed to record this withholding at the time the payroll is paid.

EXHIBIT 31.2

Payroll Disbursement Register

Camp Spqr Pn
Payroll Disbursement Register
2014

DATE	Payer	Check No.	Net Pay	(65) Counselor	(62) Kitchen	(63) Salaries Camp Director	(64) Office	(65) Other	Income	Withholding Taxes	TICA
1/17	John Harris	16100	8,000	10,000					1,500	500	
1/17	Tom Hartsagen	16101	8,000	10,000					1,500	500	
1/17	Beth Thomson	16102	8,000	10,000					1,500	500	
1/17	Jim Henry	16103	8,000	10,000					1,500	500	
1/17	Max Staudt	16104	10,000					1,250	1,825	625	
1/17	Tim Bradley	16105	8,000		2,500				1,725	1,725	
1/17	Steve Michler	16106	8,000		2,500				1,500	1,500	
1/17	Bill Weber	16107	10,000			12,500			1,875	4,125	
1/17	Brian Hogan	16108	9,500			12,000			1,800	4,200	
1/17	Karl Miller	16109	8,000			12,000			1,500	1,000	
1/17	Dave Johnson	16110	8,000	10,000					1,500	500	
1/17	Allen Smith	16111	8,000	10,000					1,500	500	
1/17	Barbar McHale	16112	8,000	10,000					1,500	500	
1/17	Sean Bradley	16113	8,000	10,000					1,500	500	
1/17	Bob McDonald	16114	8,000	10,000					1,500	500	
1/17	Harold Faler	16115	18,000			12,000			3,375	2,625	
1/17	Words	16116	8,000						1,500	500	
1/17	Brian	16117	8,000						1,500	500	
1/17	AL Davidson	16118	8,000						1,500	500	
1/17	Steve Kline	16119	8,000						1,500	500	
1/17	Ralph Henderson	16120	8,000						1,500	500	
1/17	Ken Samuels	16121	8,000						1,500	500	
1/17	Karl Miller	16122	16,000						3,000	1,000	
1/17	Jim Henry	16123	8,000	10,000					1,500	500	
1/17	Brian Hogan	16124	9,500			12,000			1,800	4,200	
			81,150.00	370,650.00	4,450.00	36,072.00	8,224.00		73,500.00	26,718.87	

(a) Illustrative Treatment

Exhibit 31.2 shows an illustration of the payroll register for Camp Squa Pan. Notice that the amount shown in the salary expense columns for each employee is the full gross amount of salary. The net amount paid after deductions is shown in the net paid column. The withholding taxes are posted in total at the end of the month to the liability account in the general ledger. When such withheld taxes are paid, they are entered as a disbursement in the cash disbursements book with the offset to the withholding tax account. In the cash disbursements book in Chapter 30 (Exhibit 30.6), the offset (or debit) would be recorded in the miscellaneous column (account No. 33—withholding taxes payable). The total payment of withheld taxes for the month will be posted from the cash disbursement book to the general ledger as an offset to the liability account. At any month end, the remaining amount in the liability account should represent the unpaid taxes.

Unlike the payroll register illustrated in Chapter 30 (Exhibit 30.3), the payroll register in Exhibit 31.2 is actually used to record the disbursement of the net pay to each employee. Notice that there is a space for the check number to be indicated. At the end of the month the total amount disbursed will be posted to the general ledger cash account.

(b) Employer Taxes

There is one final problem. In addition to withholding taxes, there are some taxes that are employer taxes. An example is the employer share of FICA taxes. These amounts will be paid at the same time as the withholding taxes are paid and probably as part of the same payment. These employer tax amounts should be recorded at the end of each month in an accrual entry similar to the entry recording unpaid bills. The debit, in this illustration, would be to payroll tax expense (account No. 69) and the credit account would be to taxes payable (account No. 33). This entry should *not* be reversed at the beginning of the following month since payment is recorded in the cash disbursements book; the “debit” entry will be directly to the taxes payable account as discussed above.

31.5 FIXED-ASSET REGISTER AND DEPRECIATION SCHEDULE

Every organization, including those on a cash basis, should keep a ledger of fixed assets. As was discussed in Chapter 23 of this book, the board has a fiduciary responsibility to effectively control the organization’s assets. The first step in controlling fixed assets is to know what assets the organization owns. A fixed-asset ledger is merely a listing of these assets in a systematic manner. Exhibit 31.3 shows an example of the type of ledger that might be kept by a not-for-profit organization. The first part

records details on the asset itself; the second part records the calculation of depreciation.

A separate page of the fixed-asset register is usually kept for each major category of asset. This categorization should follow the general ledger account description. For example, Camp Squa Pan has separate ledger accounts for buildings, furniture and fixtures, automobiles, canoes, and other camp equipment. Thus there would be a separate page for each of these categories. *Note:* This can also be maintained by using computer spreadsheets software or specialized software designed to track large number of assets. Every time an asset is acquired it should be entered on this ledger. The total dollar amount shown in this ledger should agree with the general ledger account. Thus at December 31, 20X1, the total of the assets listed in the automobile account will equal \$13,456, the amount shown on the balance sheet.

In order to do this, entries must be made in the fixed-asset ledger to not only record additions but also to record when an asset is sold or junked. Two entries must be made. The first is to record the date of disposal on the line in this ledger on which the original entry was recorded at the time it was acquired. This will indicate that the asset has been disposed of. The second entry is recorded in the current period to remove the original cost of the asset. To do this, the original cost is shown in the amount column, in parentheses to indicate that it should be subtracted rather than added. In this way, the amount column should agree with the general ledger. These two entries can be seen in Exhibit 31.3, where an automobile is sold.

At the time a fixed asset is acquired, the bookkeeping entry to set the asset up in the general ledger will be made automatically through the cash disbursements book. The account charged in the cash disbursements book will be the asset account, using the miscellaneous column. The entries to record a sale of fixed assets are discussed below.

(a) Depreciation Schedule

The second part of this fixed-asset ledger shows depreciation and is used only for accrual-basis organizations that capitalize and depreciate fixed assets.⁴ This schedule is used to spread depreciation expense over the depreciable life of an asset using a columnar format. As with the fixed-asset ledger, a separate page should be used for each general ledger category of assets, and often, as illustrated here, it is shown on the same page as the fixed-asset register.

There are several equally correct methods for calculating depreciation in the year of acquisition. If an organization wants to be accurate to the

⁴ Depreciation is the subject of Chapter 5.

EXHIBIT 31.3

Fixed-Asset Ledger and Depreciation Schedule

DATE Acquired	DESCRIPTION	Tag Serial No.	Location	Cost	Depreciable Life	Depreciated	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
April 11	Balance Forward			43,750.00	5													
Aug 16	Ford Pickup Truck	3174610117		43,000.00	5													
Nov 11	Chevrolet Subvan Wagon	3156510746		33,000.00	5													
July 21	Trade-in Ford Purchased in 2008	3171610103		23,000.00	5													
Dec 31	Balance			255,800.00														
June 15	Ford Station Wagon	3116107001		20,000.00	5													
June 15	Trade-in Chevrolet Purchased in 2001	311651744E		13,000.00	5													
Dec 31	Balance			3,117,720.00														
Depreciation Schedule - Automobiles 15 Yrs:																		
Date	Description	Tag Serial No.	Cost	Depreciable Life	Depreciated	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	
Nov 11	Balance Forward	3174610117	43,000.00	5														
Nov 16	Ford Truck	3156510746	33,000.00	5														
July 11	Chevrolet Station Wagon	3171610103	23,000.00	5														
July 11	Sale of 2008 Ford	3171610103	23,000.00	5														
Dec 31	Balance		2,228,120.00															
Nov 15	Ford Station Wagon	3116107001	20,000.00	5														
Nov 15	Sale of 2001 Chevrolet	311651744E	13,000.00	5														
Dec 31	Balance		1,417,500.00															

last penny, depreciation should start in the month the asset is acquired. This degree of accuracy is usually not necessary. A more practical approach that many organizations follow is to assume that all assets are purchased halfway through the year and therefore charge one half year's depreciation in the year the asset was acquired. Thus, for the automobile with a five-year life, the first year's depreciation in 20X1 would be \$350 ($\$3,500 \div 5 \text{ years} - \frac{1}{2} \text{ year} = \350). In 20X2, depreciation would be \$700.

(b) Depreciation Spread Year by Year

All acquisitions for the year for each category should be summarized and entered on this schedule at the end of the year.⁵ All assets with the same depreciable life can be summarized and entered as one amount or each asset can be entered separately. The bookkeeper then calculates the amount of depreciation applicable to each future year and enters these amounts in the columns for that year. For example, if an automobile with a five-year life is acquired on July 1, 20X1, for \$3,500, \$350 depreciation would be shown in the column for 20X1, \$700 in each of the columns for 20X2, 20X3, 20X4, and 20X5, and \$350 in the column for 20X6. To determine the amount of total depreciation for each year, the bookkeeper refers to the total depreciation in each column. In our illustration, depreciation is \$2,221.00 for 20X1 and \$2,412.90 for 20X2.

An adjustment must also be made to this schedule if the automobile is sold before it has been fully depreciated. Depreciation for future periods must be removed from the appropriate years' columns. This future depreciation is removed by subtracting it from these columns. Exhibit 31.3 shows the removal of depreciation on an automobile sold in 20X1 and one sold in 20X2.

(c) Depreciation on Acquisitions during the Year

At the end of the year, the depreciation column for the current year is totaled. As indicated earlier, the amount of depreciation recorded in the monthly accrual entries will normally not be adjusted throughout the year as assets are purchased or sold. Instead, for the sake of simplicity the same amount is used each month. This means that the amount of depreciation actually charged during the year should be compared to the current year's depreciation column in this schedule. An adjustment should be recorded for any difference.

This is less complicated than it seems. It does require that the bookkeeper systematically keep track of acquisitions and disposals. Since for

⁵ If there have been major acquisitions during the year, such as a building, they can be entered during the year to enable the bookkeeper to start depreciating them, as part of the monthly depreciation entry. If no entry is made until the end of the year, the additional depreciation for the current year is recorded at that time.

most organizations purchases of fixed assets are not voluminous, this should not be too difficult.

(d) Entries for Disposal of Assets

Many bookkeepers have difficulty in preparing the bookkeeping entry to record the sale or disposal of a fixed asset. This entry is not difficult if the objective of the entry is kept in mind: namely, to remove the cost of the fixed asset and to remove the accumulated depreciation. Let's take a typical example of an automobile acquired in 20W8 at a cost of \$3,000 with a five-year life. It was sold in July 20X1 for \$800. The biggest problem is to calculate the amount of depreciation that has been taken. In 20W8, the year acquired, one-half year's depreciation was taken, a full year's depreciation in 20W9 and 20X0, and half a year's depreciation through June 30, 20X1 (the asset is sold in July so depreciation has been charged only through June). In total, that is three years' depreciation or \$1,800 ($\$3,000 \div 5 \text{ years} = \$600 \text{ per year} \times 3 \text{ years} = \$1,800$). Here is the entry that records this sale:

July 31		
Entry No. 8		
Debit No. 10	Accounts receivable	\$ 800
23	Accumulated depreciation—automobile	1,800
57	Loss on sale	400
Credit No. 18	Automobiles	\$3,000
To record the sale of an auto acquired in 20W8 for \$3,000, sold in July for \$800, and to remove the accumulated depreciation.		

Notice that we have debited accounts receivable for \$800, the sales price of the automobile. When the cash is received it will be entered in the cash receipts book and the credit will be to accounts receivable. In this way, the cash receipt is recorded in the cash receipts book. The \$400 loss is simply the amount needed to make the entry balance.

A typical variation on the above entry occurs if instead of receiving cash for the old car, this \$800 is allowed as a trade-in value on a car costing \$3,500. The organization pays \$2,700 and its old car and receives a later model. Here is the journal entry that would be made to record this transaction:

July 31		
Entry No. 9		
Debit No. 18	Automobile	\$ 500
23	Accumulated depreciation—auto	1,800
57	Loss on sale	400
Credit No. 31	Accounts payable	\$2,700
To record purchase of an automobile costing \$3,500 and trade-in of old automobile with original cost of \$3,000.		

EXHIBIT 31.4

Investment Ledger

1234 5678
9012 3456

The Jerome M. Starrick Foundation

Investment Ledger

Date	Investment Description	No. of Shares Par Value	Cert. No.	Location of Cert	Cent or FMV at Date Rec'd	Date Sold	Sale Proceeds	Gain or Loss	Acquired	Donor's Name & Address	FMV #	Donor's Tax Basis
7-9-83	Boval	1090	11714	Danville Bank	187,000.00					J.A. Starrick, Danville, Va	1231198*	15,000.00
7-2-83	Boval	3,000	141014		130,000.00	9-13-84	457,500.00	327,500.00	Gift	J.A. Starrick, Danville, Va		15,000.00
7-14-83	Boval	1,775	106075		107,250.00				Gift	J.A. Starrick, Danville, Va		14,000.00
7-14-83	Bank Note	20,000	21573		2,157,300.00				Gift	J.A. Starrick, Danville, Va		1,200,000.00
	Total Dec. 31, 2004				3,447,200.00							
2-1-84	Boval	300	142304	Danville Bank	13,000.00							
2-2-84	U.S. Bond	6315	648156		2,252,000.00				Gift			
	Total Dec. 31, 2004				1,845,190.00							

*Required only for securities held on their date

31.7 CONCLUSION

Notice that the automobile asset account has been increased by \$500, the difference in cost between the two automobiles. Instead the entry might have shown a debit of \$3,500 to record the purchase, and a credit of \$3,000 to remove the old car. Either would be acceptable since the end result is the same. When the organization makes out its check for \$2,700 it will be entered in the cash disbursement book in the same manner as any other disbursement except that the account debited will be accounts payable. This will be shown in the miscellaneous column.

With respect to the old automobile, the bookkeeper must not forget to remove the depreciation for future periods from the depreciation schedule. Notice that depreciation of \$300 in 20X1, \$600 in 20X2, and \$300 in 20X3 has been removed in Exhibit 31.3. If the auto had been sold three months later, in October instead of July, the amount removed from the 20X1 column would have been \$150 instead of \$300. This amount is calculated right up to the end of the month prior to sale since the monthly accrual entry has recorded depreciation to that time.

It is recommended that periodic inventory of fixed assets be performed to ensure accuracy of listing, and if necessary the proper recording of any lost assets.

31.6 INVESTMENT LEDGER

All organizations must keep a record of the investments they own. Often this record is not formalized and when questions are raised later, the organization has difficulty in providing details. Exhibit 31.4 shows an example of the type of investment ledger that should be kept. The information on this schedule is pretty straightforward, except for information on the tax basis of investments received as gifts. This information is required only with respect to "private foundations" and results from the special tax rules for calculating gains for these organizations.⁶ Other organizations can eliminate these columns.

31.7 CONCLUSION

Many organizations will find that the simplified accrual-basis system presented here is a practical way to have the advantage of cash-basis accounting throughout the period while still recording the necessary adjustments at the end of the period to convert to an accrual basis at that date. The only difficulty with this system is determining the amount of each of these accruals at the end of the period. Nevertheless, this is not

⁶ See Chapter 26 for a discussion of these requirements.

SIMPLIFIED ACCRUAL-BASIS BOOKKEEPING

hard to do if it is done systematically. Most nonbookkeepers can keep books in this fashion if they carefully study and follow the examples shown in this and the previous chapter. Where problems arise that are not discussed, a commonsense approach should be used, or help solicited from someone with more experience.

CHAPTER THIRTY-TWO

Full Accrual-Basis Bookkeeping

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The simplified accrual system discussed in the previous chapter will meet the needs of many smaller and even some medium-sized organizations. However, there are many other organizations for which this system is too cumbersome because they have a large number of transactions. For these organizations, a “full” accrual system is more appropriate. This chapter discusses such a system and illustrates the principal records that must be kept.

32.1 BOOKS AND RECORDS

The following records constitute a “set” of books for an organization using a full accrual-basis bookkeeping system. Listed first are the new or revised books or records discussed in this chapter.

FULL ACCRUAL-BASIS BOOKKEEPING

- *Sales register.* This records all sales of goods and services at the time they are made (Exhibit 32.3).
- *Accounts payable register.* This book records all purchases and other obligations at the time the bill or invoice is received from the vendor, rather than at the time paid, as in previous systems (Exhibit 32.6).
- *Accounts receivable subsidiary ledger.* This book records the details of all amounts that others owe to the organization (Exhibit 32.4). Organizations with many pledges receivable will likely want to keep a similar ledger for these.
- *Cash receipts book.* This book changes from that discussed in the previous chapter because much of the information previously recorded in this book is now recorded in the sales register (Exhibit 32.5).
- *Cash disbursements book.* This book changes also from that discussed in previous chapters because much of the information previously recorded in this book is now recorded in the accounts payable register (Exhibit 32.7).
- *Chart of accounts.* This chart is more complex than previously illustrated (Exhibit 32.1).

Books or records that were discussed elsewhere include:

- General ledger (Chapter 30)
- General journal (Chapter 30)
- Trial balance (Chapter 30)
- Payroll register (Chapter 31)
- Fixed-asset register (Chapter 31)
- Investment ledger (Chapter 31)

The new “books” not previously discussed are those in which two types of transactions are now recorded at the time they take place rather than at the time cash is involved—the sales register in which all sales are entered and the accounts payable register in which all bills are entered at the time they are received from the vendors. The basic distinction between a full accrual system and the simplified accrual system discussed in the previous chapter is that transactions are recorded at the time they occur rather than at the end of the month in accrual entries. In all other significant respects, the two systems are similar.

The reader should refer to the previous two chapters for a description of records discussed earlier and for an explanation of how they tie into a total bookkeeping system. These chapters are cumulative and closely interrelated.

(a) Automated Bookkeeping Systems¹

The discussions in Chapters 30–32 generally illustrate manual bookkeeping systems—that is, systems not normally electronic or other automated data-processing operations normally. Organizations, especially larger ones, may find it efficient and cost-effective to use partly or fully computerized systems for bookkeeping and the preparation of financial reports.

Computerized bookkeeping can be done on equipment kept in the organization's own office, or data can be sent out to a service bureau—an organization that uses its equipment to process data for other organizations. There are various existing automated systems available which will meet the needs of most not-for-profit organizations, or an organization with complex or unusual bookkeeping needs can have a custom-made system designed for its use.

Automated bookkeeping systems do not differ at all in concept from the manual systems illustrated, so no separate detailed discussion of them is necessary. Merely, the mechanical aspects of the process are partly or wholly done by automated equipment instead of by human bookkeepers. An important internal control consideration to remember when using automated systems is that the organization must carefully monitor the data processing function, whether performed in-house or at a service bureau, for completeness and accuracy of processing.² It is wishful thinking to assume that because a machine is doing the processing, mistakes cannot occur. Such an assumption will inevitably lead to trouble. Chapter 34 discusses the process of automating a manual system.

(b) Background for Illustrative Example

The full accrual system can best be illustrated by using a typical organization as an example, and in this chapter we will study some of the procedures followed by the Valley Country Club. The procedures discussed here are applicable to many other types of not-for-profit organizations and careful readers will be able to see how the books and procedures illustrated here can be adapted to their own organization. The Valley Country Club's budgeting problems and financial statements were discussed in some detail on pages Chapter 20 and the reader may want to refer to the financial statements shown on those pages. This club is a typical small- to medium-size club. It has an 18-hole course and an Olympic-size swimming pool. The only public building is the clubhouse, in which there is a restaurant, a separate bar, and locker rooms. There are several small maintenance buildings. Members may bring guests to the club but

¹ See Chapter 34 for further discussion of this subject.

² Internal control is discussed in Chapter 24.

the member must pay a greens fee of \$50 and a swimming fee of \$25 for each guest. The members pay no fees as this is part of the annual dues. Guests are welcome in the restaurant and bar but they must be accompanied by a member and in all cases the member is billed for the fees and charges incurred by a guest. No cash is handled and the member signs a "charge slip" for each charge incurred. No tips are allowed, since 5 percent tax and 15 percent gratuity are added to all charges. The members are billed in the first week of the month for the previous month's charges.

32.2 CHART OF ACCOUNTS

Exhibit 32.1 shows a chart of accounts for the Valley Country Club. This chart of accounts is considerably more complex than the chart shown in Chapter 31. It is complex not only because of the greater number of accounts, but because expenses are kept by type of club activity.

(a) Coding

Look first at the top group of accounts under the major caption, "Expenses." These are the major expense groupings. The subcodes that are immediately below this group are used with each of the major codes. For example, if salaries are to be charged to golf activities the code number would be "410." If salaries are to be charged to the bar then account "710" would be used, and so forth. This type of classification allows the bookkeeper to learn quickly almost all account numbers since only the major group codes and the major subcodes must be learned. There are also a number of specific accounts, mostly involving general and administrative expenses, and these are listed separately.

The income and expense accounts are three-digit codes; the asset and liability accounts are two-digit codes. In this accrual system, the code numbers frequently will be used instead of account names. This is one of the advantages of having a chart of accounts. It cuts down on both the amount of writing and the space involved.

32.3 SALES REGISTER

Exhibit 32.2 shows an example of the charge slip used by the Valley Country Club. Notice that it is prenumbered to ensure that accountability is maintained. Charge slips are prepared for every charge to members. At the end of each day, all of the charge slips are forwarded to the bookkeeper in numerical sequence for each activity or location. The bookkeeper should check the sequence carefully. If some of the charge slips were lost before they were recorded, the club would lose income since there would be no way to know whom to charge, or the amount. After

32.3 SALES REGISTER

EXHIBIT 32.1

Chart of Accounts for a Country Club

THE VALLEY COUNTRY CLUB	
CHART OF ACCOUNTS	
<u>Assets</u>	<u>Liabilities</u>
10 Cash in bank	70 Accounts payable
11 Cash in bank—payroll	73 Short-term loans payable
12 Cash in bank—savings	74 Accrued expenses
20 Members' accounts receivable	75 FICA and withholding taxes payable
21 Employees' accounts receivable	76 Sales taxes
22 Other accounts receivable	77 Real estate taxes
23 Allowance for bad debts	78 Other taxes
32 Inventories—greens and grounds	79 Wages payable
35 Inventories—pool supplies	80 Employees' tip fund
36 Inventories—restaurant	85 Mortgages—long-term
37 Inventories—bar	87 Member bonds due 20X8
40 Prepaid expenses—insurance	90 Contributed capital
41 Prepaid expenses—taxes	95 Surplus
42 Prepaid expenses—other	
50 Land (original cost)	<u>Income</u>
52 Greens and grounds improvements	110 Initiation fees
53 Clubhouse	111 Dues—full members
54 Golf carts	112 Dues—social members
55 Swimming pool	120 Golf fees
56 Restaurant equipment	130 Locker room fees
57 Bar equipment	140 Golf cart rentals
58 Automotive equipment	150 Swimming fees
59 Club furniture and fixtures	160 Sales—dining room
63 Accumulated depreciation—clubhouse	170 Sales—bar
64 Accumulated depreciation—golf carts	180 Other
65 Accumulated depreciation—swimming pool	190 Discounts earned
66 Accumulated depreciation—restaurant and dining room	191 Interest income
67 Accumulated depreciation—bar	192 Cash over/short
68 Accumulated depreciation—automotive equipment	
69 Accumulated depreciation—club furniture	<u>Expenses</u>
	299 Greens and grounds
	300 Clubhouse
	400 Golf activities
	500 Swimming pool
	600 Restaurant
	700 Bar
	900 Administrative

FULL ACCRUAL-BASIS BOOKKEEPING

EXHIBIT 32.1 (CONTINUED)

Chart of Accounts for a Country Club

	<u>Subcodes</u>		914	Janitorial
10	Salaries		915	Other
20	Supplies		940	Interest expense
30	Repairs and minor maintenance		941	Auditing and legal
40	Other costs		942	Postage
60	Depreciation		943	Telephone
			944	Insurance
			945	Real estate taxes
	<u>Specific Accounts</u>		946	Income taxes
610	Dining room salaries		947	Pension expense
611	Kitchen salaries		948	Electricity
620	Food		949	Water
720	Liquor and mixes		950	Unemployment insurance
911	Club manager's salary		951	Bad debts
912	Secretarial and clerical		952	Employer payroll taxes
913	Bookkeeping			

accounting for the sequence of all charge slips, the bookkeeper enters each charge slip in the sales register. Exhibit 32.3 shows an example of a sales register. Each charge slip has been entered individually in the sales register in order to establish a permanent record of all charges.³ The distribution of the charge, sales tax, and gratuity is shown in the appropriate column.⁴ The account numbers shown at the top of the page are the general ledger account numbers. At the end of the month all columns are totaled and the totals posted to the general ledger. The total sales column figure is posted to the accounts receivable control account in the general ledger. The other columns are posted to the general ledger account indicated at the top of the column. In order to be sure that all accounts are posted, the bookkeeper puts a checkmark (✓) beside each column total as it is posted.

³ Some clubs do not enter these charge slips individually in the sales register. Instead the bookkeeper, using an adding machine, runs a recap of the charge slips for each day, by account classification. Then only the total of these charges is entered in the sales register. When this procedure is followed, the charge slips will probably be photocopied before being sorted by member number. In this way, a permanent record is created to support the summary entry in the sales register.

⁴ While in this illustration the sales tax and gratuity amounts have been posted separately for each charge slip, some time could have been saved by entering only the total amount of the member's charge (including the sales tax and gratuity) and the income account distribution. Because both the sales tax and the gratuity amounts are a fixed percentage (5 percent and 15 percent) of charges, these amounts can be calculated at the end of the month by multiplying the total of all income accounts by these fixed percentages. In Exhibit 32.3 the aggregate of the income accounts (accounts 120-180, or \$62,505.27) multiplied by these two percentages would give the amounts shown in the sales tax column (\$3,125.26) and gratuity column (\$9,375.80). These last two columns could then be eliminated.

EXHIBIT 32.4

Individual Accounts Receivable Ledger Card

THE VALLEY COUNTRY CLUB		MEMBER NAME		
P.O. BOX 144		BRILLON, JOHN		
DAYTONA BEACH, FLORIDA 32117		MEMBER ADDRESS		
STATEMENT OF MEMBER'S ACCOUNT		2641 ADAMS STREET		
		DAYTONA BEACH, FLA.		
		MEMBER NUMBER		
		89		
DATE	DESCRIPTION	DEBIT	CREDIT	BALANCE
JUNE 30	BALANCE			345.18
JULY 1	# 4402	9.54		
1	22815	43.39		
3	4079	14.53		
3	23019	24.56		
8	11345	14.00		
8	4107	45.44		
14	4314	33.16		
14	PAYMENT		345.18	
22	# 4516	13.15		
22	23990	43.67		
31	BALANCE			241.44

hand-posted, or, if the volume is sufficient, a small bookkeeping machine or one-write system can be used to post the charge slip to both the sales register and the ledger card simultaneously.⁶

The organization keeps the charge slips, as a part of the organization's permanent records, and only sends the member a copy of the ledger card (or a monthly statement). They will send a photocopy of the charge slip to the member if there is a question. Obviously there will be fewer questions raised if the charge slip is sent with the bill. As noted in Section 28.7 of Chapter 28 of this book, the club must document certain information for tax purposes.

The charge slip is the most logical place to do so, and accordingly, the club may prefer to keep these slips permanently. One alternative is for the charge slips to be prepared in duplicate or to be photocopied. There will be,

⁶ A one-write system is a system where, through specially designed forms and carbon paper, multiple records are prepared simultaneously.

FULL ACCRUAL-BASIS BOOKKEEPING

of course, receipts during the month from the member paying a bill from the previous month. As discussed below, all receipts are entered in the cash receipts book and then posted to the accounts receivable ledger cards. The individual accounts to be credited can be either posted directly from the cash receipts book or from a "credit advice" slip prepared at the time the receipt is entered in the cash receipts book. If the credit advice slip approach is followed, the slips are sorted and posted in the same manner as the charge slips. Either approach can be used, but it is important to "control" carefully the postings to be sure they are posted to the right account.

The general ledger accounts receivable account becomes the "control" account for all the individual members' accounts. In the sales register in Exhibit 32.3, the total amount of all charges to the members (\$75,006.33) is posted in one amount to the general ledger accounts receivable control account. The same is true with the cash receipts book; \$70,001.65 would be posted (Exhibit 32.5). If no mistakes have been made in posting, the aggregate of the individual ledger card balances should be the same as the balance in this control account after all postings, since the sources of the postings are the same. Before mailing the members' monthly bills, all individual bills should be added together to be certain that the total of these bills does agree with this general ledger control

EXHIBIT 32.5

Cash Receipts Book

Date		Description	Member No.	Total Cash	Members' Acct. Bnc. A/C #20	Other Credits
July 14	8.50	Brillon	4851	146.18	146.18	
14	1.62	McNair	4851	1.62	1.62	
14	7.70	Seaside	4851	7.70	7.70	
14	4.80	Wander	4851	4.80	4.80	
14	6.75	Bungle	4851	6.75	6.75	
14	8.82	Aschall	4851	8.82	8.82	
14	3.80	Pilvers	4851	3.80	3.80	
14	11.41	Diagona Tour		11.41		11.41
14	6.82	Riley	21	6.82	6.82	
14	15.00	Jackson	21	15.00	15.00	
14	12.25	Allen	21	12.25	12.25	
14	2.03	Thompson	21	2.03	2.03	
14	10.45	Williamson	21	10.45	10.45	
14	6.50	McDonald	21	6.50	6.50	
14	8.13	Pearson	21	8.13	8.13	
14	13.40	Horgan	21	13.40	13.40	
14	1.50	Don		1.50		
14	2.84			2.84		
14	2.17			2.17		
14	2.39	Brillon	21	2.39	2.39	
21		Marrs				
21		Nichols				
21	5.16	Webb		5.16	5.16	
				70,001.65	70,001.65	63.61
						63.61

account. If there is a large volume of activity, this “balancing,” as it is called, can be a major job each month. But it must be done, and the individual bills should not be sent out until they are in agreement in total.

32.5 CASH RECEIPTS BOOK

As indicated above, the cash receipts book is the source of postings for the individual members’ receivable accounts. This means that the form of cash receipts book discussed in the previous chapters must change in format. Exhibit 32.5 shows an example of the new format. This is a very simple cash receipt register because the Valley Country Club makes sales only to its members, and only on a charge basis. Therefore there are seldom any receipts from sources other than the members. Because all receipts are posted to the members’ accounts, the credit entry is usually to accounts receivable. There is an “other” column in this cash receipts book to provide for the occasional receipt from some other source.

There are two ways to handle the posting to the members’ accounts. The first is to post directly from the cash receipts book to an individual member’s ledger card. This is probably the most common method where the volume is not too large. One alternative is to prepare an “advice slip”⁷ at the time the cash receipts book entry is made and use this advice slip as a posting source. Or, if a bookkeeping machine or one-write system is used, the posting to the member’s account can be made simultaneously at the time the posting to the cash receipts book is made.

32.6 ACCOUNTS PAYABLE REGISTER

An accounts payable register is a book in which all bills are formally recorded at the time they are received. In the process of recording these “payables,” the expense classification to be charged is also entered, and this book becomes the primary source of charges to the various general ledger expense accounts. Exhibit 32.6 shows an example of the first page of an accounts payable register. The actual register could extend across a double page in order to provide enough columns for all major categories of expense. Using a double page would give about 20 columns.

The date of actual payment is not of significance because the bill will show as an account payable until paid. The “date paid” and “check number” columns are provided in this register to show a record of which accounts have been paid and which have not been paid. If there is no entry in these two spaces, the bill has not been paid and it is still an

⁷ An illustration of a credit advice slip is not shown. However, the format can be very simple. Some organizations even use the envelope in which payment was received as the advice slip, marking the amount of the payment on the envelope. The bookkeeper can easily work out the preferred method.

32.7 CASH DISBURSEMENTS BOOK

account payable. This is a control to keep track of the unpaid accounts payable. Each month after all general ledger postings have been made, an adding machine tape should be taken of these unpaid accounts and the total agreed with the amount in the general ledger. If the total does not agree, an error has been made and the bookkeeper should go back and check to be sure that every cash disbursement involving accounts payable has been posted as being paid in the accounts payable register. Although it is not necessary to do so, most organizations enter all bills in this register, even those they are going to pay the day they receive them. It is easier to record an expense in this register than in the cash disbursement book since the various expense classifications are in columnar form.

At the end of the month, the accounts payable register is totaled by column. The total of the accounts payable column is posted to the accounts payable liability account. This liability account will be reduced as disbursements are made through the cash disbursement book. The various expense account columns should also be posted, and if there are any amounts in the "other" column, they should be analyzed and posted individually.

32.7 CASH DISBURSEMENTS BOOK

With all bills being entered in the accounts payable register when received, there is no longer a need to have columns for the various expense categories in the cash disbursements register. In fact, the cash disbursements book becomes a much smaller book with only a few columns. Exhibit 32.7 shows an example of this book. Notice that there are two bank account columns. Many organizations have more than one active bank account and this is how the second bank account is handled. The amount of the check disbursed is entered in the appropriate column depending on the bank on which the check is drawn. The offsetting debit is normally accounts payable since all bills are entered in the accounts payable register. A column for this debit to accounts payable is provided. The total of the accounts payable column is posted to the general ledger at the end of the month, which serves to reduce the accounts payable amount recorded as an obligation from the accounts payable register. The total of the accounts payable column is posted to the general ledger at the end of the month, which serves to reduce the accounts payable amount recorded as an obligation from the accounts payable register.

There is also a column for discounts earned. If payment is made within the time specified on the vendor's invoice for cash discounts, it should be taken. Thus the amount of the check will be less than the amount of the bill, and, therefore, less than the payable set up in the accounts payable register. The discounts earned column would be the place where this discount would be shown. In this way, the amount

EXHIBIT 32.7

Cash Disbursements Book

The Valley Country Club
Cash Disbursement Book

Date	Check No.	Disbursement	Accounts Payable (Dr)		Payroll	Other	Amount
			National Bank	Payable (Dr)			
201		Balance Forwarded from Previous Page					3,463,040
July 26	1649	McCoven's Sporting Goods	769,502	1,400,325			2,169,827
26	170	Pest Food Inc.	24,530	2,530			27,060
26	171	Volusia Tax Beard	11,231	11,231			22,462
26	172	Thompson's Hardware	4,890	4,890			9,780
26	173	Jones Meat Market	6,591	6,591			13,182
26	174	Ted's Frozen Foods	20,104	20,104			40,208
26	175	Brown's Seed Supply	4,120	4,120			8,240
26	176	Johnson's Lumber Co.	2,375	2,375			4,750
26	177	Business Review	2,000	2,000			4,000
26	178	A.C. Sporting Goods, Inc.	4,120	4,120			8,240
26	179	Pickering Pool Supplies	3,500	3,500			7,000
27	180	Charona Bank & Trust	485,571	485,571			971,142
27	181	Merton Frozen Goods	161	161			322
27	182	Williams Printers	7,350	7,350			14,700
		Bill's Produce Market	9,510	9,510			19,020
		Les Lawn Service	1,525	1,525			3,050
27	183	Pool Goods	31,575	31,575			63,150
27	184	Ludlow	45,160	45,160			90,320
27	187	A.B.C. Stationery	5,174	5,174			10,348
		Repair Service	5	5			10
31	225	Martin & Ross Linen Supplies	1,475	1,475			2,950
31	226	Thomas Lawn Care	1,850	1,850			3,700
			2,073,849	2,562,246			4,636,095
					485,571		485,571
					1,250		1,250
					45,300		45,300
					3,388,75		3,388,75
						3,463,040	3,463,040

32.8 MONTHLY ACCRUAL ENTRIES

entered in the accounts payable column will be the total amount owed. The “discounts earned” column is a credit or income item. For example, note that the July 26 payment to Thompson Hardware was less a 5 percent discount of \$4.52, but the credit to accounts payable was the total amount of the bill, \$90.45.

A column has been provided to record the payment of FICA and withholding taxes. The obligation to pay these withholding taxes is recorded in the payroll register (see Exhibit 31.2 in the previous chapter), and this column, when posted to the general ledger, serves to reduce the liability. As with the other books, a column is provided to record transactions not reflected in one of the specific columns. There will be relatively few entries recorded in this column. In our illustration, payment of the sales tax collections in June has been recorded in this column. The actual liability entry setting up the obligation was recorded through the sales register (Exhibit 32.3).

32.8 MONTHLY ACCRUAL ENTRIES

Notwithstanding the use of the various journals and registers discussed above, several entries must still be made on a monthly basis in the general journal. These entries relate principally to adjustment of accounts not involving cash.

(a) Employer Payroll Taxes

The payroll register provides a place to record the amount of withholding and FICA taxes withheld from employees’ wages. It does not provide, however, for the recording of the employer’s share of such taxes. An accrual entry must be made monthly to record such amounts. The amount of FICA taxes is usually exactly the same amount withheld from employees during the period. At the time the payroll register is totaled at the end of the month, the bookkeeper should note the amount of employee taxes and then make the following entry:

JULY 31	
ENTRY NO. 5	
Debit No. 952 Payroll tax expense	\$2,117.89
Credit No. 75 FICA and withholding taxes payable	\$2,117.89
To record the employer's share of payroll taxes for the month of July.	

In this illustration, all of this payroll tax expense was charged to a single account. Some organizations prefer to split this expense among all payroll expense accounts. If this is done, it can either be done monthly at the time the above entry is prepared, or it can be done at the end of the year by analyzing total payroll for the year and allocating the total employer taxes charged to account No. 952.

(b) Depreciation

An entry must still be made monthly to record depreciation expense. The procedures outlined in Chapter 31 should be followed.

(c) Inventories

Inventories can be handled in two ways. The first way, which is probably how it would be handled with the Valley Country Club, is to charge all inventory items to expense as the bills are received, and then to adjust, at the end of the month, for any inventory still on hand. This is the method used with the simplified system discussed in Chapter 31. The other approach is to record all inventory purchases as assets (i.e., debit to the inventory asset account and credit to accounts payable) and then periodically to reduce the carrying value of this inventory as it is consumed. The entry for this adjustment would be a debit to expense and a credit to the inventory asset account.

(d) Accrued Salary Payable

There is no automatic procedure to record accrued salary payable even with a full accrual system. Accordingly, an accrual entry must still be made for the portion unpaid at the end of the month. The procedures followed in this type of accrual are exactly as discussed in Chapter 31.

(e) Accrued Vacation Payable

There is no automatic procedure to record accrued vacation payable even with a full accrual system.

(f) Prepaid Expenses

Insurance premiums, taxes, and similar items should be charged to the appropriate prepaid asset account at the time that they are recorded in the accounts payable register. Then, at the end of the period, the portion of this prepaid expense which has expired by virtue of passage of time or usage should be written off to expense in a journal entry. The type of entry to be made would be as follows.

JULY 31		
ENTRY NO. 6		
Debit No. 944 Insurance expense	\$100.00	
Credit No. 40 Prepaid insurance		\$100.00
To record as an expense that portion of the prepaid insurance applicable to July.		

32.9 CONCLUSION

This type of entry might not be made on a monthly basis if the amounts involved were not large. Often quarterly or even semiannual entries are all that are necessary.

(g) Reserve for Bad Debts

From time to time, a reserve for bad debts will be needed. This type of entry is also handled through the general journal. The entry in the case of the Valley Country Club would be as follows.

JULY 31	
ENTRY NO. 7	
Debit No. 951 Bad debts expense	\$200.00
Credit No. 23 Allowance for bad debts	\$200.00
To set up an allowance for bad debts for the portion of accounts receivable that are in dispute with estate of deceased member.	

An alternative approach is to record the bad debt expense only at the time specific accounts receivable are written off. If this approach were followed, then the credit at the time of write-off would be to accounts receivable (account No. 20) rather than to the allowance account.

(h) Investments

An entry must be made to adjust the value of marketable securities to current market value.

32.9 CONCLUSION

The two principal books that allow an organization to record certain transactions on an accrual basis are the sales register and the accounts payable register. Both have as their intent the recording of transactions as they occur rather than when cash is involved. As with the other records discussed in earlier chapters, they are basically commonsense types of records that are designed to record transactions in a systematic manner so as to allow like transactions to be grouped together.

CHAPTER THIRTY-THREE

Fund Accounting Bookkeeping

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There is only one important difference between fund accounting and the other accounting methods used by not-for-profit organizations. In fund accounting, a number of separate accounting entities are maintained that are referred to as "funds." A fund accounting system presents no special difficulty, except for the problem of keeping the transactions of these funds separated while integrating all of the funds into a total bookkeeping system. An organization using fund accounting can be on the cash basis, a simplified accrual basis, or a full accrual basis. The same types of records discussed in the three previous chapters can be used in fund accounting. This chapter will discuss only the problems related to fund accounting.

For purposes of discussion an accrual basis research institute will be used as an illustration. The J.W.M. Diabetes Research Institute was discussed and financial statements were presented in Chapter 12 (see

Exhibits 12.13 to 12.17) and the reader may find it helpful to refer back to these statements. This organization uses fund accounting and has five fund “groupings”: unrestricted general fund, unrestricted investment fund, fund for specified purposes, plant fund, and endowment fund.¹ Readers are reminded that for purposes of external reporting, as discussed in Chapter 12, “net-asset” accounting must be used in order to comply with generally accepted accounting principles. However, the classes of net assets can be further segregated into “fund balances.” This presentation is not frequently used but is an option.

33.1 CHART OF ACCOUNTS

The key to a good bookkeeping system is a carefully thought-out chart of accounts. This is especially true when fund accounting is used because there are several completely separate accounting entities, each of which has its own accounts for assets, liabilities, income, expense, and net assets. Yet these separate entities must be integrated carefully into an overall chart of accounts. Each fund grouping must have an account structure similar to the other groupings, both for ease in keeping the records and for ease in preparing financial statements.

Exhibit 33.1 shows the chart of accounts for the J.W.M. Diabetes Research Institute. This chart is basically a three-digit system with the first digit designating the fund grouping. These fund groupings are shown at the left-hand top column on the chart. All asset, liability, income, and expense codes are two-digit codes and are the second and third digits in the three-digit account code. These two-digit codes are used with the fund grouping code to designate the specific fund grouping they belong to. For example, code 107 is “unrestricted general fund marketable securities” while 507 is “endowment fund marketable securities.” Expense groupings are also used in a similar manner. There are four expense groups (instruction, research, administration, and maintenance). For each of these groups there are six single-digit expense codes and they are the third digit from the left. For example, “0” is salaries. Code 60 is “instruction salaries” while code 90 is “maintenance salaries.” In addition to these codes, there are a few other specific codes that are not applicable to these four major expense groups and they are listed separately.

¹ The reader should be careful to distinguish between a fund “grouping” and an individual fund. A *fund grouping* is all of the individual funds having similar characteristics, whereas a *fund* is an individual entity being accounted for as a separate unit. Another expression used in this chapter is “name fund.” A *name fund* is a fund that bears a name, usually of the principal donor. There may be other funds, with identical restrictions, but the separate identification by “name” is maintained for any one of a number of reasons. These concepts were discussed in Chapter 4.

33.1 CHART OF ACCOUNTS

One of the features of this chart of accounts is that it facilitates the preparation of financial statements in columnar format or, if desired, in a consolidated format. All similar items are coded with the same last two digits and this can be a time saver for the bookkeeper.

(a) Interfund Accounts

In fund accounting, there are frequently interfund receivables and payables. In this chart of accounts, all of these interfund balances are shown in

EXHIBIT 33.1

Chart of Accounts for a Research Institute that Uses Fund Accounting

J. W. M. DIABETES RESEARCH INSTITUTE CHART OF ACCOUNTS	
<u>Fund Grouping</u>	<u>Liabilities</u>
100 Unrestricted general fund	30 Accounts payable
200 Unrestricted investment fund	31 Short-term loans
300 Fund for specified purposes	32 Payroll taxes
400 Plant fund	33 Salaries payable
500 Endowment fund	34 Grants paid in advance
	35 Other short-term liabilities
	36 Long-term debts
<u>Assets</u>	<u>Interfund Receivables (Payables)</u>
01 Cash in bank	41 Unrestricted general fund
02 Cash in savings bank	42 Unrestricted investment fund
03 Petty cash	43 Fund for specified purposes
05 U.S. Treasury bills	44 Plant fund
06 Marketable bonds	45 Endowment fund
07 Marketable securities	
08 Investment real estate	<u>Net Assets</u>
09 Other investments	46 Unrestricted
10 Contracts receivable—current year	47 Unrestricted—allocated
11 Contracts receivable—prior year	48 Restricted
12 Other receivables	<u>Income</u>
12 Inventory—books	50 Grant and contract income
14 Inventory—supplies	51 Other fees
15 Prepaid expenses	
18 Land	
19 Buildings	
20 Accumulated depreciation—building	55 Contributions and gifts
21 Equipment	
22 Accumulated depreciation—equipment	57 Investment income
23 Vehicles	58 Interest income
24 Accumulated depreciation—vehicles	59 Realized gains or losses

FUND ACCOUNTING BOOKKEEPING

EXHIBIT 33.1 (CONTINUED)

Chart of Accounts for a Research Institute that Uses Fund Accounting

<u>Subcodes</u>	-4 Books
6- Instruction	-5 Other
7- Research	<u>Specific Codes</u>
8- Administration	86 Insurance
9- Maintenance	87 Bad debts
<u>Type Expense</u>	88 Depreciation
-0 Salaries	89 Legal and accounting and investment fees
-1 Retirement benefits	97 Contracted services
-2 Major medical	98 Utilities and fuel
-3 Stationery and supplies	

five accounts for each fund grouping. The only distinction between a receivable or a payable with a particular fund is whether it is a debit (receivable) or a credit (payable). For example, if the unrestricted general fund owes the unrestricted investment fund \$100, the unrestricted general fund would show a credit of \$100 in Account 142; the unrestricted investment fund would show a debit balance in Account 241. Notice the account numbers 142 and 241. The first digit designates the fund in which the account belongs (1 = unrestricted general fund, 2 = unrestricted investment fund) and the third digit designates the fund that either is owed, or owes, the \$100. In the first instance, the 2 designates the unrestricted investment fund. In the other, the 1 designates the unrestricted general fund.

Likewise, if the endowment fund owed \$50 to the unrestricted general fund and \$10 to the fund for specified purposes, the respective fund groupings would look like this in a columnar format:

<u>Unrestricted General Fund</u>	<u>Fund for Specified Purpose</u>	<u>Endowment Fund</u>	<u>Total All Funds</u>
145 \$50		541 (\$50) credit	—
	345 \$10	543 (\$10) credit	—

As can be seen, if all interfund receivables and payables are shown in columnar form in this fashion, the “total all funds” column will net out to zero.

(b) “Name” Funds

No separate listing is shown for the various name funds within the fund for specified purposes or in the endowment fund. As can be seen from

Exhibit 12.15 in Chapter 12 of this book, the J.W.M. Diabetes Research Institute has many such funds.

If there are only one or two name funds, probably no separate set of account numbers need be assigned. There are not usually many transactions in each such fund and it will be easier to analyze each name fund separately once or twice a year than to keep a separate set of accounts for each. But if there are many name funds, as is the case here, or if the book-keeping is done using computer software where account numbers are really needed to facilitate posting, then a further account-number structure should be set up. The easiest way is to assign one more, or even two more, digits to the three-digit code to designate the specific fund involved. These would be the fourth or fifth digits reading from the left. Thus marketable securities in the Malmar endowment fund might be shown as code 507-1: the 507 being the code number for endowment fund marketable securities, and the 1 being the code number assigned to the Malmar Fund. There would be a complete balancing set of accounts maintained for this subcode 1. If more than 10 such name funds were used then a second digit would be added (507-11). The same procedure would be followed with the fund for specified purposes. In this way, the organization can have any number of name funds all within the same chart of account structure.

33.2 BOOKS AND RECORDS

The books and records used by fund accounting organizations are basically the same records discussed in Chapters 30-32 of this book. A completely separate set of books may be maintained for each fund grouping rather than trying to integrate all of the fund groupings into a single set of books. With a separate set of books the unrestricted general fund would have its own cash receipts book, cash disbursement book, accounts payable register, general ledger, general journal, grant income ledger, and so on. Each of the other fund groupings would also have its separate set of books, although not all of the books would be appropriate for each grouping. In the case of the J.W.M. Diabetes Research Institute, separate books are kept for each fund grouping, as shown below. Even where a fund grouping requires one of these books, the actual format of the book may be much simpler than the format used by the unrestricted general fund. For example, the number of expense categories and volume of transactions applicable to the fund for specified purposes are relatively few, and the cash disbursement book may have only a debit and credit column with each expenditure being posted individually to the general ledger. In fact, if there are only a few cash transactions during the year, the cash receipts book and cash disbursements book may not be used at all. All entries, including cash entries, would then be entered in the general journal and posted directly and individually to the general ledger accounts.

FUND ACCOUNTING BOOKKEEPING

Book	Unrestricted General Fund	Unrestricted Investment Fund	Fund for Specified Purposes	Plant Fund	Endowment Fund
General ledger	x	x	x	x	x
General journal	x	x	x	x	x
Cash disbursement	x		x		
Cash receipts	x		x		
Accounts payable register	x				
Tuition income ledger	x				
Payroll register	x				
Investment ledger	x	x			x
Fixed asset register	x			x	

The plant fund may or may not include assets other than plant or fixed assets. If the board places donor-restricted gifts for plant additions into the fund for specified purposes then only fixed assets would be shown in the plant fund. This type of decision, of course, affects the books that must be kept. In the case of our illustration, only fixed assets are shown in the plant fund.

(a) Books of "Name" Funds

Each individual name fund within each fund grouping will also require separate records but these records will consist only of a set of general ledger pages for the accounts maintained for each name fund. For example, if the fund for specified purposes has two name funds, each with opening net assets represented by cash in a savings account and each having contributions and expenses during the year, then the general ledger accounts would be as follows:

	<u>Name Fund No. 1</u>	<u>Name Fund No. 2</u>
Savings cash	302-1	302-2
Net assets	348-1	348-2
Contributions	355-1	355-2
Interest	358-1	358-2
Expenses	3--1	3--2

These general ledger accounts would be filed in account number order rather than being segregated by each of the name funds. When a trial balance of the general ledger of the entire fund grouping is needed, the bookkeeper will take a trial balance of the individual general ledger accounts for all of the name funds. For purposes of statement presentation these name accounts would be combined to get the figures for the fund grouping as a whole. Exhibit 33.2 shows an example of a combining

EXHIBIT 33.2

**Example of a Preclosing Worksheet in Which Individual "Name" Endowment Funds Are Combined; for Financial Statement Purposes,
Only the Totals Would Be Reported**

Sub-Code	Accounts									
	01/02	06/07	41/45	48	55	57/58	59	61/99		
	\$ 4,000	\$ 108,655	(\$ 4,970)	(\$ 110,700)		(\$4,970)	\$ 3,015	\$ 4,970		
The Malmr Fund		34,916		(25,601)		(1,150)	(8,165)			
Clyde Henderson Fund		9,205		(10,871)		(490)	2,156			
Evelyn I. Marnoch Fund	4,496	1,850,173		(1,641,300)			(213,369)			
Roy B. Cowin Memorial Fund		60,076		(53,165)	(\$ 16,153)		(6,911)			
Lillian V. Fromhagen Fund		47,974		(28,160)	(100,000)		(3,661)			
Donna Comstock Fund		100,000								
Josephine Zagajewski Fund		20,081			(6,351)		(1,580)			
The Peter Baker Fund	7,119		(7,119)	(12,150)			(819)			
The Alfred P. Koch Fund				(6,300)						
Total	\$15,615	\$2,231,080	(\$12,089)	(\$1,888,247)	(\$122,504)	(\$6,610)	(\$229,334)	\$12,089		
Net Assets		\$2,234,606								
					Fund balance after closing					
										(\$2,234,606)

worksheet for the endowment fund grouping. Notice how these figures tie into the financial statements in Chapter 12 of this book.

(b) Single Set of Books

There is no reason why an organization cannot merge all of the fund groupings into one overall set of books in much the same manner discussed for the name funds above. The chart of accounts is arranged to permit this. If all accounts were combined, the general ledger would be fairly sizable but then it would only be necessary to keep one general journal, one cash disbursement book, one cash receipts book, and so on. The principal advantage of a single set of books is that there is only one set of records, and this facilitates bookkeeping, particularly if the organization has enough volume to handle its bookkeeping on a computer system. With almost any type of computerization, it is simpler to have one complex general ledger system than to have many separate general ledgers. The principal disadvantage is that it is far easier to keep all transactions relating to one fund grouping together in a separate set of records. The bookkeeper is less likely to get confused and will be able to see what is happening more easily when separate books are used for each fund grouping. Accordingly, except when records are handled on some sort of automated system or where the organization has an especially competent bookkeeping staff, it is probably better to stick with a separate set of records for each fund grouping.

33.3 INTERFUND TRANSACTIONS

If all transactions involved a single fund, and there were no transactions between funds or fund groupings, the bookkeeping problems of fund accounting would be relatively easy. Unfortunately, these interfund transactions often cause more difficulty than they should, partly because a bookkeeper may be uncertain how to record such transactions. There are several fairly common interfund transactions, and each of these is discussed and illustrated in the following paragraphs.

(a) Investment Income Transfer

The transfer of investment income from one fund to another is very common. Typically, investment income earned on an endowment fund is deposited by the custodian bank in an endowment fund income cash account. Then, from time to time, the bookkeeper will transfer portions of this cash to the unrestricted general fund and if any of the income is restricted to a specified use, to the fund for specified purposes. Here are the journal entries that would be made if the endowment fund earned

33.3 INTERFUND TRANSACTIONS

\$250 of income, \$200 of which is unrestricted and \$50 is restricted for a specified purpose.

On endowment fund books:

Debit No. 501 (cash)	\$250	
Credit No. 557 (investment income)		\$250
To record receipt of investment income.		
Debit No. 557 (investment income)	\$250	
Credit No. 541 (payable to unrestricted general fund)		\$200
Credit No. 543 (payable to fund for specified purposes)		50
To record transfer of investment income to unrestricted general fund and fund for specified purposes.		

On unrestricted general fund books:

Debit No. 145 (receivable from endowment fund)	\$200	
Credit No. 157 (investment income)		\$200
To record transfer of investment income from endowment fund.		

On fund-for-specified-purposes books:

Debit No. 345 (receivable from endowment fund)	\$50	
Credit No. 357 (investment income)		\$50
To record transfer of investment income from endowment fund.		

In due course, when the cash is actually transferred from the endowment fund, the entry on the various books would be a debit or credit to cash and a corresponding debit or credit to the interfund payable or receivable account.

(b) Interfund Borrowings

Another frequent interfund transaction is the temporary borrowing of cash by one fund from another fund. Here are the entries to record the unrestricted general fund's borrowing of \$10,000 from the unrestricted investment fund.

On unrestricted general fund books:

Debit No. 101 (cash)	\$10,000	
Credit No. 142 (payable to unrestricted investment fund)		\$10,000
To record interfund loan from the unrestricted investment fund.		

FUND ACCOUNTING BOOKKEEPING

On unrestricted investment fund books:

Debit No. 241 (receivable from unrestricted general fund)	\$10,000	
Credit No. 201 (cash)		\$10,000
To record interfund loan to the unrestricted general fund.		

When this loan is paid off, the entries would be reversed.

(c) Expenses Paid by One Fund for Another

The unrestricted general fund may pay expenses that are chargeable to another fund. A common example is payment of expenses out of the unrestricted general fund, which are to be charged to the fund for specified purposes.

In the following example the unrestricted general fund buys \$200 worth of library books, \$75 of which can be charged to the fund for specified purposes. Here are the appropriate entries:

On unrestricted general fund books:

Debit No. 143 (receivable from fund for specified purposes)	\$ 75	
Debit No. 174 (library books)	125	
Credit No. 130 (accounts payable)		\$200
To record amount of library books purchased by unrestricted general fund, part of which is to be paid for by fund for specified purposes.		

On fund for specific purposes books:

Debit No. 374 (library books)	\$75	
Credit No. 341 (payable to unrestricted general fund)		\$75
To record purchase of library books by the unrestricted general fund, out of the fund for specified purposes.		

(d) Contributions Transferred to Unrestricted Investment Fund

All contributions not restricted by donors must be shown in the unrestricted general fund. However, if the board wishes, it can always make transfers out of the unrestricted general fund into the unrestricted investment fund. The contribution must be reported first as income in the unrestricted general fund, so any transfer is effectively a transfer of a portion

33.3 INTERFUND TRANSACTIONS

of the net assets. Here are the entries that would be made to record a gift of \$750 and the subsequent transfer to the unrestricted investment fund.

On unrestricted general fund books:

Debit No. 101 (cash)	\$750	
Credit No. 155 (contributions)		\$750
To record receipt of an unrestricted contribution from Linda Jean Baker.		
Debit No. 146 (unrestricted general fund net assets)	\$750	
Credit No. 142 (payable to unrestricted investment fund)		\$750
To record transfer to unrestricted investment fund of portion of unrestricted general fund net assets arising from gift of Linda Jean Baker.		

On unrestricted investment fund books:

Debit No. 241 (receivable from unrestricted general fund)	\$750	
Credit No. 246 (unrestricted investment fund net assets)		\$750
To record transfer from unrestricted general fund of portion of unrestricted general fund net assets arising from gift of Linda Jean Baker.		

Note that in the unrestricted general fund the transfer was out of the net assets account and not out of the contributions received account. The gift of \$750 must be reported as part of unrestricted general fund income, and accordingly the transfer cannot come from the contribution account. Second, note that in the unrestricted investment fund the \$750 receipt was shown not as a contribution but, again, as a net asset transfer. This is the important thing to remember about transfers. They don't create income; all they do is transfer portions of the net assets or net worth from one fund to another. Transfers are discussed at length in Chapter 4.

(e) Current Restricted Funds Expended through the Unrestricted General Fund

A related type of transaction between funds takes place with those organizations following the accounting principle of placing all restricted contributions in a current restricted fund (the name often given to the fund for specified purposes) and then transferring to the unrestricted general fund such portion of these restricted contributions as is actually expended by the unrestricted general fund. Basically, the entries that make this transfer happen are quite straightforward.

Assume \$600 is received in the current year but only \$500 is expended for the restricted purpose. On fund for specified purposes books:

FUND ACCOUNTING BOOKKEEPING

Debit No. 301 (cash)	\$600	
Credit No. 355 (contributions)		\$600
To record receipt of \$600 restricted contributions.		
Debit No. 355 (contributions)	\$500	
Credit No. 341 (interfund payable)		\$500
To record transfer to the unrestricted general fund of a portion of restricted contributions for current operations that were expended during the year.		

(f) Allocation of Unrestricted Fund Balances

Allocations—or, as they are often known, “appropriations”—of part of the unrestricted general fund balance are occasionally made by the board. While the use of allocations is not recommended because they are seldom understood by the reader, some organizations still use this bookkeeping technique to segregate portions of the unrestricted general fund net assets for future projects. This is an acceptable practice only if the rules outlined in Chapter 4 are followed. When the rules are followed, the entry that would be made to effect an allocation would be:

Debit No. 146 (unrestricted general net assets)	\$1,000	
Credit No. 147 (unrestricted net assets balance—allocated)		\$1,000
To record an allocation of the unrestricted general net assets for Project A.		

Note that this entry merely transfers a portion of the unrestricted general fund net assets to another unrestricted general fund net asset account. No income or expense is involved. At a future date, when the expenditure is made for Project A, it will be charged to an expense account, and not to the allocated portion of the unrestricted general fund net assets. At that time, an entry will be made reversing the entry above.

33.4 TRIAL BALANCE

One final word of caution is in order. The usual way in which posting errors are caught is through the use of a trial balance. If the debits and the credits aren't equal, the bookkeeper is alerted to look for an error. The most likely posting error a bookkeeper will make, when fund accounting is involved, is to enter a transaction involving two funds in only one of the two funds. The use of a trial balance, however, will not catch this type of error since the debits and credits may be equal, but a complete entry in one of the funds has been omitted (both debit and credit).

33.5 CONCLUSION

(a) Balancing Interfund Transactions

It is easy to prevent this from going undetected. What is required is a balancing of the interfund receivables and payables. If they balance out to zero, then the bookkeeper knows that both sides of all interfund transactions have been recorded. This balancing is easy to do with the chart of accounts provided in Exhibit 33.1 because all of the inter-organization accounts are classified in one series of account numbers. Usually all that is required is running an adding machine tape of the aggregate debit and credit balances of the interfund accounts to be sure they net out to zero; if they don't, then the bookkeeper can compare, account by account, the corresponding contra (opposite) account in the other fund. For this reason, Account 142 should be the same amount as 241 except one will be a debit and the other a credit. In this way, it is easy to pinpoint differences.

33.5 CONCLUSION

Fund accounting is not difficult from a bookkeeping standpoint, but it requires careful organization and a good chart of accounts. It also requires care to ensure that both sides of interfund transactions are recorded. Other than that, fund accounting follows the same principles used by non-fund accounting organizations. Fund accounting can be applied to either cash or accrual basis organizations. The principal problem with fund accounting is not the bookkeeping, but the problem of presentation. This is where fund accounting frequently falls down. If the suggestions and recommendations that have been made throughout this book are heeded, the treasurer will be able to put together financial statements that are straightforward and clear to the unknowledgeable reader; in short, that will easily pass the "nonaccountant" test.

Automating the Accounting Records

<p>34.1 When to Consider Automating or Upgrading 704</p> <p>34.2 What to Automate 704</p> <p style="padding-left: 20px;">(a) What Accounting Software Will and Will Not Do 704</p> <p style="padding-left: 20px;">(b) Typical Accounting Software Modules for Not-for-Profits 705</p> <p>34.3 Selecting the Right Software 709</p>	<p style="padding-left: 20px;">(a) Differences between Commercial and Not-for-Profit Accounting Software Functions 709</p> <p style="padding-left: 20px;">(b) Steps to Selecting the Right Accounting Software 710</p> <p>34.4 Implementing the New System 712</p> <p>34.5 Common Pitfalls to Successful Automation 714</p> <p>34.6 Conclusion 716</p>
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At some point, the not-for-profit organization may consider implementing its first computerized accounting system or upgrading its existing system. If the organization does not have experience with selecting, implementing, or using an automated computerized system, this can seem like a daunting task. If the computerized system is not carefully selected and implemented, the results will be less than satisfactory and could cause much wasted time, money, and frustration. However, if the system is well implemented, it could improve the quality and timeliness of financial and accounting information and help support organizational objectives.

This chapter provides an overview of the major issues to consider when selecting and implementing an automated accounting system. It highlights some of the not-for-profit specific features to be aware of when selecting automated accounting software. Some common pitfalls to successful accounting system automation are discussed. Unless someone in the organization is skilled in selecting and implementing accounting software, it would be advisable to obtain outside assistance to guide you through this process.

34.1 WHEN TO CONSIDER AUTOMATING OR UPGRADING

There are a number of indicators that suggest that it is time for an organization to consider automating or upgrading its accounting systems. Some examples of indicators include the following:

- *Size and organizational structure of the not-for-profit.* The organization has many departments/cost centers, many funds and/or restricted grants, several tiers to its organization, or is growing rapidly.
- *Complexity of the transactions.* The organization has complicated allocations or uses full accrual accountings that have become difficult to manage in the manual or existing automated system.
- *Transaction volumes.* The number of transactions processed is making it very difficult to keep up on a timely basis or is requiring excessive staff time. Generally more than 50 transactions in a particular accounting function per month warrants automation.
- *Reporting requirements.* If there is a multiple tier reporting structure, if project or activity level reporting are desired, or if significant manual effort or re-keying is currently required to produce financial statements and special reports.

The organization should not feel compelled to automate everything or to automate everything at once. A careful assessment of the automation requirements should be performed before any commitment is made to purchase accounting software or hardware.

34.2 WHAT TO AUTOMATE

Once the decision to automate has been made, the next step is to consider what the accounting system will be expected to do and the extent of automation desired. This section highlights some of the benefits and misconceptions regarding automated accounting systems and lists some of the more common accounting software modules used by not-for-profit organizations.

(a) What Accounting Software Will and Will Not Do

Compared with service bureaus¹ or manual bookkeeping systems, an automated accounting system can:

- Provide better internal control
- Provide better and timelier access to data

¹ A *service bureau* is an organization that uses its equipment and software to process data for other organizations for a fee. This chapter assumes an organization is considering obtaining its own equipment and automated software. However, many of the concepts presented in this chapter can also be applied in selecting a service bureau.

- Allow greater data security
- Improve clerical productivity
- Reduce some administrative costs
- Stabilize cost as volume increases
- Improve professional quality
- Integrate with other software to perform decision analysis²

There are things an automated accounting system will not do: It will not make accounting decisions or tell you how to record transactions, improve poor judgment, or generate reports for data that were not properly organized and recorded. For these reasons, it is important that a professional accountant provide assistance in selecting and implementing the automated system.³ Once properly implemented, the system can be operated for the most part by a less experienced bookkeeper.

An automated accounting system will not replace a bookkeeper; what it can do is help an organization make more effective use of its accounting staff. Another major benefit of an automated system is the ability to generate more meaningful management reports. Once the system automates repetitive tasks, people are able to turn their attention to more challenging and satisfying work.

(b) Typical Accounting Software Modules for Not-for-Profits

Before deciding what to automate, there should be a basic understanding of the types of accounting software modules generally available and used by not-for-profit organizations.⁴ All the major manual books and records discussed in the preceding chapters have an equivalent within the automated accounting software modules available on the market today. An exception generally relates to an operational area that is unique to a particular organization. If an organization has such an area that it wishes to

² *Automated systems* are considered to be integrated when information entered into one system is shared by or passed automatically to another system. The primary objective of “integrated” systems is to eliminate duplication of data entry and data redundancy.

³ *Implementation* is the series of tasks and steps required to initially set up a new automated system. The system is not ready to use the moment it is loaded on the computer. There are many decisions that must be made, options within the software package selected, chart of accounts and reports designed and developed, and initial accounting data entered in order to tailor the package to the organization. Major implementation tasks are discussed later in this chapter.

⁴ *Accounting software modules* refers to the different units of software that an organization would need to purchase to set up its automated accounting system. With some exceptions, most accounting software vendors sell their software by module. Unfortunately, there are no industry-wide standards regarding the accounting functions found in each module. Some vendors, for example, will sell a separate module each for general ledger, for budgeting, and for financial reporting; another vendor might include all three functions in one module. Understanding the differences among the software vendors is an area where professional assistance would be helpful.

automate, a custom-made system may need to be developed for its use. This chapter does not address customized accounting systems issues.

The following lists some of the typical types of packaged general accounting and specialized not-for-profit software modules.⁵

(i) General Accounting Modules.

- *General ledger.* Just as in a manual records system, this is where all transactions from the other systems (subsidiary ledgers) are summarized and where transactions not posted through the subsidiary ledgers are entered. Typically, the general ledger system also has some budgeting capability. Some vendors offer a separate software module for more sophisticated budget planning and forecasting. The general ledger system also provides report-writing capabilities for generating the financial statements and management reports. In some cases, however, an additional report-writer software module may also be required for complex reporting. The general ledger is usually the first system an organization will automate.
- *Accounts receivable.* Customer information, credit terms, and billing data are entered in the accounts receivable module to manage the aging of accounts receivable and recording credits and collections. Unless the organization regularly bills individuals for amounts due to the organization, this module may not be required. Many not-for-profits, especially those relying on revenue from donations, grants, and fundraising, will not need an accounts receivable system. There are other specialized revenue-related systems that may be better suited to the organization, such as a membership system, subscription system, meetings/conventions/events system, and donor/pledges/fundraising system (see following).
- *Accounts payable.* Vendor information, payment terms, invoice, and employee expense reimbursement data are entered in the accounts payable module to facilitate automated check-writing and accrual entries for unpaid invoices. The benefit of an accounts payable system is better management of the timing of paying invoices, which can result in improved cash management. The accounts payable system also creates automatic accrual entries for the unpaid invoices, and provides an improved history of payments by vendor. In addition to the general ledger, most organizations will implement an automated accounts payable system.

⁵ *Packaged* refers to software that has been developed for broad general usage, unadapted to any particular organization, and sold to a mass market. Contrast this with “custom” software that is specifically developed for an organization.

- *Fixed assets.* Used to record the capital assets (generally furniture and equipment) and calculate depreciation. This is among the least frequently used automated accounting modules for smaller not-for-profit organizations. Many smaller organizations can adequately handle fixed-asset records either manually or using an electronic spreadsheet package. The extent of fixed-asset records required will in part be dictated by local property tax laws or by government grant requirements.
- *Payroll.* Used to record employee salary information, time worked, vacation and leave taken, generate payroll checks, and calculate the allocation of personnel costs to projects. Many organizations (including large commercial organizations) have found it cost-effective to have payroll processed by a service bureau rather than to perform the task in-house. This is primarily due to the complexity and frequency of change in federal, state, and local withholding and other payroll tax rules and rates. A service bureau also assists in the tax filings.
- *Purchasing.* Sometimes part of the accounts payable system and sometimes separate, this module is used to record purchase requisitions and create purchase orders. The purchase order is then passed to the accounts payable system, where it is later matched (either manually or automatically) with the vendor invoice and possibly a receiving document. The need for a purchasing system will depend on the purchasing controls and policies of the organization (i.e., whether purchase orders are required) and the volume and nature of purchasing activity. It is not necessary to have a purchasing system in order to have an accounts payable system. The decision factor is the volume of transactions and internal control requirements surrounding purchases.
- *Inventory.* If an organization has a significant number of items that it holds for sale or use, an inventory system may be helpful. This system records the amount of items on hand, including items on backorder and purchase orders. The inventory system will often interface with the purchasing system.⁶ The inventory system may also have an order entry capability, or be interfaced with a separate order entry/billing system.

⁶ *Interface* is the automated passing of information created or entered in one accounting module to another accounting module, eliminating the need to re-enter data. The most common form of automated interface is from the subledgers, such as accounts payable and accounts receivable, to the general ledger to post activity balances to the accounts. In more advanced interfaces, such as between an inventory system and a purchasing system, transactions are originated by the software. For example, an inventory system may automatically generate a purchase order when an item in inventory falls to a certain predetermined level. In the other direction, a purchasing system might send information to the inventory system when certain items are placed on order.

(ii) **Specialized Modules for Not-for-Profit Organizations.** There are a number of specialized software packages that are used by not-for-profit organizations to support their organizational objectives and revenue-generating activities. Most of these are primarily informational databases with strong query and report-writing capabilities that are tailored for the organization through the use of user-defined codes.⁷ These packages frequently have a mail-merge capability to extract selected information to be used with word processing software for mass mailings. These packages, while not primarily financial transaction-oriented, often include a cash receipts capability that could be interfaced with the general ledger module. The following are examples of some types of specialized not-for-profit software modules.

- *Meeting/convention/event software.* Helps the not-for-profit plan event budgeting, scheduling and logistics, and recording event registration and payment information for the event, as well as generating attendance statistics and mailings lists. Similar software can handle ticket sales for concerts and exhibits.
- *Donors/pledges/fundraising software.* Helps track solicitations and follow-up of prospective and successful donor, pledge, and fundraising activities. Some include databases of donor profiles that can be used for targeted mailings. These would include a history of donations that, if combined with a cash receipts capability, could be interfaced with the general ledger.
- *Membership software.* Used to record member profiles and generate membership dues invoices, and can include an extensive array of other supporting capabilities for the membership organization. It may include a cash receipts module that would interface with the general ledger, or with the accounts payable system for dues refunds. Similar, but more complex, software is used by colleges for student records and by hospitals for patient records.
- *Project accounting.* Maintains a detailed subledger to accumulate the costs and revenues associated with individual projects or activities. This would be required, for example, if an organization wishes to keep more detailed records related to a project or a restricted grant than would normally be recorded in the general ledger. Some general ledger systems, especially those intended for not-for-profit organizations, have capabilities to handle project accounting.

⁷ *Query* is the capability to automatically search the information in the system for data meeting user-specified search criteria. Some systems have the ability to quickly query the data and present the results on the computer screen without the need to generate a report. This is a very useful feature and a tremendous benefit of automating.

34.3 SELECTING THE RIGHT SOFTWARE

This is not an all-inclusive list of possible automated accounting modules. There are many additional packaged software modules available to address most common business and accounting needs of an organization. A qualified business and accounting software consultant can help you determine whether it is likely that a packaged system already exists to meet a particular need.

34.3 SELECTING THE RIGHT SOFTWARE

After the decision has been made to automate, and there is a general idea of the functions that would benefit from automation, the next step is to more closely analyze the specific accounting system requirements of the organization. This effort should result in a comprehensive list of requirements that the organization will use to evaluate and select the most suitable accounting software. The possibilities are too numerous to include here, especially because there are many accounting packages on the market and thousands of not-for-profit organizations, each with a wide range of capabilities and needs. The best advice for this process is to obtain assistance from a qualified professional who can help you determine the requirements and select a well-suited package.

(a) Differences between Commercial and Not-for-Profit Accounting Software Functions

For many not-for-profit organizations, almost any commercial accounting package may serve its purposes. However, there are some software features that differentiate commercial accounting software from those suitable for certain not-for-profit organizations. The reader should be aware of these differences that impact his or her organization. This is one area that must receive special attention in selecting the right package for the organization. The following are some areas where commercial and not-for-profit accounting software capabilities might differ.

- *Fund accounting.* If the organization has many different funds, the selected software must be able to maintain a balanced set of books and report on each fund separately and also consolidated. This may not be easy for some software that is not specifically designed with fund accounting in mind. There are “fund accounting” systems on the market that simplify meeting this requirement.
- *Grants accounting.* If the organization must keep track of restricted grants and must report its accounting back to the grantor, there are a few system capabilities to look for. Similar to fund accounting, the system must be able to separately report on each grant. An additional complexity is the ability to report on the grant

from its inception to date. This could mean being able to accumulate the grant expense history across fiscal year-ends. Therefore, the system must be able to generate reports for multiple years and for user-defined periods of time. Some commercial accounting systems do not handle multiyear reporting very well. There are accounting systems on the market that specialize in “grants accounting.”

- *Financial reporting.* Many not-for-profits have more complex financial report presentation requirements than commercial businesses. Not-for-profits often require the ability to present functional financial statements as well as to report by account classification. Some commercial accounting packages cannot handle this type of matrix reporting (with accounts listed down the page and functions or funds across the top). Others may offer an additional report-writing module to provide this ability. It is important to verify that the software will be able to generate the types of reports required by the organization. This matrix reporting ability is provided by many specialized not for-profit accounting packages.

(b) Steps to Selecting the Right Accounting Software⁸

There are some general steps that should be followed in selecting the accounting software that is best suited for the organization. There are hundreds of accounting packages to choose from and no two provide exactly the same features and capabilities. Similarly, no two organizations have exactly the same requirements. Without having a system custom-developed for the organization, which could be cost prohibitive, there rarely will be a “perfect” match. However, by following the steps suggested below you will increase the odds of selecting the best match without requiring much, if any, modification to the software.

The following are the typical steps to software selection:

1. *Determine the requirements that must be met by the software.*
 - Include those who are to produce and use the information that is to be processed in the requirements determination process.
 - Concentrate on critical and unusual requirements.
 - Consider system-generated calculations.
 - Define all significant reporting requirements.

⁸ The reader will note that this chapter has been focusing on the functional aspects of the accounting software and not on the potential computer hardware requirements. This is intentional because the more important decision should be selecting the right software, which will in turn determine the hardware requirements. However, if there are limitations on the hardware that will be used by the organization, this information must be considered as a requirement for the software.

34.3 SELECTING THE RIGHT SOFTWARE

- Consider nature and sources of transactions.
 - Consider required interfaces among modules and with other systems.
 - Consider any limitations on computer hardware¹⁷ or costs.
 - Prioritize requirements by importance.
2. *Identify likely packages for detailed review.*
- Use requirements list to screen potential vendors for suitability.
 - Focus on critical and unusual requirements.
 - Eliminate obviously unsuitable packages based on requirements and/or cost.
 - Narrow the list to two or three vendors.
3. *Perform a detailed evaluation of the finalist vendors.*
- Prepare a detailed list of questions to ask each vendor.
 - Arrange to have the vendor provide a detailed demonstration of the accounting modules being considered.
 - Evaluate functionality and ease of use.
 - Obtain examples of reports produced by the system.
 - Obtain examples of documentation and manuals provided by the vendor.
 - Obtain financial information and business history of the vendor (especially if not well known).
 - Obtain at least three references from each vendor, preferably similar organizations.
4. *Contact vendor references.* Develop questions to ask references, including the following:
- Perception of software strengths and weaknesses
 - Software problems encountered and limitations
 - Ease of use, ease of implementation
 - Report-writing capabilities and ease
 - Modifications made to the software
 - Availability and adequacy of vendor training and documentation
 - Vendor support and responsiveness (e.g., local presence, telephone assistance, response time to inquiries)
 - Satisfaction with software performance

5. *Obtain and compare cost information.* Consider all potential costs and compare each candidate vendor in regard to:
 - Computer equipment requirements
 - Accounting modules
 - Other software (e.g., additional software required to operate the vendor's accounting software)
 - Cost for installation, modifications, data conversion, training, other additional costs to implement the system^{9, 10}
 - Ongoing maintenance costs (annual expenses for both hardware and software)
6. *Make a selection.*
 - Be willing to compromise.
 - Consider alternatives for missing requirements.
 - Select the software vendor with the best overall match.
 - Base final decision on value, not just lowest cost.

It is tempting to bypass some or all of these steps and select accounting software based on a single recommendation or on hearsay regarding a package's reputation. Automated accounting software represents a major investment for many organizations; being too hasty in its selection can be a costly mistake.

34.4 IMPLEMENTING THE NEW SYSTEM

Critical factors to ensure a successful implementation are to have a detailed plan, timetable, and staff resources to complete the necessary tasks. Do not underestimate the time, effort, and hidden costs required to implement the system. The timing of the implementation is also important. If the accounting staff are under stress keeping up with the current system, consider the additional stress of implementing and learning a new system at the same time. Some organizations will engage consultants to help implement the

⁹ There is a difference between "installing" the system and "implementing" the system that many first-time computer users are not familiar with. The accounting software is "installed" when it is loaded on the computer; being installed does not make it ready for use. "Implementation" is the series of tasks and steps required to initially set up a new automated system. There are many decisions that must be made, options within the software package selected, chart of accounts and reports designed and developed, and initial accounting data entered in order to tailor the package to the organization. Major implementation tasks are discussed later in this chapter.

¹⁰ Make sure there is a very clear understanding regarding the services the software vendor, third-party dealer, and software consultant will provide and for what cost. Many vendors only sell their software through a third-party dealer, and if this is the case, the third-party dealer will most likely charge an hourly rate or monthly fee for any services. Based on the understanding of the services provided by the software vendor or third-party dealer, you will have a better idea of where additional assistance from an independent consultant will be required.

system and/or hire temporary staff to help keep up with the old system during the implementation period.

An important starting point is to train the users in the new system. The best software will not work well if the users do not know how to operate it. The primary system users (who should have been involved in the automation process from the beginning) should receive training early in the implementation and be involved in the implementation tasks.

Depending on the sophistication and complexity of the selected package, the following tasks would typically be included in a general ledger and accounts payable system implementation. (Similar tasks would be required for other automated accounting modules.)

- Site preparation for hardware and software installation
- Order required forms and supplies (e.g., custom checks)
- Definition of data system security and software backup procedures
- Definition of the chart of accounts and subaccounts
- General ledger reporting definitions
- Definition of general ledger journal types and other coding structures
- Accounts payable vendor master file definition
- Loading and configuration of the application system software
- Loading initial tables
- Loading chart of accounts
- Customization of interfaces
- Conversion of data:
 - Plan approach, cut-off dates, and crosswalks of data from old to new system
 - Conversion data entry (e.g., beginning balances, open invoices)
 - Conversion data reconciliation
- System administrator training (hardware and software troubleshooting)
- User application training
- Financial report formatting and customization
- Preparation of procedures and custom documentation
- Parallel processing period using both the old and new system and comparing results
- Developing month-end closing, historical data archiving, yearend closing guidelines

One of the most critical implementation tasks for a new accounting system is the chart of accounts definition. The chart of accounts should include cost centers, project accounts, the organization structure, and anything requiring reports. A properly designed chart of accounts (discussed in Chapter 33) will take all reporting requirements into consideration, will result in the ability to generate meaningful reports, and will reduce the effort in producing financial statements. There may be system restrictions both on how the chart of accounts can be established and on how the software report-writer will work with the chart of accounts. Therefore, it is advisable to obtain professional assistance from your external accountant or a qualified accounting software consultant when you first set up the chart of accounts for the new system.

34.5 COMMON PITFALLS TO SUCCESSFUL AUTOMATION

Sometimes the pressure to automate outweighs the need to spend the time and resources required to properly implement the system. The following are some of the most common pitfalls that could jeopardize the success of automating the accounting records.

- *Not defining requirements, or selecting the software for the wrong reason.* After the software is purchased and you discover your mistake, it cannot be returned. Do not purchase software without having a reasonable basis for its selection. Also, do not purchase a system that is too complex for your organization. Be aware that with increased system flexibility and functionality comes greater complexity. More highly skilled staff is required to deal with the more complex systems.
- *Purchasing the hardware and operating system before making the software selection.*¹¹ The users' requirements should determine the software selection; the selected software should determine the hardware and operating system requirements. Unless the already installed hardware and operating system happens to be widely used, the choice of accounting software may be severely limited. Also, hardware upgrades may be required sooner and at a greater cost than if the hardware decision had been delayed and coordinated with the software selection.
- *Purchasing a software package and then heavily modifying it.* A heavily modified software package poses several problems. First, the software vendor will not support it, or if it does support it the cost will

¹¹ Operating system is the collection of programs that control a computer's internal functions. A specific type of hardware might be able to run different operating systems (for example, a microcomputer might be able to run Windows, Macintosh, Linux, or UNIX operating systems), but a software package might be written to work only with a specific operating system.

be greater than for an unmodified version. Second, modifying the package increases the risk that the software will not function as well as desired and could introduce unforeseen problems in other parts of the software. Third, the organization will need to make sure there are qualified staff (internal or external) who can support the modified system. If extensive modifications seem to be necessary, either consider alternative processing methods, or consider having a system custom-developed.

- *Inadequate user training and cross-training.* If the users do not have adequate training, the result could be improper use of the system and unreliable financial data. In addition to training the primary system user, make sure there is at least one backup person trained in the system in case the primary user leaves or is away.
- *Trying to automate too much at once.* There are no requirements that all accounting modules must be implemented at the same time. Also, it may not be cost-effective or prudent to automate all accounting functions. Remember that implementing a new system adds unscheduled work to the day-to-day operations of your organization. The systems should be implemented at a pace you can deal with to reduce errors.
- *Inadequate procedures and documentation.* The new automated system may come with user manuals that describe how to use the system. What the software vendor will not provide, however, are procedures for incorporating the system into your manual procedures to fit your organization. Supplementary procedures, forms, and checklists will need to be developed to tailor the system to your organization.
- *Poorly designed chart of accounts and reports.* This cannot be stressed enough. A well designed chart of accounts makes a major difference in the performance of an automated accounting system. The chart of accounts is the backbone to the reporting capabilities of the system. If the chart of accounts is not designed to capture the data to the level of detail required, no report-writer in the world can produce the reports desired. If the organization believes that its current automated system needs replacing, it should first analyze the chart of accounts. Often “poor” systems can be salvaged through redesigning the chart of accounts and reports.
- *Poor backup and recovery procedures.* The system may be successfully implemented, and everything working fine, when all of a sudden a hardware problem or electrical failure causes the system to lose its data. Procedures need to be in place to make sure the automated programs and data are backed up frequently and stored

in a safe, off-site location. This is important to make sure your organization does not lose important data should something happen to the computer or your office space.

34.6 CONCLUSION

Very small organizations may outgrow a checkbook system and move on to a manual double entry ledger system. As time goes on and the organization grows in size and complexity, the manual system may become too cumbersome and automating the accounting records is considered. There are many issues to consider and decisions to make before automating the accounting records. Through careful requirements definition, evaluation of the software alternatives, and implementation, the automation can be a success. However, a not-for-profit organization should not feel compelled to automate all of its accounting functions or to automate everything at once. A well-planned approach to automation will help the organization maximize its resources.

A P P E N D I X A

Accounting and Disclosure Guide for Not-for-Profit Organizations

INCLUDES SFAS 116, 117, 124, AND *NOT-FOR-PROFIT ORGANIZATIONS*

The following checklist is intended for use in connection with financial statements of not-for-profit organizations covered by the AICPA audit guide, *Not-for-Profit Organizations*. References to paragraphs of this guide are in the form AG X.XX. (This checklist is not designed to cover organizations which follow the state and local government or the health care organizations audit guides.)

This checklist is *not* an audit program, and does not include all matters included in authoritative literature; rather, it highlights matters relating to accounting principles and to reporting practices (such as financial statement format and disclosures) that are unique to not-for profit organizations or call for special attention in the not-for-profit environment. *It is intended to be used in conjunction with other programs and checklists appropriate to the organization.*

As with all accounting and reporting principles, materiality should be considered when using the checklist.

APPENDIX A

	Yes	No	N/A
A. General			
1. Are all required financial statements presented, including statements of:			
a.) Functional Expenses (for VHW organizations only: SFAS 117, par. 26)	___	___	___
b.) Cash Flows (SFAS 117, par. 29–30; SFAS 95)	___	___	___
i.) Are cash flows from agency transactions included as operating cash flows (even though they are not reported as revenues and expenses)? (AG 3.16)	___	___	___
ii.) Are cash flows from purchases and sales of securities reported gross? (SFAS 95, par.11–13, 31, 75–79)	___	___	___
2. Does it appear that the financial statement format (columnar [single vs. multiple] vs. layered) is preferable for the organization? (No particular format is mandatory, however.)	___	___	___
a.) Is the statement of cash flows prepared using the direct method? (SFAS 95, par. 27, 119) (The indirect method is permitted.)	___	___	___
3. As appropriate, does the accounting policies footnote (APB No. 22) include descriptions of significant accounting policies, including particularly those relating to:			
• Classes of net assets (fund accounting)			
• Restricted revenue			
• Pledges (unconditional promises to give)			
• Contributed services and materials			
• Bequests			
• Contributions made			
• Membership dues			
• Valuation of investments			
• Capital gains/losses			
• Collection items (owned by museums or others)			
• Long-lived assets			
• Functional allocation of expenses			
• A measure of operations, if used			
• Related organizations (see also Question 6, below)	___	___	___
4. If any accounting changes have occurred, are they in conformity with SAS No. 69 and APB No. 20?			
a.) If a merger has taken place, have the matters discussed in AG 1.15–.16 (pooling of interests) been considered?	___	___	___

ACCOUNTING AND DISCLOSURE GUIDE FOR NOT-FOR-PROFIT ORGANIZATIONS

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
5. If the basis of accounting is other than GAAP, has SAS No. 62 been complied with?	_____	_____	_____
a.) If the basis is one required by a regulatory agency, and is not an OCBOA, does the auditor's report include a paragraph restricting its use to the client and the regulatory agency? (AG 14.12)	_____	_____	_____
6. Where related (for-profit or not-for-profit) organizations exist:			
a.) If they meet the criteria for inclusion in the financial statements of the reporting entity, are these organizations included? (SOP 94-3; and when effective, SFAS XXX)	_____	_____	_____
b.) If they do not meet the criteria for inclusion, is the relationship disclosed? (SFAS 57; SOP 94-3)	_____	_____	_____
7. With respect to disclosure of related party transactions, has consideration been given to transactions with chapters, foundations, student organizations, auxiliaries, guilds, circles, lodges, fundraising organizations, trusts, and other related entities (including board and committee members and staff, and other organizations with which such persons are affiliated)?			
a.) Are trusts which benefit the reporting organization, but which do not meet the criteria for consolidation or the recording of a beneficial interest, disclosed?	_____	_____	_____
8. If the financial statements cover less than the entire organization (e.g., a fund, department, branch, grant, etc.), do the statements and footnotes clearly indicate what is included, what is not included, and relationships between them?	_____	_____	_____
9. If the organization has chosen to present an intermediate measure of operations, have the requirements of SFAS 117 paragraph 23 been complied with, and is the organization's classification of items as operating and nonoperating appropriate?	_____	_____	_____
10. Have the requirements of SFAS 117 paragraph 12, regarding information about liquidity, been complied with?			
a.) If a classified Balance Sheet is presented, are current items appropriately categorized? (AG 3.03-.04; ARB 43, Chapter 3A)	_____	_____	_____

(continued)

APPENDIX A

(continued)

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
B. Classes of Net Assets			
11. Are all legally unrestricted income and net assets (including quasi-endowment and other board-designated amounts) reported in the same income statement?	_____	_____	_____
a.) If unrestricted amounts are shown in more than one column (not preferable), are the totals thereof clearly shown?	_____	_____	_____
12. Are all funds/classes of the organization included in the financial statements?	_____	_____	_____
a.) Are total assets, liabilities, and net assets presented? (SFAS 117, par. 10)	_____	_____	_____
13. Is the change in net assets clearly shown, in total and for each class? (SFAS 117, par. 18, 19)	_____	_____	_____
14. If only a total column is presented for the preceding year and if a two-year opinion is to be issued, are all required disclosures made with respect to the preceding year? (AG 3.20–21)	_____	_____	_____
a.) If all required disclosures are not presented, is there an additional paragraph in the auditor’s report describing this fact? (AG 14.05)	_____	_____	_____
15. Do temporarily and permanently restricted net assets include only amounts restricted by outside donors, and are all restricted net assets clearly disclosed?	_____	_____	_____
a.) Are all revenues and assets received in exchange transactions reported in the unrestricted class (even though there may be legal restrictions on their use, such as under a contract, bond indenture, the organization’s bylaws, etc.)? (AG 5.18)	_____	_____	_____
16. Is disclosure made of the details of temporarily and permanently restricted net assets, and reclassifications? (SFAS 117 par. 14, 15, 19)	_____	_____	_____
17. If the organization has chosen to present, as unrestricted revenue, restricted contributions and investment income whose restrictions are met in the same period, has this policy been followed consistently for all such contributions and investment income, and is the policy disclosed? (SFAS 116, par. 14; AG 5.29, 8.17)	_____	_____	_____

ACCOUNTING AND DISCLOSURE GUIDE FOR NOT-FOR-PROFIT ORGANIZATIONS

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
18. Are all intraclass transfers (e.g., the establishment of a quasi-endowment fund within the unrestricted class) shown in such a manner that they are clearly not revenue or expense of either subclass?	_____	_____	_____
19. Are interclass receivables and payables clearly disclosed (if a multi-class Balance Sheet is presented)? (Also see SFAS 117, footnote 8 to par. 85.)	_____	_____	_____
a.) Where a single column format is used for the Balance Sheet, are any interclass (-fund) due to/due froms <i>not</i> included in total assets and total liabilities? (SFAS 117, footnote 8 to par. 85)	_____	_____	_____
b.) If repayment of borrowings appears in doubt, has the guidance in AG paragraphs 3.25–.27 regarding noncompliance with donor-imposed restrictions been considered?	_____	_____	_____
C. Assets			
20. Are unconditional promises to give (pledges receivable), including any required allowance for estimated uncollectible amounts, properly recorded as assets and revenue?	_____	_____	_____
a.) Have the provisions of APB 21, with respect to discounting, been appropriately applied? (SFAS 116, par. 20; AG 5.51–.53)	_____	_____	_____
i.) Is accretion of the discount recorded as contributions, not interest? (SFAS 116, par. 20, second sentence)	_____	_____	_____
b.) If appropriate confirmation procedures have not been performed, has the guidance at AG 5.68 been considered?	_____	_____	_____
21. Has appropriate disclosure of the following been made (AG 5.64, ex. 2):			
a.) Maturity schedule of unconditional promises to give? (SFAS 116, par.24a)	_____	_____	_____
b.) Allowance for estimated uncollectible pledges receivable? (SFAS 116, par. 24b)	_____	_____	_____
c.) Conditional promises to give? (SFAS 116, par. 25)	_____	_____	_____
d.) Any concentrations of credit risk? (SFAS 105, par. 20)	_____	_____	_____
22. Are requests receivable recorded, when they qualify as unconditional promises to give?	_____	_____	_____

(continued)

APPENDIX A

(continued)

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
23. Are investments appropriately valued?			
a.) Covered by SFAS 124: at market?	___	___	___
b.) Not covered by SFAS 124: in accordance with the appropriate guidance at AG 8.28?	___	___	___
c.) Have the disclosure requirements of SFAS 124 been complied with?	___	___	___
24. Have the provisions of SFAS 105, 107 (but see SFAS 126), 119, and, when effective, 133 been complied with?	___	___	___
25. When investments from more than one fund are managed in a pooled account, are transactions in the account recorded using the market-value method (even though the underlying accounting records may be kept on some other basis)?	___	___	___
26. Are fixed assets capitalized? (Optional for museum collections—see 26a.)	___	___	___
a.) If collection items are not capitalized, have the requirements of SFAS 116, paragraphs 11–13 (with regard to meeting the criteria for noncapitalization, method of recording accessions and deaccessions, and required footnote disclosures) been met?	___	___	___
i.) Even though a museum collection is not capitalized, have the auditing procedures discussed at AG 7.17–.19 been considered?	___	___	___
b.) Have assets acquired under terms of grants or contracts—where the funder retains legal title, but it is expected that the organization will obtain title at the end of the grant period—been capitalized? (AG 9.04)	___	___	___
27. Have direct-response advertising costs meeting the criteria of SOP 93-7 been appropriately deferred? (AG 13.08–.10) (Note also Question 53.)	___	___	___
28. If the organization has adopted a policy that the restriction on donated fixed assets expires ratably over the life of the assets, has this policy been followed consistently for all such assets? (SFAS 116, par.16)	___	___	___
29. Are long-lived tangible assets depreciated? (SFAS 93) (Optional for individual works of art and historical treasures, if the criteria in paragraph 6 of SFAS 93 are met.)	___	___	___
30. Have the provisions of SFAS 121 (Impairment) been complied with?	___	___	___

ACCOUNTING AND DISCLOSURE GUIDE FOR NOT-FOR-PROFIT ORGANIZATIONS

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
D. Liabilities and Net Assets (see also E, Revenue Recognition)			
31. Are the following disclosed?			
a.) The status of the organization under applicable income tax laws?	___	___	___
b.) Any contingent tax liabilities?	___	___	___
c.) Any contingent liabilities under government grants or contracts?	___	___	___
d.) Employee benefits (SFAS 87, 106, 112—but also consider SFAS 132 par. 8, 56–59)	___	___	___
32. Do the financial statements, footnotes, and other printed material included in the annual report contain no language which might reflect adversely on the organization’s tax status, such as language which might cause the IRS to assert that the organization:			
• Is a private foundation (if it is not)			
• Is subject to tax on unrelated business income			
• Is engaged in activities that might jeopardize its tax-exempt status			
• Is subject to any penalty taxes?	___	___	___
a.) Have the provisions of SFAS 109 been complied with regarding any timing differences related to unrelated business income and the private foundation excise tax on net investment income? (AG 10.03)	___	___	___
i.) For purposes of computing deferred tax related to the private foundation excise tax on net investment income, has the tax effect of the timing difference between book (tax) basis and market value (per SFAS 124) been computed at the 2%, <i>not</i> the 1%, rate?	___	___	___
33. If the organization makes contributions (grants) to others, is a liability for unpaid unconditional pledges (including future installments of multi-year pledges) recorded as an expense and a liability at the time the recipient is entitled to the contribution? (SFAS 116, par. 18; AG 10.06–.08)	___	___	___
34. Are compensated absences, including sabbatical leave, properly accounted for? (SFAS 43)	___	___	___
35. Are encumbrances and other commitments not meeting the criteria of SFAS No. 5 <i>not</i> recorded as liabilities?	___	___	___

(continued)

APPENDIX A

(continued)

	Yes	No	N/A
36. Has the organization appropriately reclassified its funds into classes for financial statement purposes?	_____	_____	_____
a.) If net assets have been appropriated, is the financial statement presentation such that it is clear that such appropriations are <i>not</i> expenses or liabilities, but are part of net assets?	_____	_____	_____
E. Revenue Recognition			
<i>Contributions received:</i>			
37. Have receipts which are in substance purchases of goods or services, and transfers of assets in which the reporting entity acts as an agent, trustee, or intermediary, rather than a donor or donee, been excluded from application of the requirements of SFAS 116? (SFAS 116, par. 3, 4; SFAS 136)	_____	_____	_____
a.) For asset transfers subject to SFAS 136, is the accounting and reporting appropriate?	_____	_____	_____
38. Have all split-interest gifts, (including irrevocable perpetual trusts held by third parties) of which the organization is a beneficiary been properly recorded in accordance with AG Chapter 6?	_____	_____	_____
39. For noncash donations, have the following types of gifts been recorded? (SFAS 116, par. 5)	_____	_____	_____
• Investment securities	_____	_____	_____
• Land, buildings, and equipment (for investment or use)	_____	_____	_____
• Use of facilities or utilities	_____	_____	_____
• Services provided by other organizations	_____	_____	_____
• Assets or services for which payment was made directly to a vendor by a third party, whose intention was to support the organization	_____	_____	_____
• Materials and supplies that can be used or sold (AG 5.07-.08)	_____	_____	_____
• Intangible assets	_____	_____	_____
• The contribution element of bargain sales and purchases (SFAS 116, par. 3, last sentence)	_____	_____	_____
• Contributed services of individual volunteers which meet the criteria in SFAS 116, paragraph 9 recorded (and others not recorded)?	_____	_____	_____
a.) Have the disclosures regarding contributed services required by SFAS 116, paragraph 10, been made? (See example at AG 5.64, Example 4)	_____	_____	_____

ACCOUNTING AND DISCLOSURE GUIDE FOR NOT-FOR-PROFIT ORGANIZATIONS

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
40. Are all gifts, grants, unconditional pledges, and other contributions, whether or not restricted by a donor for a particular purpose or for a particular time period, recorded as revenue when received? (SFAS 116, par. 8)	_____	_____	_____
a.) Are they reported in the class of net assets appropriate to any donor restrictions? (See also Question 17, above)	_____	_____	_____
b.) Are pledges due in future periods reported as restricted support, unless clear donor intentions indicate otherwise? (SFAS 116, par 15)	_____	_____	_____
c.) Are gifts subject to temporary restrictions, which will become permanently restricted when the temporary restrictions expire (e.g., promises to give, term endowments, split-interest gifts), recorded immediately in the permanently restricted class?	_____	_____	_____
<i>Other Revenue:</i>			
41. Gross amounts of revenue and expenses:			
a.) If investment revenues are reported net of related expenses, is the amount of expenses disclosed? (SFAS 117, par. 24)	_____	_____	_____
b.) "Special" fundraising events (similar logic applies to sales/cost of sales):			
i.) If direct expenses benefiting participants are netted against revenues, are we satisfied that the event meets the definition of peripheral or incidental transactions? (SFAS 117, par. 138; SFAC 6, par. 82-89)	_____	_____	_____
ii.) If special events do not qualify as peripheral or incidental transactions, are both gross revenue and gross expenses from the events reported in the statement of activity? (SFAS 117, par. 24, 25, 138; AG 13.17-.22) (Note: It is permissible to present the expenses as a deduction, on the face of the statement immediately following the revenue.)	_____	_____	_____
c.) Are all other revenues and expenses presented gross? (SFAS 117, par. 24)	_____	_____	_____
i.) If the organization regularly provides discounts to certain recipients of its goods or services, are revenues reported net of those discounts? (AG 12.05)	_____	_____	_____
42. Are membership dues (including "life membership" dues) recognized as revenue ratably over the periods during which members are entitled to services? (AG 5.14-.15)	_____	_____	_____

(continued)

APPENDIX A

(continued)

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
43. Is investment income recorded directly in the class appropriate to the nature of any restriction on the income? (SFAS 124, par. 9; see also Question 17, above)	_____	_____	_____
44. Are realized and unrealized capital gains recorded in the unrestricted class of net assets, unless there are explicit donor stipulations or applicable law which require otherwise? (SFAS 117, par. 22; SFAS 124, par. 8, 10; AG 8.14–.16)	_____	_____	_____
a.) Is the organization’s determination of the amount of capital gains which must be retained permanently appropriate under relevant law? (See also AG, footnote 9 to par. 8.14, regarding unappropriated gains, and par. 8.27 regarding UMIFA.)	_____	_____	_____
45. If a donor of a restricted endowment fund has explicitly restricted investment income, but is silent regarding gains, are capital gains (realized and unrealized) reported in the same class as the investment income? (SFAS 124, par. 11, last sentence)	_____	_____	_____
F. Expenses			
46. Are all expenses reported in the unrestricted class? (SFAS 117, par. 20)	_____	_____	_____
47. Are expenses reported on a functional basis, either on the face of the statement or in a note? (SFAS 117, par. 26)	_____	_____	_____
a.) Are total expenses reported for:			
i.) Program expenses (AG 13.27)	_____	_____	_____
ii.) Fundraising expenses (AG 13.30)	_____	_____	_____
48. Have expenses which apply to more than one function (including occupancy, depreciation, and interest) been appropriately allocated to all affected functions? (SOP 98-2)	_____	_____	_____
a.) Have all applicable expenses, including a portion of management salaries, occupancy, and depreciation expenses, been included with fundraising expenses?	_____	_____	_____
49. Where an organization remits a portion of its receipts to an affiliate, is this amount properly reported? (AG 13.47–.48)	_____	_____	_____

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	<u>Yes</u>	<u>No</u>	<u>N/A</u>
50. If expenses have been incurred for purposes for which both unrestricted and temporarily restricted net assets are available, has the organization appropriately reclassified temporarily restricted net assets to unrestricted net assets in accordance with SFAS 116, paragraph 17, third sentence?	_____	_____	_____
51. Are the following reported as management/general expenses?			
a.) Soliciting revenue from exchange transactions (e.g., advertising)? (AG 13.29, last sentence)	_____	_____	_____
b.) Interest cost which cannot be allocated to other categories? (AG 13.45, last sentence)	_____	_____	_____
52. Are the following reported as fundraising expenses?			
a.) All expenses of fundraising activities of federated fundraising organizations (AG 13.49)	_____	_____	_____
b.) Costs of recruiting volunteers (AG 13.30)	_____	_____	_____
53. Are fundraising expenses <i>not</i> deferred to future periods? (AG 13.06)	_____	_____	_____

A P P E N D I X B

Code of Conduct

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A code of conduct is a written standard that is designed to deter wrongdoing and to promote:

- Honest, ethical conduct
- Full, fair, accurate, timely, and understandable disclosure in reports and documents
- Compliance with applicable governmental laws, rules and regulations

APPENDIX B

- Prompt internal reporting of code violations to a designated person or place
- Accountability for adherence to the code¹

The Sarbanes–Oxley Act directed the U.S. Securities and Exchange Commission (SEC) to require companies that issue publicly traded securities to disclose in their annual reports whether they have a code of conduct. If they do not have such a code, they must disclose that fact and say why.²

Subsequently, the New York Stock Exchange (NYSE) and NASDAQ required that companies listed on their exchanges adopt a code of conduct. Also, two important reports make the same recommendation. The first comes from the Commission on Public Trust and Private Enterprise.³ The second report, which was written by Richard Breeden, the former SEC Chairman and Corporate Monitor for WorldCom,⁴ recommends that companies not only have a code of conduct but also that senior management exhibit its ethical values in the way they operate the company.⁵ Breeden notes: “A well-governed company should avoid conduct that is too sharp, or too close to the line of illegality. That is where internal codes of conduct come into play to create a healthy margin of safety.”⁶

B.1 CODES OF CONDUCT IN THE NOT-FOR-PROFIT SECTOR

Although colleges, universities, and other not-for-profit educational institutions are not subject to the rules of the SEC, NYSE and other groups, we recommend that they develop and enforce codes of conduct that are designed to promote the highest standards of honest and ethical conduct at all levels of the institution. Board members, officers, faculty

¹ SEC final rule #33-8177, *Disclosure Required by Sections 406 and 407 of the Sarbanes–Oxley Act of 2002*, issued on January 23, 2003, and found at: <http://www.sec.gov/rules/final/33-8177.htm>

² SEC final rule 33-8177, *Disclosure Required by Sections 406 and 407 of the Sarbanes–Oxley Act of 2002*.

³ The Conference Board established the 12-member Commission on Public Trust and Private Enterprise to address the abuses that led to declining public trust in the U.S. capital markets. Specifically, the Commission was asked to address compensation, auditing and governance issues. The Commission released the first section of the report on executive compensation in September 2002, and subsequently issued sections on auditing and governance issues. The Commission’s resulting three-part report *Findings and Recommendations* (Part 1: Executive Compensation; Part 2: Corporate Governance; Part 3: Audit and Accounting) can be found at: http://www.conference-board.org/pdf_free/758.pdf or drill down to corporate governance on the site map.

⁴ The Judge in the U.S. District Court for the southern district of New York and the SEC agreed that the court would appoint a “Corporate Monitor” to oversee compensation paid to former WorldCom executives, directors, employees, or affiliates. The court appointed Richard Breeden to be the Corporate Monitor for WorldCom. He was charged with developing recommendations that would prevent a reoccurrence of governance abuses like those that led to WorldCom’s collapse. Breeden’s report, *Restoring Trust*, was submitted to the Judge in August 2003. It can be found at: http://www.nysd.uscourts.gov/rulings/02cv4963_082603.pdf.

⁵ *Restoring Trust*, 139.

⁶ *Ibid.*

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and other employees hold positions of trust in the academic community, and they should be required to exhibit ethical behavior as they perform their duties.

Many if not most institutions already have individual policies in place about workplace conduct and conflicts of interest, but a lesser number have comprehensive, formal codes of conduct. They should pull individual policies together, and then review and update them as necessary to make sure they align with the emerging leading practices that are described below.

In this time of heightened concern about security and individual privacy, officers and trustees also will need to consider how to balance academic, speech, and assembly freedoms and civil liberties with the rules and regulations set forth in the code of conduct. Such freedoms have traditionally been at the heart of the educational environment.

(a) Leading Practices

Colleges, universities, and other not-for-profit educational institutions should consider the following important points:

The code of conduct should be comprehensive and clearly identify to whom it applies. It should outline expectations in a broad range of areas governed by laws, regulations and policies.

- Parties governed by a code of conduct should be able to access the code easily either through a website or from a designated department or party within the institution.
- The policies and procedures in a code of conduct should be easy to understand and implement.
- The codes and policies should be communicated across the campus community; there should be broad awareness of them. (One way to ensure that everyone is aware of the code is to require employees to read and sign it periodically or annually. New employees may well be required to do this during orientation.)
- The code should establish a confidential mechanism through which violations could be reported. For example, an institution might set up a confidential or anonymous hotline. Safeguards protecting the rights of those who report suspected violations also should be established.
- The code should be enforced. In order for it to be effective, violators should face consequences, such as financial restitution and termination of their employment.
- Institutions should provide a contact person in case there are questions about the code.

- The code of conduct should include a conflict of interest policy as well as guidelines about how to identify and avoid conflicts of interest.

A sample code of conduct is presented below. Also, for general context, it might be helpful to review the U.S. Federal Sentencing Guidelines at http://www.uscourts.gov/2000guid/8a1_2.htm. In particular, see note 3(k) of the Federal Sentencing Guidelines. Many colleges and universities structure their institutional compliance programs to meet these guidelines.

B.2 SAMPLE CODE OF CONDUCT, INCLUDING A CONFLICTS OF INTEREST POLICY⁷

(a) Introduction

This sample code of conduct was developed for a hypothetical university. Institutions should tailor the code to their own circumstances. Generally, the code should include the following elements:

- The code of conduct should be comprehensive and clearly identify to whom it applies. It should outline expectations in a broad range of areas governed by laws, regulations, and policies.
- The codes and policies should be communicated across the campus community. There should be broad awareness of them.
- Parties governed by a code of conduct should be able to access the code easily either through a website or from a designated department or party within the institution.
- The policies and procedures in a code of conduct should be easy to understand and implement.
- It should include a confidential mechanism through which violations of the code could be reported. For example, the institution might set up an anonymous hotline. Safeguards protecting the rights of those who report suspected violations also should be established.
- The code should be enforced. In order for it to be effective, violators should face consequences, such as financial restitution and termination of their employment.

⁷ This sample code borrows and combines ideas from numerous existing university codes that are available in the public domain. Notable examples include the codes of conduct of the University of Texas System and the University of North Carolina. These codes are available on their respective websites. (Also, note that many examples can be accessed through Google.com by searching for the keywords: “‘code of conduct’ and ‘university.’”)

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- The institution should provide the name of a contact who can answer questions that employees may have.
- The code of conduct should include a conflict of interest policy as well as guidelines about how to identify and avoid conflicts of interest.

The code of conduct should be displayed prominently on the website. If it is on the Web, provide links to more detailed policies, so that all of them can be accessed from one place.

(b) Statement of General Principles

This code applies to the following members of the university community: (1) individuals who are paid by the university when they are working for the university, including officers, faculty, and staff; (2) consultants, vendors, and contractors when they are doing business with the university; (3) trustees; and (4) individuals who perform services for the university as volunteers. The code of conduct refers to all these persons collectively as “members of the university community” or “community members.”

(c) Integrity and Ethical Conduct

The university is committed to the highest ethical and professional standards of conduct as an integral part of its mission, the promotion of learning. To achieve this goal, the university relies on each community member’s ethical behavior, honesty, integrity, and good judgment. Each community member should demonstrate respect for the rights of others. Each community member is accountable for his/her actions.

This code of conduct describes standards to guide us in our daily university activities. We believe that these standards are already being followed. Our goal is to commit them to writing and to ensure that they are understood and followed by the community.

(d) Compliance with Laws and University Policies

The university and each community member must transact university business in compliance with all laws, regulations, and university policies related to their positions and areas of responsibility. Understanding and following these standards can be complex, such as for example, in the areas of procurement (including limitations on the ability to contractually bind the university) and employment matters. In addition, community members are expected to behave in a manner that respects the freedom of others as well as refraining from interfering with, obstructing or disrupting a normal university activity, even while exercising their own freedom of expression. Managers and supervisors are responsible for teaching and monitoring compliance in their areas.

(e) Reporting Suspected Violations or Concerns

The university’s compliance efforts focus on teaching members of the university community the appropriate compliance standards for the areas in which they work. Nevertheless, violations may occur. In addition, members of the university community may have concerns about matters that they are not sure represent violations. This section describes community members’ responsibilities for reporting violations or concerns, and how these responsibilities may be carried out.

Each community member is encouraged to report violations or concerns about violations of this code of conduct that come to his/her attention. Managers have a special duty to adhere to the standards set forth in this code, to recognize violations, and to enforce the standards. Disciplinary actions for proven violations of this code of conduct, or for retaliation against anyone who reports possible violations, will be determined on a case-by-case basis and may include termination of employment. Individuals who violate the code may also be subject to civil and criminal charges in some circumstances.

(f) How to Report a Violation or Discuss a Concern

You may report violations or concerns to your immediate supervisor or department head, if appropriate. You may also call the university Compliance Office (if applicable) at the number established for this purpose: xxx-xxx-xxxx. Reports may be made anonymously to this number, if the caller so desires.

For matters dealing with one of the specific areas below, you may call the number indicated, or you may call the University Compliance Office.

Conflict of interest issues	(xxx) xxx-xxxx
Conflict of interest—procurement issues	(xxx) xxx-xxxx
Environmental health and safety issues	(xxx) xxx-xxxx
Financial issues	(xxx) xxx-xxxx
Human resources/personnel issues	(xxx) xxx-xxxx

Please also note that the University Compliance Office telephone line has no caller identification or number recognition.

(g) Conflicts of Interest

This policy addresses situations where there might be a potential financial or personal conflict, or the appearance of such a conflict, between a particular outside interest of a member of the university community and the obligation that the community member owes to the university such

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that the community member's profit or advantage may come, or reasonably appear to come, at the expense of the well-being of the university.

- Members of the university community may not have a direct or indirect interest, financial, or otherwise, of any nature that is in conflict with the proper discharge of the community member's duties.
- Members of the university community shall adhere to the laws, rules, regulations and policies of applicable governmental and university authorities. The failure to do so may be grounds for disciplinary action, up to and including termination of employment.
- No member of the university community shall accept or solicit any gift, favor or service that might reasonably influence the community member in the discharge of his or her duties or that the community member knows or should know is being offered with the intent to influence his or her official conduct.
- A member of the university community shall not accept other employment or engage in any business or professional activity that he or she might reasonably expect would require or induce the employee to disclose confidential information acquired by reason of the community member's official position.
- No member of the university community shall disclose confidential information gained by reason of his or her official position or otherwise use such information for his or her personal gain or benefit.
- No member of the university community shall transact any business in his or her official capacity with any business entity of which the employee is an officer, agent or member, or in which the member of the community owns a substantial interest.
- Members of the university community must disclose potential conflicts of interest as soon as possible after they realize that a conflict or potential conflict may have arisen. Disclosure guidelines and procedures may be obtained from department heads, department chairs or from the office of the Dean.

If a conflict or potential conflict of interest is reported and allowed to exist under the advice of an officer or the Provost's office, it is required that the conflict or potential conflict be reported to General Counsel and that it be reconsidered annually until it is resolved.

(h) Confidentiality

The university maintains confidential records for a variety of business needs. Records include detailed information about patients undergoing

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tests or receiving treatment, students, job applicants, employees, finances, and future planning. Many records, such as medical records and student records, must be kept confidential as a matter of federal law. Other information, including social security numbers, must be kept confidential to protect the privacy of individuals doing business with the university.

Members of the university community are expected to protect this information by safeguarding it when in use, storing it properly when not in use, and discussing it only with those who have a legitimate business need to know. Community members who are uncertain about the use of university records and information should contact their supervisors.

(i) Outside Employment

Outside professional commitments should not interfere with a community member's obligations to the university. No member of the university community shall accept outside employment that actually or potentially results in any conflict of interest with or intrudes upon or detracts from his or her responsibilities to the university, or the programs, policies and objectives of the university.

(j) Environmental Health and Safety

The university must comply with government rules and regulations that protect the environment and promote workplace safety. The university must operate its facilities with all of the necessary permits, approvals, and controls, especially with respect to handling and disposal of hazardous and bio hazardous materials and waste.

Anyone working with or around these materials must be familiar with the rules, regulations, and policies that apply to them.

Contact the Environmental Services Office at xxx-xxx-xxxx for assistance and answers to questions

(k) Human Resources Matters (Including Equal Employment, Harassment, etc.)

The university is committed to a work environment free of harassment and disruptive behavior, and to providing an equal opportunity work environment where every member of the university community is treated with fairness, dignity, and respect. No one shall discriminate against any individual on the grounds of race, color, religion, sex, age, disability, national origin, sexual preference or any other factor prohibited by law.

All members of the university community, especially supervisors, must be familiar with laws, regulations, and policies related to employment

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matters. Some of the relevant university policies on employment matters include: (1) the policy against harassment, including sexual harassment, and (2) the Policy on Equal Opportunity. Assistance is available from the Office of Human Resources at xxx-xxx-xxxx (campus) or xxx-xxx-xxxx (medical school).

(l) Sponsored Research Grants and Contracts

The university receives grants and contracts from federal and nonfederal sources. Faculty and staff who are involved in federally sponsored research must strictly follow federal rules and regulations related to that work. Failure to observe government rules and regulations can result in the loss of funds from grants and contract, and, in some instances, civil fines and criminal penalties. With respect to grants and contracts from non-federal sources, the university expects compliance with their requirements. Compliance support is available from the Associate Vice President for Research Administration at xxx-xxx-xxxx or the Director of Sponsored Projects Accounting at xxx-xxx-xxxx.

(m) University Documents and Record Retention

Every member of the university community is responsible, within the scope of his/her work, for the integrity and accuracy of the university's documents and records. No one may falsify or improperly alter information on any record or document. University documents and records are retained in accordance with the law and the university's record retention policies.

Additional assistance is available from the university's Accounting Department at xxx-xxx-xxxx and the Physician Billing Compliance Office at xxx-xxx-xxxx.

(n) Workplace Health and Safety

The university seeks a healthy and safe environment for all members of the university community and for visitors. Every community member is obligated to perform his or her job in a safe manner and to follow all safety rules and procedures. Community members should immediately report any hazardous conditions or job-related illness or injury to their supervisors. Assistance is available from the Safety Coordinator at xxx-xxx-xxxx (campus) or the Environmental Safety Office at xxx-xxx-xxxx (medical school).

The website references in this section are valid as of the (insert date) publication of this code of conduct. These references are individually managed and may change from time to time. Up-to-date references are

always available on the website version of the code of conduct, available at codeofconduct.xxxx.edu.

(o) Drug and Weapon Free Workplace

The unlawful possession of a weapon or the unlawful manufacture, distribution, possession, or use of a controlled substance in or on any premises or property owned or controlled by the university is prohibited. Any member of the community who is found guilty (including a plea of no contest) or has a sentence, fine or other criminal penalty imposed by a court for any offense involving a weapon or a controlled substance that occurred in or on university property shall report such action to his or her supervisor or to the Office of Human Resources within five (5) days.

Any member of the university community who unlawfully manufactures, sells, distributes, possesses or uses a controlled substance on university property, regardless of whether such activity results in the imposition of a penalty under a criminal statute, will be subject or appropriate disciplinary action, including termination, or will be required to participate satisfactorily in an approved drug assistance or rehabilitation program or both.

B.3 FREQUENTLY ASKED QUESTIONS⁸

1. Who is subject to the code of conduct?

All members of the university community are subject to the code of conduct. This includes officers, faculty and staff as well as individuals who are doing business with the university. Students are not subject to this code of conduct unless they are employed by the university. Students are subject to policies set by the dean's office.

2. Why do we need a code of conduct?

Members of the university community are already subject to laws, regulations and internal policies. However, they do not govern all behavior. We felt it was important for our stakeholders to understand exactly how they can expect us to conduct ourselves. Our code of conduct is basically a set of standards describing the behavior we expect of members of the university community. In addition, as a recipient of federal awards, we are required to have a code of conduct.

⁸ These questions have been adapted from PricewaterhouseCoopers' ethics website at <http://www.pwcglobal.com/ethics>. In 2002, we launched the accounting profession's first global code of conduct to help our employees sustain a culture of ethics and integrity around the world.

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3. Does the code affect my daily work?

Our code of conduct does not change our daily responsibilities. It is a restatement of guidelines we believe the members of the university community are already following. It articulates the way we strive to conduct ourselves.

Clearly, no code of conduct can guarantee the prevention of wrongdoing. But a code of conduct, coupled with the appropriate supporting activities, is considered a “best practice” that can help to sustain a culture in which integrity is valued and promoted through our daily work.

4. Are there sanctions to ensure compliance with the code of conduct?

Members of the university community who violate the code of conduct, or other policies, will be subject to disciplinary action—up to and including termination. A key part of developing the code has been to ensure that all decentralized units take steps to ensure that their people understand and comply with the code.

5. Can I report a potential violation of the code anonymously?

Yes. We have set up a telephone system that does not indicate where the call is coming from. All incoming calls are anonymous, unless the caller wishes to leave identifying information to help facilitate follow-up.

6. Will I get into trouble with my supervisor if I report a potential violation?

No. We encourage you to report potential violations. We do not tolerate retaliation. We will take disciplinary action if retaliation occurs.

Basic Template for an Audit Committee Charter

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C.1 OVERALL PURPOSE/OBJECTIVES

The audit committee is appointed by the board to assist it in discharging its oversight responsibilities. The audit committee will oversee the financial reporting process to ensure the balance, transparency and integrity of published financial information. The audit committee will also review: (1) the effectiveness of the institution's internal financial control and risk management system; (2) the effectiveness of the internal audit function; (3) the independent audit process, including recommending the appointment and assessing the performance of the external auditor; and (4) the institution's process for monitoring compliance with laws and regulations affecting financial reporting and its code of conduct.

The committee is responsible for maintaining free and open communication as well as effective working relationships among the committee members, independent external auditors, internal auditors, and management of the university. To perform his or her role effectively, each committee member will need to develop and maintain his or her skills and knowledge, including an understanding of the committee's responsibilities and of the organization's activities, operations and risks.

The committee will take all appropriate actions to set the overall tone at the institution for quality financial reporting, sound risk practices, and ethical behavior.

C.2 AUTHORITY

The board authorizes the audit committee, within the scope of its responsibilities, to:

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- 2.1 Perform activities within the scope of its charter.
- 2.2 Engage independent counsel and other advisers as it deems necessary to carry out its duties.
- 2.3 Have unrestricted access to members of management, faculty, and employees as well as to all books, records, and facilities of the institution.
- 2.4 Establish procedures for the receipt, retention and treatment of complaints received from employees regarding accounting, internal accounting controls, or auditing matters.
- 2.5 Be directly responsible for the appointment, compensation, retention, and oversight of the work of the external auditor.
- 2.6 Review and approve the policies for the provision of non-audit services by the external auditors [and, when required, the framework for pre-approval of such services].

C.3 ORGANIZATION

Membership

- 3.1 The board will nominate the audit committee members and the chairman of the audit committee.
- 3.2 The audit committee will comprise at least [insert number] members and all members shall be independent. Members will be considered independent as long as they do not accept any consulting, advisory, or other compensatory fee from the university and are not affiliated persons of the university, its subsidiaries, or management.
- 3.3 A quorum of any meeting will be [number] members/[proportion] of members.
- 3.4 Each member should have skills and experience appropriate to the education or not-for-profit sectors.
- 3.5 A majority of committee members shall be “financially literate.” Financial literacy is defined as being able to read and understand fundamental financial statements.
 - 3.5.1 If possible, include one member who is a “financial expert” as it is defined by the Sarbanes–Oxley Act: a “financial expert” is a person who has an understanding of generally accepted accounting principles and financial statements; the ability to assess the application of these principles in connection with accounting for estimates, accruals, and reserves; an understanding of audit committee functions; experience preparing, auditing, analyzing, or evaluating

BASIC TEMPLATE FOR AN AUDIT COMMITTEE CHARTER

financial statements, or experience actively supervising persons engaged in such activities; and an understanding of internal controls and procedures for financial reporting. The person must have acquired these attributes through one or more of the following: education or experience actually doing these functions or similar ones; actively supervising someone who is performing these functions or similar ones; experience overseeing or assessing the performance of companies or public accountants who are preparing, auditing, or evaluating financial statements; or other relevant experience.

- 3.6 Members will be appointed for a [insert number] year term of office.
- 3.7 The secretary of the audit committee will be nominated by the board.

Meetings

- 3.8 A majority of the members of the committee will constitute a forum for the transaction of business.
- 3.9 As part of its responsibility to foster open communication, the committee shall provide sufficient opportunity for the independent external and internal auditor to meet privately with the committee. The audit committee will meet with the independent external auditors [at least once annually] without management present. The independent external and internal auditors shall be invited to make presentations to the audit committee as appropriate.
- 3.10 Meetings shall be held not less than [number] times a year and should correspond with the organization's financial reporting cycle.
- 3.11 Special meetings may be convened as required.
- 3.12 The committee shall maintain written minutes of its meetings.
- 3.13 The secretary of the committee shall:
 - 3.13.1 Circulate the agenda and supporting documentation to the audit committee members a reasonable period in advance of each meeting.
 - 3.13.2 Circulate the minutes of meetings to members of the board, members of the committee, (and the internal audit director and the external auditor where appropriate).
 - 3.13.3 Convene a meeting on receipt of a request by the external or internal auditors.
- 3.14 As a minimum, the chairman of the committee [or another member of the committee] shall attend the board meeting at which the financial statements are approved.

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- 3.15 The committee should meet with in-house legal counsel on a regular basis. A meeting with outside legal counsel should be held if it is deemed necessary.
- 3.16 The audit committee may invite others (e.g., the president, chancellor, chief financial officer, internal audit director, and external audit engagement partner) to its meetings, as it deems appropriate.
- 3.17 The audit committee may want to consider requesting special reports on topics that may enhance their understanding of the institution's activities. For example, topics could include: capital projects management, new business initiatives, technology, and other initiatives that affect internal controls.

C.4 ROLES AND RESPONSIBILITIES

With regards to each topic listed below, the audit committee will:

Internal Controls

- 4.1 Evaluate whether management is setting the appropriate "control culture" by communicating the importance of internal controls.
- 4.2 Understand the internal controls systems implemented by management for the approval of transactions and the recording and processing of financial data.
- 4.3 Understand the controls and processes implemented by management to ensure that the financial statements derive from the underlying financial systems, comply with relevant standards and requirements, and are subject to appropriate management review.
- 4.4 Evaluate the overall effectiveness of the internal control framework and consider whether recommendations made by the internal and external auditors have been implemented by management.
- 4.5 Consider how management is held to account for the security of computer systems and applications, and the contingency plans for processing financial information in the event of a systems breakdown or to protect against computer fraud or misuse.

Risk Management

- 4.6 Evaluate the overall effectiveness of the risk management framework.
- 4.7 Evaluate whether management is setting the appropriate tone at the top by communicating the importance of the management of risk.
- 4.8 Inquire of management, the internal auditor, and the independent external auditor about significant risks or exposures to the institution and how these are being managed.

Financial Reporting and Disclosures

- 4.9 Review significant accounting and financial reporting issues, including recent professional and regulatory pronouncements, and understand their impact on financial reports.
- 4.10 Oversee the financial reporting process implemented by management.
- 4.11 Review as applicable: (1) the interim financial statements, (2) the annual financial statements, (3) the annual report, and (4) the audit report on federal awards that is required under Office of Management and Budget (OMB) Circular A-133.
- 4.12 Review management's process for ensuring the transparency of the financial statements and the completeness and clarity of the disclosures.
- 4.13 Meet with management and the external auditors to review the financial statements, the key accounting policies, the reasonableness of significant judgments, and the results of the audit.
- 4.14 Discuss with the independent external auditor the alternative treatments of financial information within generally accepted accounting principles as well as the ramifications of the use of such alternative treatments.
- 4.15 Confirm with management and the independent external auditor that the annual financial statements disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships of the institution with unconsolidated entities or with people that may have a material effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues or expenses.
- 4.16 Ensure that significant adjustments, unadjusted differences, disagreements with management and critical accounting policies and practice are discussed with the external auditor. Resolve disagreements between management and the external auditor.

Compliance with Laws and Regulations

- 4.17 Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any fraudulent acts or non-compliance.
- 4.18 Obtain reports concerning financial fraud resulting in losses in excess of \$10,000 or involving a member of senior management.
- 4.19 Obtain regular updates from management and the organization's legal counsel regarding compliance matters that may have a

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material impact on the organization's financial statements or compliance policies.

- 4.20 Be satisfied that all regulatory compliance matters have been considered in the preparation of the financial statements.
- 4.21 Review the findings of any examinations by regulatory agencies.

Working with Auditors

INDEPENDENT EXTERNAL AUDIT

- 4.22 Have the independent external auditor report directly to the audit committee.
- 4.23 Review the professional qualifications of the independent external auditor (including the background and experience of the engagement partner and auditing personnel).
- 4.24 Consider the independence of the auditor as well as potential conflicts of interest. Also assess the independence of the independent external auditor under Government Auditing Standards.
- 4.25 Review on an annual basis the performance of the external auditors and make recommendations to the board for their appointment, reappointment or termination.
- 4.26 Be responsible for setting the compensation of the external auditor.
- 4.27 Review the proposed audit scope and approach for the current year in the light of the institution's present circumstances and changes in the regulatory environment.
- 4.28 At the end of the audit:
 - 4.28.1 Review required communications from the external independent auditors.
 - 4.28.2 Discuss with the external auditor the quality and appropriateness of the institution's accounting policies as well as the consistency of their application and the degree of aggressiveness or conservatism in applying them.
 - 4.28.3 Discuss with the external auditor any audit problems encountered in the normal course of audit work, including any restriction on audit scope or access to information.
- 4.29 Ensure that significant findings and recommendations made by the external auditors and management's proposed response are received, discussed and appropriately acted on.
- 4.30 Meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed privately. Ensure that the auditors have access to the chairman of the audit committee when required.

BASIC TEMPLATE FOR AN AUDIT COMMITTEE CHARTER

- 4.31 Review policies for the provision of non-audit services by the external auditor [and where applicable the framework for pre-approval of audit and non-audit services].
- 4.32 Ensure the organization has appropriate policies regarding the hiring of audit firm personnel for senior positions after they have left the audit firm.

INTERNAL AUDIT

- 4.33 Review the independence, qualifications, activities, resources, and structure of the internal audit function and ensure no unjustified restrictions or limitations are made.
- 4.34 Review and concur with the appointment, reassignment, promotion, or dismissal of the director of internal audit.
- 4.35 Review the effectiveness of the internal audit function and ensure that it has appropriate standing within the organization. Discuss with the external auditor the standard of work of internal audit staff.
- 4.36 Meet separately with the director of internal audit to discuss any matters that the committee or internal auditors believe should be discussed privately.
- 4.37 Ensure that significant findings and recommendations made by the internal auditors and management's proposed response are received, discussed, and appropriately acted on.
- 4.38 Review the proposed internal audit plan for the coming year [or the multiyear plan] and ensure that it addresses key areas of risk and that there is appropriate coordination with the external auditor.
- 4.39 Receive prior to each meeting a summary of findings from completed internal audits and the status of implementing related recommendations.
- 4.40 Receive a progress report on the internal audit plan with explanations for any deviations from the original plan.
- 4.41 Review periodically the internal audit charter for necessary changes.

Complaints and Ethics

- 4.42 Ensure procedures for the receipt, retention and treatment of complaints about accounting, internal accounting controls or auditing matters.
- 4.43 Review the code of conduct to ensure that it: (1) is easy to access, (2) widely communicated, (3) is easy to understand and implement, (4) includes a confidential mechanism for reporting code

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violations, (5) enforced, (6) includes a conflict of interest policy and guidelines, and (7) includes the name of a contact for questions.

- 4.44 Review the conflict of interest policy to ensure that: (1) the term “conflict of interest” is clearly defined, (2) guidelines are comprehensive, (3) annual signoff is required, and (4) potential conflicts are adequately resolved and documented.
- 4.45 Require appropriate disclosure of related party transactions, including an annual accounting.

Reporting Responsibilities

- 4.46 Regularly update the board about committee activities and make appropriate recommendations.
- 4.47 Ensure the board is aware of matters that may significantly impact on the financial condition or affairs of the business.
- 4.48 Prepare any reports required by law or listing rules or requested by the board (e.g., a report on the audit committee’s activities and duties to be included in the section on governance in the annual report).

Evaluating Performance

- 4.49 Evaluate the audit committee’s own performance, both of individual members and collectively, on a regular basis.
- 4.50 Assess the achievement of the duties specified in the charter and report the findings to the board.
- 4.51 Review the audit committee charter annually and discuss any required changes with the board.
- 4.52 Ensure that the charter is approved or reapproved by the board annually.

Adoption of Charter

The Board of Trustees adopted this chart on ____, 2004.

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