PacificCPE

COURSE
21401A

Foundations of Not-for-Profit Accounting

Not-for-profit organizations operate under a unique set of rules that differ significantly from for-profit accounting. This chapter-based course introduces the core FASB standards governing nonprofit financial reporting, giving CPAs and tax professionals a solid grounding in the regulatory framework. It also addresses the real-world challenges nonprofits face, including reputational and governance issues stemming from high-profile scandals. If you work with or advise nonprofit clients, this course builds the foundation you need.

CREDIT HOURS 2 | FIELD OF STUDY ACCOUNTING | EXAM QUESTIONS 9

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 9 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify proper accounting recognition for not-for-profit entities.

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Chapter 1: NOT-FOR-PROFIT ORGANIZATIONS

Chapter Objective

After completing this chapter, you should be able to:

- Identify proper accounting recognition for not-for-profit entities.

Governments and not-for-profit organizations confront similar accounting and reporting issues. However, they do not necessarily resolve them in similar fashion. Differences in standards can be partly explained—and indeed, justified—by differences in the entities' characteristics and resultant differences in constituents' information needs. For example, not-for-profits lack the authority of law to generate revenues, and they have greater flexibility in administering or changing their budgets compared to many governments. Differences in standards may also be attributed to dissimilarities in the composition and perspectives of the standard-setting authorities. This chapter addresses accounting and reporting issues that affect not-for-profits in general. The following two chapters consider the issues facing two types of specialized entities—colleges and universities, and hospitals and other health-care institutions.

WHO'S IN CHARGE OF ACCOUNTING RULES?

Whereas the Governmental Accounting Standards Board (GASB) has standard-setting jurisdiction over all state and local governments and other governmental entities, the Financial Accounting Standards Board (FASB) has jurisdiction over all other nonbusiness entities except the federal government. As a consequence, even similar types of organizations may fall within the province of different standard setters. A state university or city hospital would be under the authority of the GASB, whereas a private university or hospital would be under the jurisdiction of the FASB.

In addition, the American Institute of Certified Public Accountants (AICPA) has issued (and periodically updated) two "audit" guides that summarize the FASB standards and provide guidance on issues not specifically addressed by those standards:[1]

- **Health-Care Entities** cover hospitals, clinics, health maintenance organizations, nursing homes, and home health-care organizations.
- **Not-for-Profit Entities** cover all other not-for-profits, including colleges and universities.

As becomes evident in this chapter, the accounting practices of not-for-profits are more comparable to those of private businesses rather than of governments. The FASB and AICPA pronouncements emphasize the appropriateness of the accrual basis over the cash basis of accounting for these types

of organizations and are far less indulgent of modifications of and exceptions to the accrual basis than the GASB may be.

External reporting is entirely on the full accrual basis. Irrespective of how not-for-profits maintain their records for purposes of internal management, the modified accrual basis has no place in their publicly issued statements. As a consequence, not-for-profits do not distinguish between expenses and expenditures. They have only expenses.

WHAT SHOULD BE THE FORM AND CONTENT OF FINANCIAL STATEMENTS?

Not-for-profits, like governments, may account for their resources in funds, each of which is a separate accounting entity. As in governments, most entities maintain an operating (or general) fund that includes resources not restricted by donors, as well as one or more restricted funds. Accordingly, most not-for-profits will make the journal entries illustrated in this chapter in the individual funds. In this chapter, we make them only in a broad category of fund types.

The FASB is not concerned with the specific funds maintained by not-for-profits. Instead, it is primarily interested in how entities report their overall financial position and results of operations. A key issue, therefore, is whether not-for-profits should display separately each of the funds, consolidate them into single-column presentation, or aggregate the funds in a way that would combine groups of funds. Although this chapter directs considerable attention to revenue and expense recognition, it will soon become apparent that how funds are combined affects how and when certain types of revenues and expenses are reported.

Reporting Assets and Liabilities

In 1993, the FASB issued Statement No. 117, *Financial Statements of Not-for-Profit Organizations*, which established standards for the form and content of financial statements.[2] The statement provides that not-for-profits must issue three primary financial statements:

- A statement of financial position (balance sheet)
- A statement of activities
- A statement of cash flows

FASB Accounting Standards Update (ASU) No. 2016-14 requires all not-for-profits to also report functional expenses (e.g., programs and support services). This information must be disclosed in one location, such as on the activity statement, in the notes to the financial statements as a separate schedule, or as a separate financial statement (a functional expense statement).

FASB standards also require not-for-profits to classify their net assets into two categories based on the existence or absence of *donor-imposed* restrictions:

- Net assets without donor restrictions

- Net assets with donor restrictions. Donor-restricted resources may include those intended for specific purposes, in specific periods, when specified events have occurred, and endowments that must remain permanently intact with only earnings expended.

The focus is on donor-mandated restrictions because such restrictions impose special responsibilities on management to ensure that the resources are used in accordance with donor wishes. They are therefore of special relevance to a primary group of statement users. Not-for-profits may voluntarily disclose additional information within these two categories of restrictiveness, such as those restricted to program or purpose and those restricted to endowment.

Donor restricted net assets can take several forms. Resources that must be used for research, for specific programs, or for acquisition of plant and equipment would be restricted as to *purpose* until they are expended. The resources would be released from the restriction when the organization incurred expenses that satisfied the donor's stipulations. A term endowment would be temporarily restricted as to *time*. A **term endowment** is a gift from which only the income (dividends, interest, or gains) is available for expenditure for a specified period of time. Once the period of time has expired, then the principal of the gift is also available for usage. Pledges that will not be received until future periods may also be seen as subject to time restrictions. They are unavailable for usage until then. An annuity would be restricted pending the occurrence of a *specified event*. An **annuity** is a gift that provides the donor with income until his or her death. Upon death, the balance of the gift reverts to the donee (i.e., the not-for-profit organization) and used as the donor intended (i.e., with restrictions or without).

Even assets classified as without donor restrictions are not necessarily free of all restrictions—only those imposed by *donors*. Restrictions imposed by the organization's members, by its own governing board, or by outside parties other than donors—such as bondholders and regulatory authorities—would still be reported as net assets without restrictions because only donor restrictions affect classification.

In Practice

When a not-for-profit is offered a contribution that is restricted by a donor in some way, the board and management of the not-for-profit must decide if accepting the contribution is in the best interests of the organization. For example, if a donor offered money for a not-for-profit to construct or purchase a building, the not-for-profit might have concerns about future maintenance costs that would need to be funded out of future operating budgets. Sometimes, not-for-profits even require that contributions for fixed asset acquisitions also come with endowments to help cover these costs.

The Barry-Lawrence Library system in Missouri was seeking contributions to construct a new building to replace its aging and outdated existing one. An anonymous donor offered to contribute the acquisition cost to the library, but wanted the organization to move locations. After contemplating the donor's offer, the board turned down the multimillion-dollar-restricted gift because of concerns around moving the library's location.

ASU 2016-14 requires that not-for-profits present five totals on the statement of financial position: total assets, total liabilities, total net assets, total net assets without donor restrictions, and total net assets with donor restrictions. The statement of net position (balance sheet) does not display individual funds, but instead consolidates all of the funds a not-for-profit might use. Information about the nature and amount of restrictions may be shown on the face of the statement of financial position, but at a minimum, must be disclosed in notes to the financial statements. If shown on the face of the statement of financial position, separate line items may be added to the two categories of restricted net assets (e.g., "restricted for acquisition of plant" or "restricted for scholarships"). As another (but not the only other) possibility, the two categories of assets may be presented in two separate columns, with specific resources as well as net assets assigned to each of the two categories.

Not-for-profits also must disclose information about their liquidity to financial statement users. Specifically, ASU No. 2016-14 helps users by requiring disclosures about liquidity and the availability of restricted resources to fund an organization's operations. Not-for-profits must disclose quantitative information about the availability of their financial assets to meet cash needs for general expenses and capital spending over the next fiscal year. As per FASB ASC 958-210-50-1A, financial asset availability may be influenced by its nature, internal limits placed on the asset by a governing board's decisions, or external limits imposed by a donor, contract, or law. In addition, not-for-profits are now required to disclose qualitative information about how the organization managed its liquidity to ensure operating needs are met over the next fiscal year.

The liquidity disclosures include a reconciliation of a not-for-profit's financial assets as of the financial statement date with its financial assets available to meet the organization's cash needs

within 12 months. The intent of this disclosure is to clarify that some financial assets listed on the statement of financial position may be unavailable for consumption during the year, owing to either internal or external constraints.

The following is an accounting of the organization's financial assets as of the date of the statement of financial position. The financial assets are adjusted because some are unavailable for general use owing to donor-imposed restrictions, board decisions, and contractual relationships.

In Practice

In addition to determining if a restricted contribution is worth accepting, not-for-profits should also consider the source of the funding. Activists have identified and protested not-for-profits that are believed to have accepted contributions from donors that might be considered publicly unpopular. For example, the Metropolitan Museum of Art in New York City was the scene of protests in 2018 for its acceptance of funds from the Sackler family—which was blamed for helping to fuel the opioid epidemic through the sale of OxyContin through the Purdue Pharmaceutical company. Of note, the Met's Sackler wing was funded in the 1970s, decades prior to the purported concerns surrounding the Sackler name.

A disclosure might look like the following: Financial assets, at fiscal year end $100,000 Less those unavailable within one year, due to:

Donor-imposed restrictions: Restricted by donor with purpose restrictions (10,000) Board designations:

Quasi-endowment fund	(20,000)
Liquidity reserve set aside account	(2,000)
Financial assets available to meet cash needs within one year	$ 68,000

As an alternative disclosure, a not-for-profit might simply list the assets that are cash, near cash, or expected to be converted into cash in the next fiscal year. Such a disclosure would look similar to the one above, but merely list the accounts and amounts.

Not-for-profits, unlike governments, look to the practices of business for definitions of terms. Accordingly, current assets are resources reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the enterprise, typically one year. Current liabilities are obligations whose liquidation is expected to require the use of existing resources classified as current assets, or the creation of other current liabilities. Table 1-1 (next page) presents the statement of financial position of the American Health Association, a fictional not-for-profit organization.

WHAT IS AN ENDOWMENT?

Some not-for-profits hold endowments, which are resources contributed by donors in which the principal is to be held in perpetuity to generate earnings that the not-for-profit may expend on operations or services. Others, referred to as term endowments, permit the principal to be expended after a specified number of years. Depending on the wishes of the donor, the income from an endowment may be either restricted for a specific purpose or without restriction. The following are but a few examples of endowments that are maintained by not-for-profits:

- University endowments may take the form of "chairs" or "professorships." Assigned to specific faculty members, they provide salary supplements and support teaching and research. Other types of endowments help to finance scholarships, teaching awards, research, or general operations.
- Private foundations such as the Ford Foundation and the Carnegie Corporation of New York are, in essence, endowment funds. With billions of dollars in assets, they promote a wide array of educational, social welfare, and scientific activities.
- Private primary and secondary schools sometimes maintain endowments to provide ongoing support for specific purposes, such as financial aid for needy students, or specific activities, such as extracurricular programs.
- Churches, synagogues, mosques, and comparable religious organizations maintain endowments to sponsor lectures, music programs, or youth activities.

TABLE 1-1. NOT-FOR-PROFIT ORGANIZATION

American Health Association, Local Affiliate Statement of Financial Position as of June 30, 20X0

	Without Donor Restrictions	With Donor Restrictions	Total
Assets			
Current assets			
Cash and cash equivalents	$ 806,383	$ —	$ 806,383
Short-term investments	8,884,309	288,073	9,172,382
Accrued investment income	192,427	—	192,427
Accounts receivable			—
Federated and nonfederated	—	694,382	694,382
National center	20,382	—	20,382
Bequest receivable	—	286,000	286,000
Pledges	84,601	19,000	103,601
Other	70,719	—	70,719
Educational and campaign material inventory	250,670	—	250,670
Prepaid expenses	79,410	—	79,410
Total current assets	$10,388,901	$ 1,287,455	$11,676,356
Noncurrent assets			
Accounts receivable			
Pledges, net of discount of $1,000	$ —	$ 19,000	$ 19,000
Charitable gift annuity—national center	40,500	—	40,500
Long-term investments	6,622,538	2,715,315	9,337,853
Beneficial interest in perpetual trust	—	2,767,900	2,767,900
Contributions receivable from charitable remainder trust	—	4,963,216	4,963,216
Land, buildings, and equipment, at cost			—
Less accumulated depreciation of $2,344,393	3,921,690	—	3,921,690
Total noncurrent assets	$10,584,728	$10,465,431	$21,050,159
Total assets	$20,973,629	$ 11,752,886	$32,726,515
Liabilities and net assets			
Current liabilities			
Payable to the national center			
campaign share	$ 3,181,641	$ 414,241	$ 3,595,882
purchased material	137,781	—	137,781
Accounts payable and accrued expenses	585,896	—	585,896
Research awards payable within one year	3,315,845	—	3,315,845
Total current liabilities	$ 7,221,163	$ 414,241	$ 7,635,404
Noncurrent liabilities			
Payable to the national center campaign share		$ 1,240,804	$ 1,240,804
Annuity obligation	19,640	—	19,640
Research awards payable after one year, net of discount of $50,000	1,983,172	—	1,983,172
Postretirement benefit obligation	$ 932,246	—	$ 932,246
Total noncurrent liabilities	$ 2,935,058	$ 1,240,804	$ 4,175,862
Total liabilities	$ 10,156,221	$ 1,655,045	$ 11,811,266
Net assets			
Without donor restrictions			
Net investment in land, building, and equipment	$ 3,921,690	$ —	$ 3,921,690
Designated by the governing board for programs and operations for the ensuing fiscal year	6,697,513	—	6,697,513

(*Continues*)